# Beyond the Business Judgment Rule: Protecting Bidder Firm Shareholders From Value-Reducing Acquisitions

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# BEYOND THE BUSINESS JUDGMENT RULE: PROTECTING BIDDER FIRM SHAREHOLDERS FROM VALUE-REDUCING ACQUISITIONS

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*During the takeover transactions of the 1980s, bidder firms paid target firm shareholders average premiums of approximately 50% for their shares. Did the sizable premiums paid to target firm shareholders during the 1980s reflect post-takeover improvement in the target's performance? Or were the premiums a result of the mismanagement of the bidder firms' assets?*

*The answer will help determine whether additional legal mechanisms should be established to protect bidder firm shareholders from the threat of management's consummation of value reducing acquisitions. Accordingly, this Note examines various studies which attempt to identify the source of the premiums paid to target firm shareholders. It concludes that additional protection for bidder firm shareholders is not necessary. The studies examined fail to demonstrate that premiums paid to target shareholders stem from mismanagement rather than from efficiency gains. Moreover, adequate mechanisms already exist to protect the economic interests of bidder firm shareholders.*

## INTRODUCTION

Over the past four decades, the U.S. has experienced different waves of mergers and acquisitions. During the 1960s and 1970s, the U.S. economy witnessed a spate of what are known as conglomerate mergers.[1] The conglomerate mergers involved acquirers purchasing targets whose primary business purpose was unrelated to that of the acquirers.[2] In the 1980s, "corporate raiders" engaged in "bust-up takeovers," where raiders acquired and split up the conglomerates

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1. *See* R. GLENN HUBBARD & DARIUS PALIA, A RE-EXAMINATION OF THE CONGLOMERATE MERGER WAVE IN THE 1960S: AN INTERNAL CAPITAL MARKETS VIEW (Nat'l Bureau of Econ. Research, Working Paper No. 6539, 1998).

2. *See* Clas Bergström et al., *The Regulation of Corporate Acquisitions: A Law and Economics Analysis of European Proposals for Reform*, 1995 COLUM. BUS. L. REV. 495, 499–500 (1995) (stating that "[b]y 1974, firms that had no single, dominant line of business came to represent 20.7 percent of the firms in the Fortune 500, up from only 7.3 percent in 1959").

put together during the 1960s and 1970s.[3] Most recently, the 1990s has experienced a wave of acquisitions where acquirers purchased targets engaged in the same primary business as the acquirer; these "related acquisitions" were attempts to consolidate major industries.[4] The past four decades of takeover activity caused much debate and conflict. As managers of the conglomerates put together in the 1960s and 1970s tried vigorously to defend against the onslaught of corporate raiders, the propriety of defensive tactics to defend against bust-up takeovers was called into question.[5] This debate, which took place both in legal academia and the judiciary, focused mainly on protecting target company shareholders from the abuse of target-company management in the event that a takeover bid is made for the target firm.

The underlying reason for the concentration in this specific area of corporate acquisitions is the existence of the "omnipresent specter" that the board of directors of a target company may act in its own interests, as opposed to the interests of the shareholders, in deciding whether to defend against or support a particular takeover bid.[6] Accordingly, the protection of target firm shareholders has received much attention, while the interests of bidder firm shareholders have largely been ignored. While academics have engaged in an in-depth exploration of the hypothesis that bidder firms overpay for targets, the idea that shareholders of bidder firms require any additional protection from the actions of the bidder firm managers, beyond that provided by the business judgment rule, has received little attention.[7] Although different explanations have been put forth to explain this alleged overpayment by bidder-firm management,[8] many in the field of law and finance agree on

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3. *See* ANDREI SHLEIFER & ROBERT W. VISHNY, STOCK MARKET DRIVEN ACQUISITIONS 1 (Nat'l Bureau of Econ. Research, Working Paper No. 8439, 2001), *available at* http://www.nber.org/papers/w8439 (on file with the University of Michigan Journal of Law Reform).

4. *Id.*

5. *See* City Capital Assocs. v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985);.

6. *Unocal Corp.*, 493 A.2d at 946.

7. *See generally* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989) [hereinafter *Bidder Overpayment*]. Overpayment by a bidder in the context of a hostile acquisition is said to occur when the costs of acquiring a target exceed the post-transaction value of the target. *See also* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 294–95 (2d ed. 1995) [hereinafter THE LAW AND FINANCE OF CORPORATE ACQUISITIONS]; Miriam P. Hechler, *Towards a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319, 319 (1997).

8. *See Bidder Overpayment*, *supra* note 7, at 623–29. Although Black admits that "in most cases" a particular bidder's overpayment can be attributed to bad judgment by bidder

the result of such overpayment: shareholders suffer economic losses as evidenced by the decrease in the price of bidder-company stock after the acquirer announces the acquisition.[9]

The literature discussing the effects of corporate acquisitions on bidder firm shareholders are exclusively dedicated to determining whether such acquisitions actually create wealth for all shareholders involved in a transaction and society at large;[10] little, however, has been written discussing whether bidder firm shareholders are in need of additional protections. In her article, *Towards a More Balanced Treatment of Bidder and Target Shareholders*, Miriam P. Hechler puts forth an argument in favor of establishing legal mechanisms to provide bidder company shareholders with additional protection from the "inappropriate" acts of bidder firm management; these proposed legal mechanisms go beyond those that currently exist under the business judgment rule.[11] Although the number of mergers and acquisitions has reached an eight-year low,[12] the competition for market share among the firms of various industries makes an increase in the level of mergers and acquisitions very likely.[13] Accordingly, the discussion of what additional legal protections should be provided for bidder company shareholders is timely.

This Note will explain why the protections afforded bidder company shareholders by the business judgment rule are sufficient to protect the economic interests of bidder company shareholders. This Note argues that the additional legal mechanisms suggested by Hechler are not only unnecessary, but will unduly hinder the acquisition process at the expense of overall economic efficiency. Part I begins by discussing the alleged problem: bidder overpayment. Bernard Black's "overpayment hypothesis," which attributes the high premiums that bidder companies pay to target company shareholders to bidder overpayment will be discussed. Part I also

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company management as to the quality of the deal in question, he nonetheless maintains that "[m]uch of the theoretical basis for expected overpayment comes from divergence between manager and shareholder interests." *Id.*

9. *See id.*

10. *See* PAUL ASQUITH ET AL., MERGER RETURNS AND THE FORM OF FINANCING (1987); MARK L. MITCHELL & KENNETH LEHN, OFFICE OF ECON. ANALYSIS, Sec. & Exch. Comm'n, DO BAD BIDDERS BECOME GOOD TARGETS? (1988) [hereinafter OFFICE OF ECONOMIC ANALYSIS]; JOHN POUND, CORPORATE GOVERNANCE SERVICE, ARE TAKEOVER TARGETS UNDERVALUED? (1985); Banerjee & Owers, *Wealth Reduction in White Knight Bids*, FIN. MGMT, Autumn 1992, at 48; *Bidder Overpayment*, *supra* note 7.

11. *See* Hechler, *supra* note 7.

12. *See* Kenneth N. Gilpin, *Expect A Return of the Urge to Merge*, N.Y. TIMES, Dec. 15, 2002, at 6.

13. *See id.*

examines the harmful effects of bidder overpayment on bidder company shareholders and concludes by calling into question the evidence relied upon as proof that bidders do in fact overpay for targets.

Part II of this Note will discuss the various explanations for why bidder companies overpay for targets. Unwarranted optimism on the part of bidder company managers, agency conflicts, as well as the winner's curse theory will be discussed as possible explanations for bidder overpayment. This Part ends by concluding that the reasons given fail to adequately explain why a bidder would pay more for a target than the target's true value.

Part III goes on to examine how the current legal regime protects bidder company shareholders from managerial decisions to overpay for target companies. The business judgment rule will be discussed and applied to the valuation methods commonly used by company managers in deciding whether to acquire a target. This Part attempts to show that based on the nature of corporate valuation techniques, the business judgment rule adequately protects bidder company shareholders from the harmful affects of overpayment. Part III also discusses additional protections available to bidder firm shareholders outside of the business judgment rule. The efficacy of market mechanisms, federal securities laws and interstate competition as protective devices will be examined. Finally, Part IV will present, and discuss the shortcomings of, suggested alternatives to the business judgment rule. This Part will argue that the suggested alternatives will unnecessarily hinder the market for corporate control by preventing acquisitions that increase efficiency.

## I. BIDDER OVERPAYMENT

### A. *The Overpayment Hypothesis*

During the takeovers of the 1980s, acquiring corporations paid target shareholders average premiums of about fifty percent; that is, on average, shareholders of target corporations were paid a price for their shares that was fifty percent above market value.[14] These takeovers, and the large premiums they produced for target shareholders, gave rise to a "public controversy" over whether such

14. *See Bidder Overpayment*, *supra* note 7, at 598.

transactions were harming or helping the U.S. economy.[15] Although both sides of the takeover debate agreed that takeovers benefited target company shareholders by offering high premiums, proponents and opponents of takeovers disagreed "about the extent to which takeover premiums gauge the resulting efficiency gains"[16] from the change in control. According to the critics, the high premiums paid to target company shareholders come at the expense of bidder company stakeholders (i.e. bondholders, employees and the local community). If the losses suffered by these stakeholders are greater than target company shareholders' gains, than takeovers actually destroy wealth.[17] If however, takeover advocates are correct when they assert that the premiums paid to target company shareholders "reflect the minimum amount by which the discounted cash flows of target firms are expected to increase, typically by enhancement of the target firms' operating efficiency or a restructuring of their financial claims,"[18] then takeovers actually create wealth. In short, the answer to the debate depends on identifying the source of value in takeover transactions.

The controversy over the social utility of takeovers has largely revolved around a debate between financial economists and industrial organization economists:[19] with financial economists arguing that the premiums paid in takeovers represent real efficiency gains and industrial organization economists arguing that takeovers produce no efficiency gains.[20] In his article, *Bidder Overpayment in Takeovers*, Bernard Black attempts to settle the debate by developing the "overpayment hypothesis" as a partial explanation for why the takeovers of the 1980s "produce[d] large stock price gains for shareholders of target corporations . . . ."[21]

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15. *See* OFFICE OF ECONOMIC ANALYSIS, *supra* note 10, at 1("Much of the public controversy surrounding corporate takeovers . . . concerns the economic rationale for these transactions."); *see also* POUND, *supra* note 10.

16. *See* OFFICE OF ECONOMIC ANALYSIS, *supra* note 10, at 6.

17. *See id.*

18. *See id.* at 1–2.

19. *See Bidder Overpayment*, *supra* note 7, at 598–99.

20. *Id.*

21. *Id.* Bernard Black explains the role of the overpayment hypothesis in explaining premiums paid to target shareholders as follows:

> The Overpayment Hypothesis is intended to be a partial, not a complete, account of shareholder gains from takeovers . . . . [T]he Overpayment Hypothesis, the Free Cash Flow Model, the Synergy Hypothesis, and other models will all play a part in explaining the multifaceted phenomenon of takeovers. The Overpayment Hypothesis, however, calls into question the extent to which shareholder gains imply increased efficiency.

*Id.* at 601.

According to Black's hypothesis, target corporation shareholders' gains were a result of acquiring corporations *paying too much* for targets.[22]

An example of the overpayment hypothesis is illustrated in a model constructed by Professor Black, which assumes an "artificial one-period example, in which a bidder makes one and only one acquisition."[23] To demonstrate the phenomenon of bidder overpayment, the model uses two profitable companies—"B1 (for bidder) and T1 (for target)"—both of which generate cash flow that exceeds its positive net present value investment opportunities.[24] The model also assumes that both firms have an asset value of $50 per share.[25] The model goes on to assume that B1 acquires T1 for $60 per share (a 20% premium).[26] At this time, it is important to point out two other assumptions, which are critical to the soundness of the overpayment hypothesis and to the thesis of this Note: (i) if B1 acquires T1, the acquisition will be purely "conglomerate" in nature; in other words, B1 will not realize any operating synergies or tax advantages from an acquisition of T1; and (ii) if B1 operates T1 efficiently after the acquisition, T1's value will not increase above its asset value—$50 per share.[27] These assumptions are necessary to the overpayment hypothesis, because if post-acquisition operating synergies or tax benefits exist, or if B1's managers are able to operate T1 more efficiently, then T1 may actually be worth $60 per share to B1. Professor Black's model, however, assumes that T1's post-transaction value to B1 will not exceed T1's asset value of $50 per share, and accordingly, B1 has paid $10 more per share than T1 is actually worth. Without relaxing any of the assumptions, which are critical to the soundness of Professor Black's model, the acquisition just described would cause B1's shareholders to suffer losses in the form of a decrease in the price

22. *Id.* at 599 (emphasis added).

23. *Id.* at 614.

24. *Id.*

25. Professor Black's model also assumes that the market expects both firms to engage in negative net present value projects as opposed to returning any excess cash flow to investors; because of this, the market discounts the price of both firms' shares by 20% of the asset value to $40 per share. *Id.* This Part, however, ignores this assumption because it is not necessary to demonstrate bidder overpayment.

26. In Professor Black's model, the premium is actually 50%. Although T1's assets would give T1 a value of $50 per share, Professor Black's model assumes that the market discounts this amount by 20%, because the market expects T1's management to engage in negative net present value projects—this results in a per share value of $40. Accordingly, in an exact illustration of Professor Black's model, an acquisition of $60 per share would amount to a 50% premium.

27. *Bidder Overpayment, supra* note 7.

of B1's stock. What follows is a detailed discussion of the effects of overpayment on bidder company shareholders.

### *B. The Effects of Bidder Overpayment*

Finance literature has widely accepted the assertion that when bidding firms overpay for targets, the value of the bidder firms' stock will experience a loss in value.[28] In the model discussed in the previous section, Professor Black argues that if a bidder company were to overvalue a target and bid more than the target's true value, the price of the bidder's stock would decline.[29] Indeed, citing studies that measure bidder returns during the 1970s and 1980s, Professor Black posits that "[o]verpayment . . . will tend to produce negative stock price reactions, on average."[30] Other authors have cited high-profile acquisitions as an illustration of the detrimental affect that overpayment has on the bidder company's stock value. Referring to Goodyear Tire & Rubber Co.'s conglomerate acquisition of Celeron Oil in 1983 for $850 million,[31] authors Mark Mitchell and Kenneth Lehn explain that Goodyear's diversification into the petroleum industry caused the price of Goodyear's stock to experience abnormal declines in the amount of 14.83%; this price drop translated in Goodyear shareholder losses in the amount of $359 million.[32] To these authors, the decrease in price of Goodyear's stock and the accompanying losses suffered by Goodyear's shareholders, "[are] consistent with the hypothesis that the market believed that the acquisition would raise the combined profits of Goodyear and Celeron, but that Goodyear simply overpaid for the acquisition."[33]

Bernard Black refers to the U.S. Steel acquisition of 1982 as an illustration of the overpayment hypothesis and the effects of bidder overpayment.[34] In 1982, U.S. Steel acquired Marathon Oil for $6.4

28. *See* Hechler, *supra* note 7, at 322 (arguing that by increasing their premium in order to win an auction for a target company, bidding firms make it more likely that their shareholders will suffer a loss in the value of their stock).

29. *See Bidder Overpayment, supra* note 7, at 616. According to Professor Black's model, the overpayment has to be unexpected to cause a drop in the bidder's stock price. As stated above, if the market expects overpayment, then the market will discount the price of the bidder's stock accordingly. *See supra* note 19 and accompanying text.

30. *Bidder Overpayment, supra* note 7, at 637.

31. *See* OFFICE OF ECONOMIC ANALYSIS, *supra* note 10, at 2–3.

32. *Id.* at 3.

33. *Id.* at 4 n.4.

34. *See Bidder Overpayment, supra* note 7, at 599.

billion; the purchase price amounted to a 70% premium, or $2.5 billion over the target's pre-takeover market value.[35] Citing the absence of synergies between U.S. Steel and Marathon Oil,[36] as well as the unlikelihood that the market undervalued the target,[37] Professor Black explains the high premiums paid to the target's shareholders by concluding that U.S. Steel simply overpaid.[38] Inconsistent, however, with Professor Black's overpayment hypothesis is the fact that the market value of U.S. Steel's stock remained the same after the acquisition: U.S. Steel's stock did not experience any abnormal losses as a result of the acquisition.[39] According to Black, however, no inconsistency exists. Black explains that the absence of any decrease in the price of U.S. Steel's stock does not prove that U.S. Steel did not overpay for Marathon Oil; the absence of abnormal losses simply means that the market had expected U.S. Steel to "reinvest its cash flow in the steel business, where the returns were poor to nonexistent. In contrast, overpaying for an oil company didn't look so bad."[40]

This Note does not dispute the somewhat obvious and elementary conclusion that overpayment would cause bidder company shareholders to suffer substantial economic losses. To a bidder, a potential target is worth the net present value of the target's forecasted future cash flows. Accordingly, a "good" bid involves purchasing a target at a price that makes the acquisition a "positive net present value" investment, and a "bad" bid involves purchasing a target at a price that makes the acquisition a "negative net present value" investment.[41] Negative net present value investments destroy firm value, while positive net present value investments increase firm value.[42] To demonstrate this concept, assume a bidder company with the following balance sheet:[43]

35. *Id.*

36. Synergies result when the acquiring company is able to manage the target more efficiently than the target's current management. *See id.* at 600.

37. *See id.* at 599 ("Misvaluation by the market was unlikely, because Marathon was a fairly simple company whose chief asset was the Yates oil field, on which good data were publicly available.").

38. *Id.* at 600.

39. *Id.* at 599.

40. *Id.* at 600.

41. *See id.* at 605.

42. *Id.*

43. This balance sheet is taken from STEWART C. MYERS & RICHARD A. BREALEY, PRINCIPLES OF CORPORATE FINANCE 444 (2003).

HYPOTHETICAL BIDDER COMPANY'S BALANCE SHEET
(MARKET VALUES)

| | | | |
|---|---|---|---|
| Cash ($1,000 held for investment) | 1,000 | 0 | Debt |
| Fixed assets | 9,000 | 10,000 + NPV | Equity |
| Investment opportunity/hostile acquisition ($1,000 investment required) | NPV[44] | | |
| Total asset value | $10,000 + NPV | $10,000 + NPV | Value of Firm |

This hypothetical balance sheet shows that the value of the bidder company's equity—its stock—is equal to the value of the company. Moreover, because the value of the company is equal to the value of the company's assets, plus the net present value of the acquisition, we can see why taking on a negative net present value investment would be harmful to bidder company's shareholders. By acquiring a target with a negative net present value, "NPV" on the balance sheet would be replaced by a negative number; this would have the affect of decreasing the value of bidder company and the bidder company's equity. Accordingly, this Note is not an attempt to refute the obvious proposition that overpaying for a target—or acquiring a target with a negative net present value—is bad for bidder company shareholders. This Note, however, does question the evidence used to demonstrate bidder overpayment, as well as the assertion that protective measures beyond the business judgment rule are necessary to protect bidder company shareholders from bidder overpayment. The next part of this Note will address the evidence used to demonstrate bidder overpayment.

### *C. Do Bidders Really Overpay? Evidence Demonstrating Bidder Overpayment*

Academics asserting that bidder firms overpay for targets rely heavily on studies that employ the cumulative abnormal returns (CAR) methodology.[45] The CAR methodology measures the stock performance of an acquiring firm relative to the market as a whole over a window period around the date that the acquisition is announced. Academics have often turned to event studies:

44. Where NPV equals the net present value of the target's forecasted future cash flows.

45. *See e.g., Bidder Overpayment, supra* note 7, at 602; *see also* HUBBARD & PALIA, *supra* note 1, at 9 (explaining the positive abnormal returns earned by bidders in the 1960s).

identifying when information about an acquisition is released and observing how the stock price of the bidder company moves in response to the announcement of the acquisition, to determine when a firm has overpaid for a target.[46] Supporters of the overpayment hypothesis claim that the negative abnormal returns experienced by bidder firms during a window period around the date of the announcement of an acquisition prove that a bidder has overpaid for a target. This Part attempts to show why event studies are not completely reliable, and therefore, should not be the basis for upsetting the current standard of review for managerial decisions.

*1. Cumulative Abnormal Return Methodology and the Efficient Capital Markets Hypothesis*—This Note argues that altering the current standard of review of managerial decisions to acquire a target based on available event studies is problematic for several reasons. First, in order for these event studies to have any probative value at all, it must be assumed that the capital markets are efficient in the semi-strong form;[47] that is, the use of event studies assumes that the price of a firm's stock represents an "unbiased estimate of the present value of the firm's expected future cash flows, given a publicly available information set."[48] Accordingly, if a firm overpays for a

46. THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 185. *See also* JOHN POUND, ARE TAKEOVERS REALLY UNDERVALUED: AN EMPIRICAL EXAMINATION OF THE FINANCIAL CHARACTERISTICS OF TARGET COMPANIES 4 (1985) (explaining that takeover proponents rely on evidence that "generally involves the effects of takeover attempts on the stock prices of firms, and hence on the wealth of shareholders").

47. Gilson and Black assert that the uses of event studies, "as a *test* of semistrong market efficiency, and as a *measure* of the impact of new information[] are central to evaluating the motives of acquisitions [and] understanding how acquisitions affect the value of particular firms . . ." THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, supra *note* 7, at 187.

48. *See* OFFICE OF ECONOMIC ANALYSIS, *supra* note 10, at 19 (explaining that the event study methodology, as a measure of the stock price effects of an acquisition, "is based on the theory of efficient markets, which assumes that the price of any security incorporates all currently available information and adjusts to the public release of new information instantaneously"); *see also* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 187. The efficient capital markets hypothesis posits that the prices of publicly traded stocks should match the value assigned by the Capital Asset Pricing Model (CAPM). THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 135. In other words, after having accepted the correctness of the value assigned to a publicly traded stock by CAPM, the Efficient Capital Markets Model hypothesizes that publicly released information about the issuer of that stock will cause traders in the market to assign a value to the stock that matches the value assigned by CAPM. The Efficient Capital Markets Hypothesis (ECMH) presents three forms of efficiency, which may lead to the stock prices matching their assigned value: (1) the *weak* form of ECMH claims that the market price of an issuer's stock reflects the "past history of stock prices and stock trading;" (2) the semi-strong form of ECMH states that "at any point in time, market prices *are an unbiased forecast of future cash flows that fully reflects all publicly available information*"; and (3) the strong form, which "states that market prices are an unbiased estimate of future cash flows that fully reflects *all* infor-

target—if the price that a bidder pays for a target is more than the discounted future cash flows of the target—the bidder's stock will reflect this fact and the firm's stock will experience negative abnormal returns. Many in the academic world blindly accept the notion that the capital markets operate in the semi-strong efficient form. However, the cult following that the efficient capital markets hypothesis has achieved does not mean that a time-tested legal regime should be fundamentally altered based on its theories.

The very scholars that rely on the efficient capital markets hypothesis to buttress their own arguments also recognize the shortcomings of the theory. For example, Roger Dennis, who attempts to demonstrate the utility of the efficient capital market hypothesis in determining whether information is "material" for purposes of Rule 10b-5 litigation, implicitly recognizes the flaws of the model.[49] Although the price of a firm's stock purportedly represents the public's "unbiased" estimate of a firm's expected cash flow, Dennis points out that individual investors may have "different views of the significance of information."[50] However, Dennis, like many other followers of the efficient capital markets hypothesis, dismisses this concern with the assertion that "market mechanisms . . . [will] combine[] these different perceptions of the appropriate price and produce[] an equilibrium price that equals the price that would prevail if all investors had access to complete data and interpreted that data in the same manner."[51] This is problematic, however, because Dennis assumes that individual investor biases will be so heterogeneous that on aggregate, these biases will push the price of a company's stock toward the equilibrium price.[52] In reality, investor biases may be just homogenous enough to push the price of a company's stock above or below the equilibrium price. So while the price of an acquirer's stock may rapidly reflect the reactions of the investing public to a merger announcement, the reactions reflected may not be an unbiased perception of the transaction.[53] Accordingly, the

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mation, both public and private." THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 135.

49. *See* Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. L. REV. 373 (1984).

50. *Id.* at 380. *See also* ROBERT J. SHILLER, MARKET VOLATILITY 1 (1989) ("Prices change in substantial measure because the investing public en masse capriciously changes its mind.").

51. *Dennis, supra* note 49, at 380.

52. *Id.* ("Individual investors may have biased perceptions, but the market averages these variant views to form an unbiased estimate of the value of a security.").

53. According to Gilson and Kraakman, market efficiency depends "the equilibrium that would result if everyone knew a quantity of information, and the equilibrium that is

cumulative abnormal return methodology's reliance on the efficient capital market hypothesis makes the methodology unreliable as a way to prove bidder overpayment.

*2. Acquisitions, Acquisition Announcements, and Stock Price Movements: Does a Causal Connection Exist?*—The second problem with the cumulative abnormal return methodology relates to how the methodology determines the relationship between a firm's acquisition announcement and any subsequent movement in the price of the firm's stock. The cumulative abnormal return methodology attempts to determine what portion of the price movement of a company's stock is attributable to the company's acquisition announcement. That portion of the price movement attributable to the announcement is known as the abnormal returns.[54] Generally speaking, events that may have an effect on a stock's prices can be categorized as *systematic* or *unsystematic* risk.[55] *Systematic* risk represents the portion of risk that is due to market-wide factors—that is, factors that affect the market as a whole.[56] The remainder of the risk is *unsystematic* or company specific; that is, the portion of the risk that is due to factors specific to a particular company. An event study is concerned with unsystematic risk, because the study attempts to determine how an acquisition announcement, which is company specific, affects the stock prices of the company making the announcement.[57]

In order to determine what portion of the price movement of a company's stock is attributable to an acquisition announcement, it is necessary to first determine the beta of that company's stock—determining what portion of the price movement of a company's stock is attributable to market-wide factors.[58] To do this, a regression analysis is used. The regression analysis observes the past

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actually observed," and the speed with which new information is reflected in price. Ronald Gilson & Reiner Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 558 (1984). Concerning the market's reaction to an acquisition announcement, efficiency may exist in terms of how fast this information is impounded into the price of the issuer's stock, but not in regard to how the investing public actually interprets the information. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 161 ( "Some shifts in investor demand for securities . . . seem to be a response to changes in expectations or sentiment that are not fully justified by information. Such changes can be a response to pseudo-signals that investors believe convey information about future returns but that would not convey such information in a fully rational model.").

54. THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 194–95.

55. *Id.* at 94, 194. *See also* MYERS & BREALEY, *supra* note 43, at 172–77.

56. THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 94.

57. *See id.* at 194.

58. For a detailed discussion of beta as a measure of systematic risk, see *infra* note 187 and accompanying text.

movement of a company's stock in relation to the market as a whole and assigns the stock a beta. This beta informs us of the stock's *normal* return—the amount by which the price of a company's stock would be expected to move in relation to the market.[59] Isolating the portion of the price movements of a company's stock attributable to market-wide factors, also tells us that all other price movements are attributable to company-specific factors.

This brings us to the next step in the CAR methodology. After determining a stock's beta, or the portion of the price movement attributable to market-wide factors, it is then necessary to assign each company-specific factor its respective portion of the stock's price movement. Using this methodology to determine the relationship between an acquisition announcement and a stock's price movements poses two problems. First, as stated above, estimating a stock's beta is not an exact science. The regression analysis measures the riskiness of the market as a whole as well as the riskiness of a company's stock in relation to the market as a whole. Both change over time. It seems unlikely that one is able to determine exactly the current and future riskiness of the market and the riskiness of a company's stock in relation to the market by simply observing past movements and relationships.[60] Furthermore, in any regression analysis the regression will be "noisy," which means that even the historical estimate of a stock's beta may not be accurate.[61] If the beta of a company's stock cannot be accurately determined, then one cannot definitively say what portion of a stock's price movements is attributable to market-wide factors and what portion is attributable to company-specific factors.

Any credible study attempting to show a causal relationship between a certain company-specific event and the cumulative abnormal returns that the stock of a firm experience must "reflect any of the countless variables that might affect the stock price performance of a single company. *Statistical analyses must control for relevant variables to permit reliable inferences.*"[62] Therefore, the methods of any study relying on the abnormal returns experienced by the bidder firms' stock to prove the impropriety of a firm's choice to acquire a target require careful examination. A study

59. For example, a stock with a beta of 2 would be expected to decline by 20% when the market declines by 10%. Conversely, the stock would increase by 20% when the market rises by 10%. There are a number of proxies that can be used for the market, such as the S&P 500 index or large-company stocks.

60. THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 115.

61. *Id.*

62. Akerman v. Oryx Comm., Inc., 810 F.2d 336, 343 (2d Cir. 1987) (citations omitted) (emphasis added).

must control for all other variables that may influence the abnormal returns of a bidder firm's stock, so that one may reliably say that the abnormal returns of said stock are causally connected to the bidder firm's decision to acquire a particular target.

Event studies attempt to show a connection between a company-specific announcement and abnormal returns. As stated above, many academics assert that a company's announcement of an acquisition where the price paid for the target is greater than the target's value, will result in the acquirer's stock experiencing negative abnormal returns.[63] However, any uncertainty about the exact nature of the causal connection between the bidder firm's acquisition announcement and the abnormal returns of a bidder firm's stock should prevent us from relying on such studies in determining whether to provide bidder company shareholders with any additional legal protection. Certainty about the relationship between an acquisition announcement and the abnormal returns of the acquirer's stock can be increased by extending the time period used to measure the relationship.[64] In other words, by extending the period during which the price movements of a bidder's stock are observed, event studies would provide a more precise measure of the effect of an acquisition on a bidder company's value. Indeed, "[o]ver limited time periods, high-risk assets may—and sometimes will—produce *lower* returns than low-risk assets."[65]

Bernard Black recognizes the importance of the length of the event window used to measure the relationship between the acquisition announcement and abnormal returns. In his article, *Bidder Overpayment in Takeovers,* Black examines the results of different event studies that observe the abnormal returns experienced by stock of different bidder companies at different times surrounding the announcement of an acquisition.[66] The first set of event studies examined by Black, which observe bidder returns from the bust-up and horizontal takeovers of the 1970s and 1980s, respectively, use a one to four day event window [-1, 4]. That is, these studies observe the abnormal returns of bidder company stock during a period starting one day prior to the announcement date of the acquisition and ending four days after the announcement of the acquisition. Studies using this event window showed that the bidder companies

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63. *See Bidder Overpayment, supra* note 7; *see also* Hechler, *supra* note 7.

64. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 115 ("Given actual patterns of asset price fluctuation, the time period needed to estimate the relationship between risk and return is very long.").

65. *Id.*

66. *See Bidder Overpayment, supra* note 7.

experienced negative loses on average.[67] These studies, however, do not resolve the dispute. While studies using the narrow event window of one to four days around the announcement date of the acquisition did show bidders earning negative abnormal returns on average, the second set of studies analyzed by Black, which observe bidder returns over a wider event window [-11 to 41 days around the announcement date], report only *slightly* negative returns. Further, these negative returns are statistically significant for only one day.[68]

The difference in the results between studies using a narrow event window and studies using a wider event window suggests that the market may need more time to offer an unbiased perception of the target's future cash flows under new management. Indeed, in cases where the bidder's acquisition of a target is motivated by the bidder's possession of nonpublic information about a target's true value, potential gains from synergies between the bidder and the target, or potential tax gains, the investing public may need more time than provided by even the wider event window in order to fully understand any potential increases in the future cash flows of the target after the acquisition.

"Industrial organization studies" also call into question the conclusion that the negative abnormal returns experienced by bidder company stock are demonstrative of bidder overpayment.[69] In fact, Professor Black cites two such studies, which find that takeovers result in actual productivity gains. In a study conducted by Lichtenberg and Siegel, evidence is presented showing that the plant productivity of the target's examined increased after the change in control in the target's management resulting from the takeover.[70] A similar study conducted by Paulus and Gay "report[s] that productivity growth in the 1980s was particularly strong in industries that experienced substantial takeover activity."[71] The findings reported by these two studies directly contradict the

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67. *Id.*

68. *Id.* Black reports that both sets of studies, when "[t]aken as a whole, . . . suggest that since 1975, takeover bidders have earned at best a zero, and perhaps a slightly negative net-of-market return." *Id.* at 602. When taking into account the positive abnormal returns earned by targets, there is the possibility that society experiences a net social gain, because the positive abnormal returns for targets are greater than the slight negative abnormal returns of bidders.

69. Industrial organization studies measure the *actual performance* of the merged firms. *See Bidder Overpayment*, *supra* note 7, at 605.

70. *See id.* at 606 (citing Lichtenberg & Siegel, *Productivity and Changes in Ownership of Manufacturing Plants*, 3:1987 BROOKINGS PAPERS ON ECON ACTIVITY 643 (1987)).

71. *Id.* at 606 (citing J. PAULUS & R. GAY, IS AMERICA HELPING HERSELF: CORPORATE RESTRUCTURING AND GLOBAL COMPETITIVENESS (1987)).

overpayment hypothesis. Perhaps bidders paid target shareholders such high premiums above the market price of the target company's stock because the bidder's management realized that the target's incumbent management was wasteful and inefficient. It would make perfect sense for a bidder, believing that a target's cash flows could be increased under more efficient management, to pay a premium for the target's shares, which reflect this increase.[72]

As the above discussion illustrates there is no consensus among the legal academic community over the affects of a company's acquisition announcement on the price of the company's stock. A study conducted by Mark L. Mitchell and Kenneth Lehn observing a sample of bidder companies reports that the average stock price associated with acquisition announcements shows slight *positive* abnormal returns.[73] Mitchell's sample consists of two types of acquiring firms: acquirers that go on to become targets of hostile acquisitions themselves, and acquirers that do not become targets.[74] Examining the abnormal returns of these two types of acquirers is informative. Mitchell reports that over a [-5, 1] window, the stock prices of acquirers that go on to become targets decline significantly—by 1.27%—as a result of the acquisition announcement. The decline is greater—by 3.38%—when the window is extended to a [-5, 40] window. The stock prices of acquirers that did not go on to become targets, however, experienced significant increases over the [-5, 1] and [-5, 40] window when they announced acquisitions—increases of 0.82% and 3.32%, respectively. Besides contradicting the findings of negative abnormal returns reported by other studies, the Mitchell and Lehn study demonstrates something critical to the debate over the value of takeovers and understanding the effects of bidder overpayment on bidder

72. *See* POUND, *supra* note 46, at 3. As John Pound explains:

> [Takeover advocates] argue that ... business combinations and mergers take place because the acquiring firm can utilize the assets of the acquired firm more profitably than can the target firm on its own, and that this potential for increased profitability allows the acquiring firm to offer an above-market premium for the target.

*Id.*

73. Mitchell's study uses an event window of (-5, 1)—it measures the price affect of an acquisition announcement over a period of 5 days before the announcements through 1 day after the announcements—and reports positive abnormal returns of 0.14%. Mitchell also observes the price effect over an event window of (-5, 40) and reports positive abnormal returns of 0.70 percent for bidders. Mark L. Mitchell & Kenneth Lehn, *Do Bad Bidders Become Good Targets?*, 98 J. POL. ECON. 372, 375 (1990).

74. *Id.*

company shareholders. Mitchell and Lehn show that even when bidder company shareholders suffer as a result of a value-destroying acquisition, they recapture the lost value of their equity when their company becomes the target of a takeover. So in the end, target shareholders suffer no real economic harm.

This Note does not argue that the numerous studies attempting to measure the relationship between an acquisition announcement and stock price movements have no validity or probative value as to the profitability of an acquisition. This Note simply brings to the reader's attention what other scholars have already pointed out, "that 'knowledge of the source of takeover gains still eludes us.' "[75] As such, studies reporting that bidders experience negative abnormal returns during a narrow event window around the acquisition announcement are not conclusive evidence of the value reducing affects of an acquisition, and should not persuade us that the existing legal regime used to review managerial decisions is inadequate. Indeed, subjecting corporate directors and officers to some form of strict liability whenever an acquisition is made and the company's stock experiences negative abnormal returns would have a chilling effect on the market for corporate control and the corporate decision making process. Such a rule would make corporations, directors, and officers the insurers of stockholders.

### *D. Stock Price Movement as an Indicator of Transaction Value*

Using the movement in the price of the bidder's stock to measure the value of an acquisition is problematic.[76] Sole reliance on the abnormal returns earned by the bidder's stock assumes that the market value of the bidder's stock reflects the true value of the bidder after the acquisition. Relying on abnormal returns as a signal of an acquisition's value is justifiable only if we assume that the price of a bidder's stock reflects the investing public's unbiased estimate of information regarding the acquisition.[77] However, as stated above, the investing public consists of individual investors and these investors "may have incomplete data or . . . different

75. *Id.* at 374.

76. *See* Bernard S. Black & Joseph A. Grundfest, *Shareholder Gains from Takeovers and Restructurings Between 1981 and 1986*, J. APPLIED CORP. FIN., Spring 1988, at 5, 6 ("Opponents of takeover activity often criticize the focus on shareholder gains as narrow and excessively dependent on the assumption that stock market profits accurately measure efficiency gains in the economy.").

77. *See* Dennis, *supra* note 49, at 380.

views of the significance of information."[78] Further, the biases of individual investors may be homogenous enough that the aggregation of these biases will not push the market price of the stock to the equilibrium point.

In *Smith v. Van Gorkom*,[79] the Delaware Supreme Court took exception with the defendant board of director's sole reliance on the market price of its firm's shares in concluding that the premium offered by a bidder reflected the true value of the firm. In finding that such reliance was "clearly faulty" and "fallacious," the court accepted the testimony of the defendants that the "the market had consistently undervalued the worth of the [Company's] stock, despite steady increases in the Company's operating income in the seven years preceding the merger."[80] Indeed, the parties to the dispute took no exception with the court's finding that "a publicly-traded stock price is solely a measure of the value of a minority position and, thus, market price represents only the value of a single share."[81] Accordingly, because Bernard Black's overpayment hypothesis relies heavily, if not exclusively, on the market price of the bidder's shares as evidence of overpayment, the existing standard of review for managerial decisions should not be disturbed on the basis of the hypothesis.[82]

78. *Id.*

79. 488 A.2d 858 (Del. 1985).

80. *Id.* at 876.

81. *Id.* The court's view is consistent with the findings of Robert J. Shiller. In *Market Volatility*, Shiller attempts to determine what controls the day-to-day price movements of speculative assets such as stocks and bonds. Shiller concludes that the price movements of these assets are in excess to the price movements predicted by the efficient capital markets hypothesis. *See* SHILLER, *supra* note 50, at 2. Indeed, Shiller states that "fashions, or fads are likely to be important or even the dominant cause of speculative asset price movements," *Id.* at 41, and that "[p]rices change in substantial measure because the investing public en masse capriciously changes its mind." *Id.* at 1.

82. Literature attempting to measure the value created by corporate acquisitions through the observation of indicia other than stock price gains does exist. Some academics have attempted to determine the profitability of corporate acquisitions by observing "post-acquisition performance." There is however, no consensus among the results reported from these observations of post-acquisition performance. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 361–62 (summarizing the results of studies measuring the profitability of corporate acquisitions by measuring post-acquisition performance). Accordingly, these studies are not demonstrative of the need to provide bidder firm shareholders with additional legal protections.

## II. WHY ACQUIRING COMPANIES OVERPAY

In order to provide a better understanding of the overpayment hypothesis, and to assist in this Note's efforts to determine if overpayment is an accurate explanation for the premiums paid to target shareholders, it is helpful to analyze potential reasons or motives behind bidder overpayment. In a takeover market that allows for competing bids, the appearance of a competitive bidder, "will surely cause a bidder firm to raise the [tender offer] price" that it initially made to target shareholders.[83] In addition, a target that provides a "lock-up" option to a white knight, or favored bidder, will cause a firm that makes a competing bid to pay more for the target.[84] These circumstances, however, fail to explain why a firm would pay more for a target than the target is actually worth. Several explanations have been given to explain the phenomenon of acquiring firms overpaying for a target; what follows is a brief summary of each of the suggested explanations.

### *A. Manager Overvaluation of the Target Firm*

This argument asserts that bidder company managers, in their exuberance to increase profits and shareholder wealth, sometimes overestimate a target's value.[85] Overvaluation of a target firm is said to stem in part from the unwarranted optimism on the part of acquiring firm managers:[86]

> [Optimism may cause a bidder to] err in assessing the attainable level of operating income as a percentage of sales, the target's future sales growth rate, or the proper discount rate.

83. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 795.

84. Coates and Subramanian identify three types of lock-ups: (1) stock lock-ups, which give a white knight a call option on a specified number of shares of the target at a strike price agreed to by the target and the white knight; (2) asset lock-ups, which give the white knight a call option on certain assets of the target—the target's crown jewels—at an agreed upon price; and (3) breakup fees, which give the white knight a cash payment from the target in the event that the transaction between the target and the white knight is not completed. John C. Coates & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 314 (2000). One example given by Coates and Subramanian demonstrates that providing a favored bidder with a lock-up option (a break up fee) in a competitive auction for a target will actually prevent an acquiring firm from overbidding. *Id.* at 337.

85. *See Bidder Overpayment*, *supra* note 7, at 624.

86. *Id.*

A manager who makes a relatively small error in any of these estimates can substantially overestimate a target's value.[87]

It may seem intuitive that bidder firm shareholders should be afforded additional legal mechanisms to protect against overly optimistic bidder firm management: unbridled optimism on the part of corporate managers would result in the investment of a firm's capital in assets that produce a return for shareholders lower than the returns shareholders could earn on their own if they were paid dividends and allowed to invest that capital on their own. However, the threat of optimistic managers fails to provide a sufficient reason for adopting a new legal regime. First, in a capital market that is efficient in the semi-strong form, information about the overly optimistic acquisition choices of a firm's managers will be immediately reflected by the price of the firm's stock.[88] Accordingly, "[investors] will discount the [firm's] stock price to reflect the expected over-investment, and an overpriced takeover bid will have a muted affect on the bidder's stock price."[89] In other words, the market will protect all bidder shareholders from the threat of overly optimistic manager behavior by ensuring that the price that the bidder firm shareholder pays for her stock will be discounted to reflect overly optimistic management. Second, there is no fully acceptable or reliable method for determining whether a firm's managers were overly optimistic in making their decision to ac-

87. *Id.*

88. *See* James Lorie et al., The Stock Market: Theories & Evidence 70–73 (2d ed. 1985).

89. *See* Wieglos v. Commonwealth, 892 F.2d 509 (7th Cir. 1989) (concluding that defendants' unreasonable and inaccurate projections in an S-3 registration statement were immaterial on the grounds that the market was sophisticated enough to discount management's habitually optimistic forecasts). *See also Bidder Overpayment*, *supra* note 7, at 624–25. Under the efficient capital markets hypothesis, there are three levels of market efficiency, that is, there are three types of information concerning a bidder firm, that can be reflected by the market where that bidder firm's stock is traded. *See* The Law and Finance of Corporate Acquisitions, *supra* note 7, at 135–37. *See generally*, Brealey & Myers, *supra* note 43, at 351. At the first level, the current prices of a bidder firm's stock only reflect information regarding the stock's prices in the past. This is the weak form of market efficiency. The second level is known as the semi-strong level of efficiency. A market operating at the semi-strong level of market efficiency reflects not just past prices, but all publicly available information about the bidder firm. The price of a bidder firm's stock being traded in a semi-strong efficient market will *immediately* adjust to public information (i.e. an announcement by a firm of a tender offer). In the final level of market efficiency, the market for the bidder firm's stock reflects all information, even that which is not available to the public. The Law and Finance of Corporate Acquisitions, *supra* note 7, at 135. The stock price of a bidder firm in a semi-strong market would immediately reflect information about management acquisition habits through the use of information made available to the public through different ways—SEC disclosure rules and the media are two examples.

quire a target. A determination that managers were overly optimistic in assessing a particular target's post transaction value will be made after the fact. Allowing courts that lack the business experience and expertise of seasoned managers to engage in this sort of Monday night quarterbacking will cause mangers to be too risk averse. Indeed, allowing courts with 20/20 hindsight to second guess the informed decisions of a firm's managers will cause management to make business decisions that are borne more out of caution and less out of certainty. Bidder firms' acquisitions will be made more towards achieving the goal of avoiding liability under this unduly restrictive legal regime, not towards the goal of increasing shareholder wealth. Such a result will be bad for all shareholders.

### *B. The Winner's Curse*

Winner's curse theory posits that due to the uncertainty about the value of a target, acquiring firm managers will overpay for targets on average. The existence of potential competitive bidders is said to be enough to cause a bidding firm to increase its offer above the true value of a target, when the target's value is uncertain. "If the first bid is too low," potential competitive bidders will make a higher offer.[90]

Winner's curse theory as an explanation for bidder overpayment, however, is problematic because the theory assumes that the value of the asset is uncertain and that an auction for the asset exists.[91] However, these conditions may not exist in the case of every acquisition. Although it is possible for additional bids to occur after the initial bidder's offer,[92] it is also possible for the initial bidder to protect its expectancy interests in the transaction through the use of what James Freund and Richard Easton call the "multistep acquisition."[93] Although Freund and Easton analyze the efficacy of the multistep acquisition in allowing *friendly* bidders to avoid

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90. *Bidder Overpayment, supra* note 7, at 625.

91. *See id.* Black asserts that "[t]he auction need not be explicit; it is enough that there are potential bidders waiting in the wings to make a higher offer if the first bid is too low." *Id.*

92. Coates & Subramanian, *supra* note 84, at 310–11.

93. *See* James Freund & Richard Easton, *The Three-Piece Suitor: An Alternative Approach to Negotiated Corporate Acquisitions*, 34 BUS. LAW. 1679, 1680 (1979).

competing bids for the same target, the acquisition technique can be used to provide the hostile bidder with similar protection.[94]

The first stage of a multistep acquisition requires that the acquiring company negotiate with a controlling shareholder of the target company to purchase the shareholder's stock.[95] If there is no controlling shareholder, the acquiring company should negotiate a stock purchase from a "large but noncontrolling [share]holder."[96] Similarly, the hostile bidder may also attempt to engage in negotiations with an institutional investor for the purchase of a substantial block of a target's shares.[97] If the hostile bidder cannot acquire a block of shares from a large or institutional investor, the hostile bidder may still prepare itself for its upcoming tender offer for the target by acquiring a block of the target's shares through open-market purchases.[98]

94. Freund and Easton state that:

> [The dichotomy] between negotiated (or 'friendly') acquisitions on the one hand, and hostile takeovers on the other.... has evolved into more of a continuum, with the absolutely friendly deal (lacking even covert pressures) at one end of the spectrum; the absolutely unfriendly takeover (with no lines of communication open between the parties) at the other; and most deals falling somewhere between the poles, not uncommonly possessing characteristics of each.

*Id.*

95. *Id.* at 1683–84.

96. *Id.* at 1683.

97. *Id.*

98. *See* Frund & Easton, *supra* note 93, at 1684–85. Open market purchases of the target's stock by the hostile bidder may reduce any gains that the hostile bidder may realize due to the resultant increase in the price of the target company's stock. *See* Gilson & Kraakman, *supra* note 53, at 570–572. However, any such reduction should be insignificant. Let us assume that the bidder firm wishes to acquire the target because the bidder is in possession of information that leads it to believe that the target is undervalued. Assume further that the bidder has a monopoly on this information. "In these and similar instances of monopolistic access, information first enters the market through a very small number of traders whose own resources are not large enough to induce speedy price equilibration." *See id.* at 572.

A hostile bidder possessing a monopoly over information concerning the true value of an undervalued target need only control the size and period over which it purchases a target's shares in the open market in order to prevent the price of the target's shares from reflecting the information held by the bidder. Furthermore, it is unlikely that "derivatively informed trading ... [will] erode the [bidder's] advantage by capitalizing on the 'information leakage' associated with the trading itself." *Id.* at 572. "Indirect information leakage" through "trade decoding"—uninformed traders gleaning by directly observing the transactions of informed traders—will be unlikely to erode the bidder's advantage. This is because price changes in stock through trade decoding are "especially pronounced when sellers are officers or other insiders of the issuer; moderate when sellers are investment companies and mutual funds (which act on the advice of research staffs); and barely noticeable when sellers are individuals, bank trust departments, and other traders who may liquidate their holding for reasons other than investment gain." *Id.* at 573–74. The purchase of a target's shares in the open market by a bidder who is not an insider of the target should not cause a drastic

After the hostile bidder has acquired a key block of a target's stock—either through carefully planned open-market purchases or by purchasing from a large, institutional shareholder—the bidder will then make a tender offer to all the target shareholders. The tender offer will be made at the same price as was paid for the block.[99] In announcing its tender offer, the bidder will also make known that "it has *already* purchased . . . [a] key block" of the target's stock.[100] Usually the announcement of a tender offer by a hostile bidder would bring "grey knights" into the fray,[101] which would in turn obligate the target's board of directors to put the target up for auction in order to obtain the highest possible price for its shareholders. However, the appearance of "grey knights" should be reduced as a result of the hostile bidder's purchase of a block of the target's stock prior to the tender offer.

The bidder's ownership of a block of the target's stock, even a minority of the target's stock, may create substantial problems and costs for a grey knight that ultimately purchases the target.[102] One problem which may arise as a result of an unsuccessful hostile bidder's ownership of a block of a target's stock after the target is purchased by a grey knight, is that the grey knight will be prevented from gaining unfettered access to the target's assets:[103]

> If minority shareholders are not eliminated, . . . then whether what is sought is the target company's existing cash, or the proceeds of post-acquisition of sales of target company assets,

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increase in the target's stock. Furthermore, "trade decoding remains limited by a significant constraint: uninformed traders must be able to identify informed traders individually and observe their trading activities directly." *Id.* at 574. Because it is unlikely that the investing public will determine the identity of a bidder that makes small open market purchases of a target's shares, the price increase of the target's shares should be minimal.

99. *See* Freund & Easton, *supra* note 93, at 1684.

100. *See id.* at 1683.

101. *Id.* at 1685. The appearance of "grey knights"—competing bidders "dripping with cash or proffering attractive securities"—would trigger the "obligations of the target's board of directors" under *Revlon*, which are to obtain the highest possible price for target shareholders through the use of an auction. *Id.* at 1689; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (holding that when a company's board of directors authorizes its managers to negotiate a sale of the company, "the duty of the board . . . [changes] from the preservation of . . . [the company] as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit").

102. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 1237 ("[I]t seems quite clear that acquiring companies, or at least those that counsel acquiring companies, regard the flexibility to eliminate minority shareholders as crucial to their acquisition planning.").

103. *Id.* at 1239 (stating that it is not uncommon for an acquiring company to be dependent on access to target company assets in order to pay off the debt incurred to finance the acquisition). *See also* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

> the price of the acquiring company's access to those resources is the distribution of a proportionate amount to any remaining minority shareholders.[104]

In order to gain access to the target's assets, the grey knight has two options. The grey knight can cause the target to pay a dividend, in which case the unsuccessful hostile bidder would receive a proportion of the dividend paid.[105] Alternatively, the grey knight could attempt to freeze out the unsuccessful hostile bidder, by paying the hostile bidder a specified price for its shares.[106] In either case, the result for the successful grey knight is the same: an increase in the cost of the acquisition. Furthermore, because the amount paid by the grey knight to freeze out the unsuccessful hostile bidder will be at a premium, the unsuccessful hostile bidder will most likely realize a gain.[107] In the end, the hostile bidder will be able to launch an uncontested tender offer for the target or realize gains from its minority block of target shares.

The final step of the multistep acquisition is the cash merger.[108] At this point, the hostile bidder should own a sufficient number of target shares to approve a freeze out merger of any remaining target company shareholders. In some cases, the hostile bidder may be able to purchase enough of the target's stock through the first two steps of the multistep acquisition to allow the hostile bidder to merge with the target using a short-form merger.[109] The multistep acquisition technique results in the hostile bidder achieving 100% ownership of the target. Furthermore, this acquisition method eliminates much of the uncertainty surrounding the purchase price and the successful completion of the acquisition of the target. Both benefits are realized due to the multistep acquisition's

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104. THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 1239.

105. *See id.*; *see also Sinclair Oil Corp.* 280 A.2d at 717 (holding that a parent that caused its subsidiary to payout dividends in order to satisfy the parent's cash needs, did not breach its fiduciary duty to its subsidiary where a proportionate share of the money was received by minority shareholders of the subsidiary).

106. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITION, *supra* note 7, at 1240 (estimating the cost of securing a target company's cash through a freeze out merger).

107. Because many corporation statutes provide appraisal rights to minority shareholders that dissent to a freeze out merger, and because "the very notion of a freezeout requires that the minority shareholders be paid off in cash," the grey knight will pay the hostile bidder a premium in a freeze out merger so long as the costs of a successful freeze out are less than other methods of accessing the target's cash. *See id.* at 1253.

108. Freund & Easton, *supra* note 93, at 1680–95.

109. "The corporation statutes of most leading commercial states allow a majority shareholder with a high enough ownership—Delaware and California for example require 90%—to approve a merger without a vote of the target company shareholders ...." THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 1253.

ability to reduce the likelihood of a full-blown auction for the target. Accordingly, the winner's curse theory does not adequately explain bidder overpayment.[110]

*C. Agency Conflicts Between Bidder Firm Management and Shareholders*

One could also attribute overpayment to the divergence of the interests of bidder firm managers and shareholders.[111] The connection between the shareholders and managers of a firm can be defined as an agency relationship.[112] Agency theory tells us that, assuming that both shareholders and managers seek to maximize their own utility, it is highly probable that managers will not always act in the best interests of shareholders.[113] Managers' interests diverge from shareholders' interests because of the position that managers occupy in relation to the corporation and the capital markets as a whole, as compared to shareholders. Furthermore, efforts by shareholders are unlikely to prevent managers from acting in their own best interests. Any efforts on the part of shareholders to limit divergences from their interests will entail monitoring costs.[114] An individual shareholder owning a small percentage of a firm has very little incentive to incur these monitoring costs, because the costs of monitoring the activities of managers

110. Freund & Easton state the popularity of the multistep acquisition has increased due to "an era of intense competition for desirable acquisition candidates—where auctions and bidding contests are very much the 'in' thing." Freund & Easton, *supra* note 93, at 1682.

111. *Id.* A discussion of agency conflicts between managers and shareholders is essential to any argument for providing bidder firm shareholders with additional protection outside the business judgment rule. While other explanations for overpayment depend on the ignorance of management, agency conflict implies some form of conscious wrongdoing on the part of management. It was this "omnipresent specter" that management would act in its own interest, as opposed to the interests of the firm's shareholders, that gave rise to the heightened standard of review in *Unocal. See Unocal*, 493 A.2d at 954.

112. Jensen and Meckling define the agency relationship as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976). Bernard Black states that it is inevitable that the interests of shareholders and managers diverge in some way. *See Bidder Overpayment*, *supra* note 7, at 625.

113. *See* Jensen & Meckling, *Theory of the Firm*, *supra* note 112, at 308. The underlying assumption of this argument—that the interests of the principal and agent, or in the case of a corporation the shareholders and managers, diverge—is not necessarily clear.

114. *See id.*

would far outweigh any gain that may be realized by the individual shareholder.[115]

Agency conflicts between managers and shareholders of acquiring firms fall far short of justifying the adoption of a legal regime beyond the business judgment rule to review the acquisition decisions of management. As stated above, many believe that shareholders are incapable of protecting their own interests due to collective action problems. However, as shown in Part III of this Note, the combination of a federal mandatory disclosure regime and the presence of large and institutional shareholders address most of the collective action problems. Institutional investors, because of their equity position in the acquirer and the decreased cost of obtaining, analyzing, and verifying information brought about by the mandatory disclosure regime, serve as adequate monitors of managerial conduct.

Agency conflicts fail to provide an adequate justification for moving beyond the business judgment rule for another reason. Because two different types of investors can hold equity positions in the acquirer, diversified and undiversified investors, one must explore the different interests that exist among these different equity holders in order to determine the extent of any agency conflict that may exist. An in-depth analysis of the distinct interests of these two types of shareholders reveals that the conflict between the interests of managers, which are aligned with the interests of the corporation as an entity, and the interest of the corporation's shareholders, is grossly over-exaggerated.

Diversified stockholders are not very concerned with firm-specific risk.[116] Accordingly a diversified stockholder will see a manager's duty as "maximiz[ing] profits even at the risk of bankrupting the firm."[117] So long as the actions of management produce adequate returns, the diversified stockholder has little reason to

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115. *See id.*

116. *See* Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429, 430 (1998) [hereinafter Booth, *Stockholders, Stakeholders and Bagholders*] ("An internationally diversified portfolio can eliminate almost ninety percent of firm specific risk."); *see also* Richard A. Booth, *The Suitability Rule, Investor Diversification, and Using Spread to Measure Risk*, 54 BUS. LAW. 1599, 1607 (1999) [hereinafter Booth, *The Suitability Rule*]. A diversified stockholder is indifferent to whether any specific company in her portfolio takes on very risky projects—projects with a high expected return on the firm's investment, but with the high probability that the actual returns will deviate from the expected returns. *See* Booth, *Stockholders, Stakeholders and Bagholders*, *supra*, at 434 ("A diversified investor will prefer that individual companies pursue high-return strategies even if they entail high risk (because with diversification you win some and you lose some, buy only the average matters).").

117. *See* Booth, *Stockholders, Stakeholders, and Bagholders*, *supra* note 116, at 430.

concern herself with firm-specific risk. Maximizing short-term stockholder wealth at the expense of the very existence of the firm is antithetical to the interests of management and the corporation:

> Ironically, management is the one constituency, which identifies most with the fortunes of the corporation as an entity. A diversified stockholder can afford to win some and lose some. Management cannot. Management stands to lose the most if the corporation fails. [M]anagement is not likely to pursue the high-risk, high-return strategies ... [a]fter all, if such strategies lead to the ruin of the company, it is management that is left holding the bag.[118]

On the other hand, the interests of undiversified stockholders mirror those of management. Similar to managers, the undiversified investor's interest is served by a management strategy that "maximize[s] profits *and*... minimize[s] risk."[119]

> An undiversified stockholder will likely prefer a merely adequate return [a return that is in proportion to the low risk involved] to a high return with high risk. Such an investor cares very much about the survival of the firm.[120]

Accordingly, an analysis of the agency conflict between shareholders and managers must begin with identifying the nature of the acquirer's equity holders.[121] Identifying the firm's equity

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118. *Id.* Indeed, "[e]ven if management does not own a large percentage of the stock of its company, it is likely to have a disproportionate percentage of its own wealth tied up in company stock in the form of incentive stock options or similar stock price-based rewards." *Id.* at 436.

119. *Id.*

120. *Id.*

121. Because it would be highly onerous at any given time for the board of directors of a publicly-traded firm to attempt to determine what percentage of the firm's equity holders fall into the diversified or undiversified category, it is unlikely that any given firm will know just which type of shareholder interests are at stake. Furthermore, even if we assume that a firm's equity holders consist of "rational" investors, and that a rational investor will diversify her portfolio, it would still be unwise for management to make acquisition decisions based on the preferences of these individuals. As Booth states:

> [P]ractically speaking, managers cannot be expected to make business decisions on the basis of what a diversified investor would prefer. For all management knows, there are many different kinds of diversified investors out there following very different models in making their diversified investment decisions. What one investor might prefer management to do (in light of that investor's particular portfolio) might differ radically from what another investor might like to see.

*Id.* at 435.

holders becomes particularly important in the context of a firm's managers' decision to acquire a particular target. If the acquiring firm's stockholders are undiversified, management may be doing what is exactly in the best interest of the acquiring firm's shareholders.

A number of theories attempt to explain why bidder-firm management may engage in the acquisition of a target firm.[122] One explanation is that managers "have a preference for maximizing . . . stability, and may pursue . . . diversification programs . . . " in furtherance of this preference.[123] As shown above, by pursuing programs that promote stability and diversity, firm managers further the interests of the firm's stockholders that are undiversified. If courts go beyond the mandate of the business judgment rule and prevent bidder firms from making acquisitions that would give the bidder firm a diverse portfolio of holdings, undiversified stockholders in bidder firms may suffer.[124]

122. *See* Coates & Subramanian, *supra* note 84; *see also* Hechler, *supra* note 7, at 347–68.

123. Coates & Subramanian, *supra* note 84, at 354.

124. Consider a bidder firm faced with choosing from the two following portfolios of acquisition strategies to invest in. One of the most basic investment principles is that "the more risk an investment carries, the more return it must offer to the investor." However, through diversification, an investor can eliminate most of the unsystematic risk of a particular investment without sacrificing returns. Accordingly, if the shareholders of a firm faced with choosing from among the following investment options are diversified, they would prefer that the firm's management choose Investment B over Investment A.

| | INVESTMENT A | |
|---|---|---|
| Estimated Probability of Outcome | *Expected* Profit or Loss | Value |
| 0.4 | +6 | 2.4 |
| 0.4 | +2 | 0.8 |
| 0.2 | +1 | 0.2 |
| 1.0 | | 3.4 |

| | INVESTMENT B | |
|---|---|---|
| Estimated Probability of Outcome | *Expected* Profit or Loss | Value |
| 0.02 | +150 | 3.0 |
| 0.2 | -13 | -2.6 |
| 0.2 | -20 | -2.0 |
| 0.32 | | -1.6 |

Indeed, in *Joy v. North*, the Court of Appeals for the Second Circuit stated "diversified stockholders may prefer risky investments if they carry the prospect of greater return than safer investments." Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982). *But cf.* MYERS & BREALEY, *supra* note 43, at 177 (arguing that, although "[d]iversification is undoubtedly a good thing, . . . that does not mean that firms should practice it. If investors were *not* able to hold a large

Even if we were to assume that every equity holder in a bidder firm is diversified, bidder firm management should make acquisition decisions as if it were serving the interests of undiversified investors. An examination of the option grant as management compensation illustrates this point. Option grants to corporate managers are often used to align the interests of managers that generally seek to diversify the corporation's portfolio, with the interests of diversified shareholders.[125] Providing management with call options—the right to buy an issuer's stock at or before a given expiration date at an agreed upon exercise price—management is encouraged to take on investments with increased systematic risk.[126] To understand why this is so, it is necessary that we understand the nature of the call option. The call option gives an issuer's management the right to purchase the underlying asset—the issuer's stock—on or before a certain date, at an agreed upon price. Management, however, is not obligated to purchase the issuer's stock. Management will only exercise the call option if the value of the issuer's shares on the expiration date exceeds the exercise price.[127] If the market value of the issuer's stock is below the exercise price on the day the option terminates, management will elect the option, and will experience neither gain nor loss. Therefore, as a holder of a call option, management sees only the upside of the option, but not the downside. Because investments with greater systematic risk have a greater upside—higher expected returns—than investments with less systematic risk, management will take on investments with greater systematic risk to increase the value of its call options.[128] Accordingly, options encourage managers to make acquisitions that serve the interests of diversified shareholders.

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number of securities, then they might want firms to diversify for them. But investors *can* diversify . . . more easily than firms").

125. *See* Gretchen Morgenson, *When Options Rise to Top, Guess Who Pays*, N.Y. TIMES, Nov. 10, 2002, at 1.

126. THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 240.

127. *Id.* at 233. If the value of the issuer's stock exceeds the exercise price of the option on the date of termination, the holder of the option will purchase the issuer's stock from the writer of the option at the exercise price and then sell the issuer's stock to someone in the secondary market at the market price, which is greater than the exercise price.

128. Gilson and Black explain that "[a] central factor in valuing a [call] option is the variance in value of the underlying asset. The *greater* the variance in the value of the underlying asset, *holding constant the value of the asset*, the more the option is worth." THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 239. Investments with greater systematic risk also have a greater downside than investments with relatively less systematic risk. As pointed out earlier, however, the holder of the call option is not concerned with the downside of the option, because the holder merely elects not to exercise his rights if the option is out of the money. MEYERS & BREALEY, *supra* note 43, at 579–81.

However, this is not necessarily a good thing for shareholders. One academic study conducted by two Rutgers University professors suggests that when managers behave too much like diversified shareholders, all shareholders suffer.[129] After observing stock option grants and shareholder returns at the 1,500 largest American companies from 1962 to 2001, the professors report that companies that distributed "larger-than-average option grants to their top five executives produced decidedly lower total returns to shareholders over the period than those dispensing far fewer options."[130] Despite the fact that bidder firm management may engage in acquisitions that actually serve the interests of bidder firm shareholders—diversified and undiversified—the bidder firm shares experience negative abnormal returns after it launches a tender offer for a target firm.[131] Those who argue that the conglomerate mergers of the 1960s and 1970s created inefficiencies, as opposed to wealth, rely heavily on these negative returns to buttress their claims. However, Andrei Shleifer and Robert Vishny argue that the negative abnormal returns experienced by bidders engaging in diversification mergers notwithstanding, the firm's shareholders do benefit.[132] argue that by "us[ing] their stock to diversify and to build conglomerates," managers advanced the interests of long-term shareholders by raising these shareholders' claims to long-term capital.[133] The authors go on to state that:

> Even though conglomerates do not appear to have increased profits, and the long run stock market returns to the acquirers have been negative, such [conglomerate] acquisitions were still preferred to doing nothing .... [N]egative bidder returns are not evidence of a failure to serve shareholder interests—conglomerate values would have fallen even more without [the acquisitions].[134]

129. Morgenson, *supra* note 125 ("'At the very least, options tended to promote a short-term focus, and at the worst, they promoted fraudulent activity to manipulate.'"). *But cf. Bidder Overpayment, supra* note 7, at 638 (arguing that "[t]he poor returns from conglomerate acquisitions[which reduce firm-specific risk]may explain why owner-controlled firms tend to shun such acquisitions, despite their potential to diversify the owner's investment portfolio").

130. *See* Morgenson, *supra* note 125.

131. *See Bidder Overpayment, supra* note 7, at 640 (stating that on average, bidders "tend to experience positive net-of-market returns in the period prior to a takeover announcement and negative net-of-market returns in the post-announcement period").

132. *See* SHLEIFER & VISHNY, *supra* note 3.

133. *Id.* at 20.

134. *Id.* (citations omitted).

Shleifer and Vishny point out that the conglomerate mergers also resulted in bidders realizing short-term gains. The authors state that both acquirers and targets realized short-term gains due to the "efficiency gains from conglomeration [which were] obtained through better management."[135]

Understanding the effect options have on managerial decision making helps predict when and how managers can further the interests of all shareholders with corporate acquisitions. Option holders are in a position akin to that of diversified shareholders. As shown above, managers that hold call options in an acquirer's stock are affected by risk in very different ways than are holders of the underlying security.[136] In corporate acquisitions, issuing call options to management encourage managers to acquire targets, even though the expected return of the acquisition is insufficient to compensate for the associated risk.[137]

## III. BIDDER PROTECTIONS UNDER THE CURRENT REGIME

### A. *The Business Judgment Rule*

1. *An Overview of the Business Judgment Rule*—Bidder company management wishing to engage in a hostile acquisition of a target company need only comply with the business judgment rule in order to fulfill its fiduciary obligation to its shareholders.[138] Under the Delaware Code, a corporation's board of directors is responsible for managing the business and affairs of the company.[139] However, "[i]n exercising these powers, directors are charged with an unyielding fiduciary duty to protect the interests of the corporation and to act at the best interests of its shareholders."[140] The business judgment rule creates a rebuttable presumption that the board of directors, in making a business decision, "act[s] on an informed basis, in good faith and in the honest belief that the

135. *Id. Cf.* HUBBARD & PALIA, *supra* note 1 (stating that the abnormal returns earned by bidding firms participating in the conglomerate acquisitions of the 1960s suggests that the market rewarded diversification).

136. THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 242.

137. *Id.*

138. *See Van Gorkom*, 488 A.2d at 858; *see also* Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir. 1981); Hechler, *supra* note 7, at 322.

139. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360 (Del. 1993) (citing 8 Del. C. 141(a))

140. *Id.* (citing Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)).

action taken is in the best interest of the company."[141] The party attacking a board decision bears the burden at the outset to rebut the business judgment rule's presumption.[142] A plaintiff successfully rebuts the presumption with a showing that, in approving a challenged transaction, a company's board of directors breached one of the three prongs of its fiduciary duty: good faith, loyalty, or due care.[143] What follows is a discussion of the due care prong of the fiduciary duty obligation.

A plaintiff can rebut the presumption provided by the business judgment rule by demonstrating that a firm's management has breached its duty of care. In the context of making an acquisition, a firm breaches its duty of care if the transaction lacked a proper business purpose or the directors were not acting on an informed basis. Hence, there are two options available to a plaintiff attempting to prove that a defendant firm has breached its duty of care by making a particular acquisition: (1) plaintiff may demonstrate a lack of *substantive* due care;[144] or (2) plaintiff may demonstrate a lack of *procedural* due care.[145] This Note argues that due to the methods that firms employ to value an investment decision, both the substantive and procedural due care theories make it highly probable that any acquisition choice that does not protect the interests of the firm's shareholders will expose the firm's managers to liability.

*a. Lack of Substantive Due Care*—A lack of substantive due care on the part of a firm's board of directors may be found when the board consummates a deal that is so bad that no reasonable director could possibly have approved it. In other words, the deal had no proper business purpose.[146] In *Litwin v. Allen*, a derivative action brought by aggrieved shareholders against the Guarantee Trust

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141. *Van Gorkom*, 488 A.2d at 872 (quoting Aronson v. Lewis 473 A.2d 805, 812 (Del. 1984)).

142. *Id.*. *See also Cede & Co.* 634 A.2d at 361.

143. *See Cede & Co.*, 634 A.2d at 361. For the purposes of this Note, only the due care prong of a board's fiduciary duty will be addressed.

144. The substantive prong of the due care obligation requires a court to look to the substance of a transaction; that is, the court scrutinizes the transaction in question to determine whether a rational business objective is furthered. *See* Litwin v. Allen, 25 N.Y.S.2d 667 (N.Y. Sup. 1940); *see also Panter*, 646 F.2d at 298 (stating that the presumption afforded directors by the business judgment rule will be removed by showing a lack of a rational business purpose); *Cede & Co.*, 634 A.2d at 361 (stating that a decision by a "loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose'").

145. *See Cede & Co.*, 634 A.2d at 360 (quoting *Aronson*, 473 A.2d at 812).

146. *See Litwin*, 25 N.Y.S.2d at 667; *see also Panter*, 646 F.2d at 298.

Company (GTC), the New York Supreme Court[147] found that the GTC board of director's sale of certain securities lacked substantive due care. Specifically, the court found liability on behalf of members of GTC's board of directors, "because the entire arrangement of [the purchase][148] was so improvident, so risky, so unusual and unnecessary as to be contrary to fundamental conceptions of prudent banking practice."[149]

Elaborating on the nature of the directors' breach of their duty of care, the court emphasized that the "obligation, which the law itself impose[d]" on the GTC directors required "more than honesty." Directors were required to be diligent and that meant exercising "care and prudence."[150] According to the court's interpretation, the GTC directors failed to fulfill their obligation because the challenged transaction resulted in "any appreciation . . . inur[ing] to the benefit of the seller and any loss . . . be[ing] borne by the bank[.]"[151] The court concluded its analysis of the transaction by pointing out that "[t]here is more here than a question of business judgment as to which men might well differ. The directors plainly failed in this instance to bestow the care which the situation demanded."[152]

The business judgment rule's mandate that managerial decisions be made with substantive due care buttresses the point that bidder firm shareholders are in need of no additional protection. According to the court's holding in *Litwin*, where the economic benefits of the transaction adhere to the target and the economic losses are born by the acquirer, substantive due care is lacking.[153] This

147. In New York State, the trial court is designated as the Supreme Court, while the intermediate court of appeals and the court of last resort are designated as the Appellate Division and the Court of Appeals respectively.

148. Although the court continuously referred to this particular transaction as a "sale" of securities, the court recognized that the economic realities made the transaction a "loan." The GTC directors gave the sellers of the securities a call option—an option to purchase the securities from GTC within six months of the date of GTC's purchase at the price that GTC paid for the securities. The court stated: "*The fact is that the only purpose served by the option was to make the transaction conform as closely as possible to a loan without the usual incidents of a loan transaction.*" *Litwin*, 25 N.Y.S.2d at 692 (emphasis added).

149. *Id.* at 699.

150. *Id.*

151. *Id.*

152. *Id.*

153. This portion of the *Litwin* holding is particularly relevant to the thesis of this Note, because it squarely deals with one of the major criticisms of corporate takeovers: That "the [large premiums paid] to target shareholders . . . reflect wealth transfers rather than improved efficiency of the merged firms." *See Bidder Overpayment*, *supra* note 7, at 611; *see also* OFFICE OF ECONOMIC ANALYSIS, *supra* note 10 (stating that "critics often argue that, although takeovers benefit target stockholders, they often diminish the value of acquiring firms").

interpretation of the business judgment rule gives bidder firm shareholders a cause of action against the firm's board of directors where an acquisition is a mere wealth transfer from acquiring shareholders to target shareholders.[154]

*b. Lack of Procedural Due Care*—The mechanics of the procedural due care test can be seen in the notable case *Smith v. Van Gorkom.*[155] While the substantive due care component of the business judgment rule requires a reviewing court to examine the merits of a particular transaction, the procedural due care component is concerned with the process used by a firm's managers in selecting a transaction. A plaintiff challenging the propriety of the decisions of a firm's managers based on a lack of procedural due care must demonstrate that a board's decision to acquire a target was *uninformed.*[156]

In *Smith v. Van Gorkom,* the Delaware Supreme Court was faced with determining whether a business decision of the board of directors of a target company was an informed decision under the business judgment rule.[157] The court's answer turned on whether

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154. Gilson and Black state that:

> In its strongest form, the notion [of wealth transfers] is that the positive returns experienced by target shareholders simply represent a wealth transfer from acquiring company shareholders to target company shareholders; target shareholder gains are offset by acquiring shareholder losses.

THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 635. Wealth transfers, although producing significant gains for target shareholders, cause other stakeholders, such as employees, holders of bonds and preferred stock of the bidder company, to suffer offsetting losses. *See Bidder Overpayment, supra* note 7, at 611. The wealth transfer, however, does not always result in acquiring shareholder losses being offset by target shareholder gains. As Mitchell and Lehn explain, "[i]f the losses [are] sustained by [other stakeholders], . . . corporate takeovers actually destroy, not create, wealth." An acquisition resulting in such a wealth transfer would violate the substantive due care prong of the business judgment rule as interpreted by the *Litwin* court.

155. 488 A.2d 858 (1985).

156. *See id.* at 872.

157. The Delaware Supreme Court explained the workings of the business judgment rule as follows:

> Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 Del. C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors . . . The business judgment rule exists to promote the full and free exercise of the managerial power granted to Delaware directors. The rule itself 'is a presumption that in making a business decision, the directors of a corporation acted on an informed basis in good faith and in the honest belief that the action taken was in the *best interests of the company.*'

prior to making a business decision, the directors have informed themselves of all material information reasonably available to them.[158] Directors whose decisions are "unintelligent or unadvised" are not afforded the rebuttable presumption provided under the business judgment rule.[159] Furthermore, directors, once informed, are obligated to use the acquired information to protect the interests of their shareholders, whose financial interests the directors represent.[160]

As with a claim of lack of substantive due care, mere honesty or good faith will not satisfy a director's obligation to act on an informed basis; indeed, "considerations of motive are irrelevant . . ."[161] Under the business judgment rule, "director liability is predicated upon concepts of gross negligence."[162] In other words, "the concept of gross negligence . . . is the proper standard for determining whether a business judgment reached by a board of directors was an informed one."[163]

*2. Bidder-Company Shareholders' Interests are Adequately Protected by the Business Judgment Rule*—The business judgment rule, as interpreted by Delaware courts, adequately protects the interests of bidder-company shareholders. First, a company's board of directors is shielded by the business judgment rule's presumption only when it acts in good faith; that is, "in the absence of fraud, bad faith, gross overreaching or abuse of discretion, courts will not interfere with the exercise of business judgment by corporate directors."[164] Therefore, in order to qualify for the presumption of the business judgment rule, a board's business decisions must be devoid of fraud, bad faith, and overreaching. This initial qualification provides bidder firm shareholders with significant protection under the business judgment rule. Although, this protective measure is incomplete, because it does not deal with actions by a board of directors where the mental state does not rise to an intentional level, both the substantive and procedural due care tests allow a plaintiff to rebut the business judgment rule with a showing of gross negligence.

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*Id.* (citations omitted) (emphasis added).

158. *Id.* (quoting *Aronson*, 473 A.2d at 812).

159. *Id.*

160. *Id.*

161. *Id.* at 873.

162. *Id.* (quoting *Aronson*, 473 A.2d at 812).

163. *Id.* In *Mitchell v. Highland-Western Glass*, the Delaware Court of Chancery phrased the question as "whether the board acted 'so far without information that they can be said to have passed an unintelligent and unadvised judgment.'" 167 A. 831, 833 (Del. Ch. 1933).

164. *Panter*, 646 F.2d at 293.

Whether the business judgment of a director a company's board is an informed one turns on "whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'"[165] This test prevents the managers of a bidding company from acquiring a target without first informing itself in preparation for the acquisition. By "proceed[ing] with a critical eye in assessing information" relating to a particular target prior to its decision to launch a tender offer, the financial interests of the bidding company's shareholders are assured adequate protection.[166]

Even though it involved a suit brought by target company shareholders, *Smith v. Van Gorkom*, clearly demonstrates that the business judgment rule sufficiently protects bidder firm shareholders. In *Smith v. Van Gorkom*, the court held that the board of directors' decision to approve a merger did not qualify as an informed decision under the business judgment rule.[167] The court found that due to the board's lack of adequate "valuation information" concerning its own company, the decision to approve the sale of the company for $55 a share was not an informed one.[168] Although *Smith v. Van Gorkom* dealt with a board's decision to *sell* the company, the reasoning adopted by the Delaware Supreme Court is germane to board decisions to purchase a target as well. A major factor in the Delaware Court's determination in *Van Gorkom* was the board's ignorance as to the "intrinsic value of [its] company."[169] The court found that the board's reliance on the company's market price, without any documentation, as a basis for selling the company at $55 a share, made the board's decision an uninformed one.[170] Elaborating, the court found that even though a major asset of the company was its cash flow, "at no time did the Board call for a valuation study taking into account that highly significant element of the company's assets."[171] This rationale would apply with just as much force to a board decision to acquire a target. A board's decision to buy a company without sufficient evidence concerning the target's value would be no less a breach of the board's fiduciary duty. The economic losses suffered by the company's shareholder

165. *Van Gorkom*, 488 A.2d at 872 (citing Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971)).

166. *Id.*

167. *Id.*

168. *Id.* at 875.

169. *Id.* at 874.

170. *Id.* at 875, 876.

171. *Id.* at 876.

would be just as real; in fact, it stands to reason that shareholders on the buy side of the transaction would suffer greater losses. Notwithstanding the fact that the defendants in *Van Gorkom* may have sold the company for an inadequate price, the shareholders still would have received a premium of $17 above the market price. Shareholders on the buy side of a transaction, however, receive no such premium.[172]

Applying the Delaware Supreme Court's interpretation of the business judgment rule in *Van Gorkom* to a company's decision to *acquire* a target will ensure that, prior to any decision to launch a tender offer for a particular target, the bidding company will fully inform itself of all reasonably available information about the target.[173] Indeed, if the holding in *Van Gorkom* is strictly applied, bidder company management is obligated to fully inform itself of all reasonably available information on the *value* of the target. Moreover, *Van Gorkom* requires that such information be used to protect the interests of the bidder company's shareholders.[174]

In illustrating the business judgment rule's efficacy in protecting bidder company shareholders from value-reducing acquisitions, it is helpful to apply the above legal analysis to a hypothetical firm faced with the decision of whether to acquire a target. Assume a hypothetical firm faced with the decision to invest in one of two projects: Project A and Project B. The two investment options available to the firm are: acquire a particular target, or expand its existing business by opening up an additional branch office. Also assume that this firm exists at a time when the rate of return on a market portfolio ($R_m$)—an index fund—is twenty percent and the rate of return on a risk-free security ($R_f$)—a ninety-day Treasury bill—is eight percent. Further assume that both projects require a cash pay out of one million dollars and both projects have an expected return of 1.8 million (eighteen percent). A firm faced with such an investment decision will use the Net Present Value Method (NPVM),[175] in conjunction with the Capital Asset Pricing Model (CAPM), to determine which project to undertake.[176]

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172. *See id.* at 868.

173. *Id.* at 874.

174. *See id.*

175. The Net Present Value is a "discounted cash flow technique[] that reduce[s] future cash receipts to present value in determining the value of the asset giving rise to the payments."

176. The Capital Asset Pricing Model is a tool used to determine the relationship between the risk and return of a particular asset. For a discussion of the Capital Asset Pricing Model, see Franco Modigliani & Gerald Pogue, *An Introduction to Risk and Return: Concepts and Evidence (Part II)*, FIN. ANALYSTS J., May–June 1974, at 69–70.

This hypothetical company will use these two valuation techniques for the following reasons. First, the Net Present Value accounts for the value of money. "A dollar today is worth more than a dollar tomorrow"[177] because of opportunity costs: tomorrow, the *opportunity* to invest that dollar today and start earning interest immediately is forgone.[178] This is relevant to a company's decision to buy a target because when a company buys a target, it is paying for a claim on the target's forecasted cash flows. These forecasted cash flows, however, may not materialize until five, ten, or even twenty years after the purchase date. Accordingly, the hypothetical company must take into account the *time value of money*.[179]

The Net Present Value method reduces future cash receipts to *present value*.[180] This allows an asset, the value of which depends on future cash flows, to be valued today at a price that takes into account the foregone opportunity of investing those future cash flows and start earning interest immediately. To begin using the Net Present Value method, the acquiring company first forecasts the cash flow to be generated by the target over the target's expected economic life.[181] The company would then apply the NPV technique to discount the forecasted cash flows to its present value so that the target's value, as determined by its future cash flow, reflects the opportunity cost of capital. However, before the company can take this step, it must first determine the appropriate opportunity cost of capital.[182] To do this, the Capital Asset Pricing Model is used. CAPM tells the hypothetical company how the target's price should reflect certain types of risks–risks which may cause the target's cash flow to be different than expected.[183] In other words, CAPM tells the company what the target's rate of return should be based on the risk involved.

The first step for the company in calculating the opportunity cost associated with each investment option would be to determine the risk associated with each project, or the *beta* of each project, as

177. *See* MYERS & BREALEY, *supra* note 43, at 93.

178. *Id.*

179. *Id.* ("Any investment rule which does not recognize the *time value of money* cannot be sensible.").

180. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 76–77.

181. *See* MYERS & BREALEY, *supra* note 43, at 91.

182. *Id.* The opportunity costs of capital are what the company uses to discount the future cash flow. *See id.*

183. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 81–116 (discussing how risk affects the expected cash flow from a risky investment).

represented by $\beta$.[184] This will enable the firm to determine what the rate of return on each project *should* be.[185] Assume the market has already determined that the systematic risk of the firm's current operations is $\beta = 0.8$, and the firm's investment bankers conclude that the expansion of the firm's existing business will also have a beta of 0.8 ($\beta_e$ = *beta* of expansion project = 0.8). Based on this information, the firm would be able to determine what the rate of return on the expansion project *should* be:

$$R_f + (R_m - R_f)\beta_e$$
$$= 8 + (20 - 8).8$$
$= 17.6$ (discount rate/market rate of return for expansion project is equal to 17.6% or .176).[186]

This tells us that if the firm's shareholders would be able to receive a 17.6% rate of return in the market if they put their money in an investment with a beta of 0.8. This also tells us that the firm's managers should undertake the expansion project, because it offers a rate of return of 18% for a beta of 0.8, but the market will offer only 17.6%.[187]

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184. Gilson and Black explain that a firm is "subject to two qualitatively different types of risk. Some risks are common to many firms . . . though perhaps to differing degrees. . . . These risks affect the profits of all firms . . ." and are called *systematic risk* or *market risk*. THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 91. "Beta is a measure of the *systematic risk* of a particular firm's stock, *relative* to the risk of the market as a whole." *Id.* at 95. The other type of risk is company or industry specific, and is known as *unsystematic risk* or *unique risk*. *Id.* at 91.

185. Determining the systematic risk associated with the target tells us what the target's rate of return should be, because "assets with the same risk should have the same expected rate of return. That is, the prices of assets in the capital markets should adjust until equivalent risk assets have identical expected return." *Id.* at 91. *See also* MYERS & BREALEY, *supra* note 43, at 196 (explaining that if investors are looking for a 9.2% return from an issuers current business, then the cost of capital for a further investment in the same business is 9.2%).

186. As Myers and Brealey admit, "choosing a discount rate is seldom so easy." MYERS & BREALEY, *supra* note 43, at 196. As Myers and Brealey do in their use of an expansion project in a similar hypothetical this model assumes the expansion project has the same risk as the company's existing business. The method described below for determining the beta of the acquisition project will be different. *See id.*

187. According to the Capital Asset Pricing Model, the expected return on an investment should exceed the riskless rate of return by an amount, which is proportional to the portfolio of the *beta*. In other words, if the market gives a rate of return of 8% for a risk-free security with a *beta* of zero, and a rate of return of 20 percent on an investment with a *beta* of 1.0, then CAPM tells us that an investment with a *beta* of 0.8 should offer a rate of return of 17.6%:

After determining the beta of the expansion project and the cost of capital or discount rate for the project, the company is now ready to apply the NPV method to discount the expansion project's forecasted cash flow. If the net present value of the project is positive, then the project will increase shareholder wealth. To determine the net present value of the project, we apply the following formula:

> ERe/(1 + .176) (where ERe is equal to the expected return on the expansion project and 1.176 is the discount rate)
>
> = 1,800,000/1.176
>
> = 1,530,612

The present value of the expected cash in flows of the expansion project is 1,530,612 dollars. The firm would subtract the required cash pay out from this amount:

> 1,530,612 – 1,000,000
>
> = 530,612

The expansion project has a positive net present value and will increase shareholder wealth; therefore, management should undertake the expansion project.[188]

This, however, is not the end of the story. Although the expansion project would increase shareholder wealth, it is still possible for the acquisition project to be a more attractive investment opportunity. To determine this, the management applies the methods used above to the acquisition project. Let us assume that after conducting a regression analysis of the target's stock, the investment

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| BETA | EXPECTED RETURN |
|---|---|
| 0.0 | 8 |
| 0.2 | 10.4 |
| 0.4 | 12.8 |
| 0.6 | 15.2 |
| 0.8 | 1.0 |
| 1.0 | 20.0 |

Investing in a project with a *beta* equal to 0.8 that did not offer a return equal to or greater than 17.6 would expose the firm's managers to liability for breach of their fiduciary duty.

188. *See* MYERS & BREALEY, *supra* note 43. This method can also be used to compare different investment decisions.

bankers decide that the acquisition project has a *beta* of 1.2 ($\beta_a$ = beta of acquisition project = 1.2).[189] The above valuation methods determines whether the acquisition project is more desirable than the expansion project. First, CAPM will be applied:

8 + 1.2(20 – 8)= 22.4where 8 (8%) is the rate of return on the risk-free security, 1.2 is the beta of the acquisition project and 20 (20%) is the rate of return on the market, which has a beta of 1.0. This number (22.4) represents the cost of capital for the acquisition project, or the discount rate for the future cash inflows of the target, which in turn describes the present value of those cash inflows. This number also represents the rate of return that the market would offer on an investment with a beta of 1.2. The acquisition project should *not* be undertaken by the firm because the rate of return on the acquisition project is a mere 18%, while the firm's shareholders could invest in a security with a *beta* of 1.2 and receive a rate of return of 22.4%. The Net Present Value method also demonstrates the acquisition project's undesirability. Applying the Net Present Value formula to the acquisition project reveals a *negative* net present value of –$360,000. Accordingly, the acquisition project would result in a decrease in shareholder wealth and it should not be undertaken by the firm's managers.

Although simplified, the above example does present a rough approximation of the valuation method that is commonly used by many firms to choose between competing investment options. More importantly, however, it demonstrates how the business judgment rule, as construed by Delaware and New York, will adequately protect bidder company shareholders when firm managers employ the Capital Asset Pricing Model and the Net Present Value method. If a board of directors decides to acquire a particular target after being told that the acquisition has a negative net present value, shareholders would have little difficulty in showing that the board's decision lacked substantive due care. Making an acquisition with a negative net present value is clearly "contrary to the fundamental conceptions of prudent [business]

189. According to Gilson and Black, "[t]he best available way [to determine a company's beta] is to run a regression analysis. . . ." THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 94. The regression analysis observes the returns of the company's stock and treats those returns as dependant on return of the entire stock market. That is, the return on a target's stock is a dependent variable that can be explained by (or is dependent upon) factors that contribute to systematic risk. The regression analysis referred to in this note uses just one contributing factor: the entire stock market. *Id. See also* MYERS & BREALEY, *supra* note 43, at 224 ("An obvious way to measure the beta is to look at how its price has responded in the past to market movements.").

practices."[190] Similarly, if management were to make an acquisition with an expected return that, although positive, was lower than the expected return that the market would pay for an investment within the same risk class, shareholders would have a cause of action under the business judgment rule based on a lack of substantive due process.[191]

Consider another scenario, using the above example, where the firm decides to make an acquisition that, while showing a positive net present value, is made on the basis of grossly inadequate or incomplete information.[192] Having failed to take advantage of "all material information reasonably available to it, the board of directors of the firm would be exposed to potential liability based on a lack of procedural due care.[193] Indeed, under *Van Gorkom's* interpretation of the business judgment rule, management of the bidding company can be held personally liable if it does not fully

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190. *See Litwin*, 25 N.Y.2d at 699. It is not completely outside the realm of reason for a firm to make an acquisition with a zero or negative net present value. As Myron Scholes points out, stockholders of a firm with a high debt to equity ratio—a firm worth $100, with outstanding debt with a face value of $90—have a strong incentive to engage in very risky acquisitions that have a zero net present value. Myron Scholes, *Options—Puts and Calls, in* ENCYCLOPEDIA OF INVESTMENTS 559–78 (Marshall Blume & Jack Friedman eds., 1982) *reprinted in* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 234–47. However, negative net present value investments actually harm stockholders. Negative net present value investments reduce firm value, as well as result in the company paying higher interest rates on debt. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 246; *see also supra* note 43 and accompanying text.

191. MYERS & BREALEY, *supra* note 43, at 62 (stating that "at each point in time *all securities in an equivalent risk class are priced to offer the same expected return*").

192. It is possible for a firm to value an acquisition through the use of CAPM but still violate the procedural due care prong of the business judgement rule. For instance, determining a target's *beta* is a necessary step in the CAPM formula—it tells the acquirer what the rate of return on the target should be. The beta of the target would be measured by observing how the price of the target's stock has responded in the past market movements. *See* MYERS & BREALEY, *supra* note 43, at 224. This observation is known as a regression analysis. THE LAW & FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 115. Although a regression analysis can describe the movements of a target's stock and the market, the analysis does not explain *why* the movements occurred. "The event study technique does not eliminate the need to assess cause through deductive reasoning; it only . . . helps delineate what needs to be explained." THE LAW & FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 221. Accordingly, constructing a regression analysis is only the first step in estimating a target's risk. Managers would be held to the business judgment rule's standard of procedural due care in using the results of a regression analysis to determine a target's *beta*. Additionally, managers must forecast the acquisition's future cash flows by using all material information reasonably available to them at the time in order to comply with the procedural due care requirement of the business judgment rule.

193. *See Van Gorkom*, 488 A.2d at 872.

investigate all available information relating to the target-company's value.[194]

Such a case was indeed brought by aggrieved shareholders in the Delaware Court of Chancery. In *In re Cheyne Software, Inc. Shareholders Litigation*,[195] shareholders alleged that management failed to exercise due care when it rejected a tender offer for $27.50 a share, at a time when Cheyne's stock was trading on the market at $15 a share.[196] The tender offer of $27.50 a share, which proposed to use the acquirer's stock as consideration, was "based on the prevailing price of [the acquirer's] stock."[197] However, management determined that if the merger were to succeed, the price of the acquirer's stock would be worth considerably less—$3.50 a share less.[198] Management came to this conclusion by discounting the post-merger cash flow of the acquirer to its present value. Shareholders of the target alleged that management failed to exercise due care because it did not question the discount rate used by the investment bank it hired to value the acquirer's stock after the merger.[199] The Delaware Court of Chancery framed the issue as "[w]hether [the directors of the target] ... acted on an informed basis."[200] According to the court, the answer to this question depended upon "'whether the directors ... informed themselves "prior to making [the decision to reject the tender offer] of all material information.'"[201] Although the court ultimately found that defendants did not breach the duty of care owed to the shareholders,[202] *In re Cheyenne* demonstrates that courts in fact do recognize that managerial decisions concerning such matters as choosing discount rates are subject to the business judgment rule's strict standard of review.[203]

194. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 1054; *see also Trans Union Corp's Ex-directors to Settle Suit for $23.5 Million*, WALL ST. J., Aug. 2, 1985, at 10 [hereinafter *Ex-directors to Settle Suit*].

195. 1996 WL 652765 (Del. Ch. 1996) (unpublished opinion).

196. *Id.* at *3.

197. *Id.*

198. *Id.*

199. *Id.* at *7.

200. *Id.*

201. *Id.* (quoting *Van Gorkom*, 488 A.2d at 872).

202. The court found that the investment bank chosen by defendants to value the acquirer's stock was "selected with reasonable care," and that the information presented by the investment bank was within the bank's "expert competence." *Id.* at 7. The court further found that defendants adequately considered the use of the twenty-one percent discount rate "as well as the impact that different discount rates would have upon the [acquirer's] share price." *Id.*

203. Although *Cheyenne* deals with management's decision to reject a tender offer, the case demonstrates the general proposition that shareholder challenges to a board's selection

While the business judgment rule provides bidder firm shareholders with substantial protection, it does not give aggrieved shareholders a cause of action in cases where the directors took advantage of all material information and invested corporate funds in a project that was both prudent and safe, but still suffered a loss. This however, should not be the goal of the business judgment rule, which "operates to bar courts from providing additional, and unnecessary, constraints on management discretion through judicial review of operating decisions."[204]

In the end, truly overpaying for a target will expose a bidding-company's board of directors to substantial monetary penalties whether the plaintiff bases her claim on a lack of substantive or procedural lack of care.[205] Such penalties efficiently deter any breach of fiduciary duties that bidder-company management owes to shareholders.[206]

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of a discount rate—a choice that must be made in acquiring targets as well as selling the company—will be recognized.

204. Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 839 (1981). Gilson argues that because the various markets—the product market and the market for managerial talent—provide managers with non-legal incentives to avoid inefficient or self-dealing decisions, the "legal elements" of the corporate structure should not provide "redundant controls." *Id.* Gilson believes that this conclusion is true due to the current structure of the "typical corporate statute[which]assigns management responsibility to the board of directors. The business judgment rule measures the discharge of that responsibility." *Id.* This framework prevents the judiciary from imposing restraints on the decision making power through a corporate statute that may duplicate restraints already imposed by the market.

205. In the case of *Smith v. Van Gorkom*, the settlement between the defendant board of directors and the plaintiffs exceeded defendants' coverage under director and officer liability insurance provided by the corporation by $13.5 million.

206. *See* Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1453 (1985). Professor Fischel asserts that the Delaware Supreme Court's decision in *Smith v. Van Gorkom* would result in all firms obtaining a fairness letter from an investment banker before making a fundamental corporate change. *Id.* Professor Fischel's somewhat cynical view of investment bankers as guns-for-hire notwithstanding, *Smith v. Van Gorkom* will cause firms—both on the target and the acquiring side—to make decisions more carefully.

Some would argue that the business judgment rule is of minimal benefit to bidder firm shareholders in such situations. It is unlikely that the opportunity to apply the business judgment rule will arise in a situation where a firm has decided to acquire a target that has a negative net present value. It is more likely that a firm will be faced with two options: acquire a target or distribute the funds that would have been used to acquire the target to bidder firm shareholders. Ideally, the firm should devote funds to the project that maximizes shareholder wealth. That is, a project undertaken by a firm should have a *positive* net present value, and the project should *not* offer an expected return lower than the expected return that the market would offer investments in the same risk class as the project. In the event that shareholders allege that the firm's management overpaid for a target and breached its fiduciary duty, management will most likely call in investment bankers to show that management is purchasing the target at a bargain price. In turn, attorneys for the shareholders will respond by bringing in their own investment bankers who will show that management

### *B. Other Protections For Bidder Shareholders*

*1. Mandatory Disclosure Under the Federal Securities Laws*—Recent academic literature has explored federal securities disclosure requirements and their efficacy in enforcing fiduciary obligations to bidder firm shareholders.[207] In his article, *Required Disclosure and Corporate Governance*,[208] Professor Merritt Fox analyzes the indirect effect of the federal securities laws' mandatory disclosure regime on corporate governance. He argues that mandatory disclosure furthers shareholder participation in corporate governance by "helping shareholders enforce management's fiduciary duties"[209] and by "assist[ing] shareholders in effectively exercising their voting franchise."[210]

*a. Disclosure and the Fiduciary Duties of Managers*—Professor Fox argues that without mandatory disclosure requirements, corporate managers will not disclose the optimal level of information to their shareholders.[211] As a result of the federal securities law's mandatory disclosure system however, firms are required periodically to disclose information that would otherwise remain private. "Without [this] information, it is often impossible for shareholders to know about the potential breach."[212] Professor Fox uses the example of an "issuer transaction[] in which managers have an interest"[213] to demonstrate how mandatory disclosure rules assist shareholders in preventing mangers from breaching their fiduciary duties. Professor Fox argues that:

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has overpaid. The dispute may revolve around the proper discount rate. This game of dueling investment bankers has played out in a number of Delaware cases where shareholders have challenged management's use of tactics to defend against a hostile tender offer. *See* City Capital Associates v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988); *see also Van Gorkom* 488 A.2d at 858; *Cheyenne*, 1996 WL 652765 (Del. Ch. 1996).

207. *See* Edward Rock, *Securities Regulations as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 678 (2002) (describing the mandatory disclosure regime of the "SEC-system" as: "[being] divided between the Securities Act of 1933, ... which regulates issuance of securities, and the Securities Exchange Act of 1934, ... which imposes continuing and periodic reporting requirements in connection with the subsequent trading of securities").

208. Merritt B. Fox, *Required Disclosure and Corporate Governance*, 62 LAW & CONTEMP. PROBS. 113 (1999).

209. *Id.* at 118.

210. *Id.* at 116.

211. *See id.* at 118; *see also* Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

212. Fox, *supra* note 208, at 118.

213. *Id.* at 119.

> Once the existence of a conflict-of-interest transaction is known, shareholders can force management to satisfy its burden of establishing the validity of the transaction. To do this, management must show either that the taint of conflict has been removed by appropriate procedures in the transaction's authorization or, alternatively, that the terms of the transaction are fairly clear to the issuer. Without shareholder knowledge of such a transaction, the burden placed on management by corporate law is meaningless.[214]

This argument is equally convincing in the case of aggrieved shareholders that decide to bring an action against a firm's managers alleging that an acquisition, or series of acquisitions, amounts to a breach of the managers' fiduciary duty. A plaintiff alleging a breach of fiduciary duty based on a lack of substantive or procedural due care will have to show that the transaction in question was unreasonable or that the directors made their decision on an uninformed basis. This requires that shareholders have access to information regarding the merits of the transaction, as well as the process used and information considered in assessing the value of the acquisition. The mandatory disclosure regime of the federal security laws provides bidder company shareholders with this information. For example, the Management Discussion and Analysis section of the Securities and Exchange Commission's form 10-K, in addition to form 10-Q, requires management's analysis of current financial operations and conditions.[215] These analyses amount to more than just conclusory statements; they contain pages of detailed information concerning the issuer's financial operations and condition.[216]

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214. *Id.*

215. Section 78m of the 1934 Exchange Act requires issuers that are registered with the SEC under § 78l of the Exchange Act to file periodic reports with the SEC "as necessary or appropriate for the proper protection of investors. . . ." With the enactment of the Exchange Act, Congress gave the newly formed SEC the power to prescribe the form and content of such periodic disclosures with the mandate that "such information and documents . . . keep reasonably current the information and documents required to be included in or filed with an application or registration statement[,] . . . [and] such annual reports . . . certified . . . by . . . independent public accountants, and such quarterly reports . . . as the Commission may prescribe." 15 U.S.C. § 78m(a) (1994). *See also id.* § 78m(b) ("The Commission may prescribe . . . the form or forms in which the required information shall be set forth, [as well as] the items or details to be shown in the balance sheet and the earning statement . . ."). In keeping with Congress' mandate, the SEC created periodic reporting obligations for covered issues in the form of current (Form 8-K), quarterly (Form 10-Q), and annual (Form 10-K) reports. *See* 17 C.F.R. 249.308, 249.308a and 249.310, respectively.

216. The forms used by issuers making periodic disclosures provide shareholders with valuable information concerning the issuer's financial condition. This information enables

*b. Disclosure and the Shareholder Voting Franchise*—The mandatory disclosure regime of the federal securities laws also enables bidder firm shareholders to better protect themselves through use of their voting franchise.[217] The information distributed to a firm's shareholders through the mandatory disclosure regime results in "better informed" shareholders,[218] who "are more likely to know whether their interests favor retention or ouster of [incumbent management]."[219] Furthermore, Professor Fox argues that the collective action problems normally experienced by a large group of dispersed shareholders that attempt to vote as a bloc would be overcome by the existence of large, or institutional, shareholders and the mandatory disclosure regime.[220] Mandatory disclosure allows large shareholders to obtain information concerning an issuer at little to no cost. As a result:

> Substantial positive externalities exist when a large shareholder does receive information because the shareholder likely will exercise its franchise in a way that will enhance the interests of all shareholders. When these externalities are added up, it becomes cost-justified for each shareholder to receive the same amount of information from management as the single owner would want. Required disclosure can be seen, therefore, as a way of aggregating the demands of each

the issuer's shareholders to intelligently assess business decisions made by the issuer's board of directors and to exercise their voting rights accordingly. For example, Items 301–305 of Form 10-K (also known as the "management discussion and analysis" section) require issuers to disclose "'known events, trends or uncertainties, that are *reasonably likely* to impact the company making the disclosure.'" *See* Martin H. Dozier, *Barings's Ghost: Item 305 in SEC Regulation S-K and "Market Risk" Disclosures of Financial Derivatives*, 34 GA. L. REV. 1417, 1453–54 (2000). Item 303 obligates issuers to disclose any known information that may affect the future liquidity, capital resources, or operating results of the issuer. *See* 17 C.F.R. § 229.303. Of all the disclosure requirements, Form 8-K provides bidder company shareholders with the most significant protection. It requires issuers to provide shareholders with information concerning special events that take place between the required annual and quarterly reporting dates. Pursuant to § 17 C.F.R. 249.308, an issuer must file a special report with the SEC for specific events, "such as bankruptcy, *significant mergers or acquisitions*, or a director's controversial resignation." D. Casey Kobi, *Wall Street v. Main Street: The SEC's New Regulation FD and its Impact on Market Participants*, 77 IND. L. J. 551, 570 n.161 (2002) (emphasis added).

217. *See* Fox, *supra* note 208, at 116.

218. *Id.*

219. *Id.*

220. Collective action problems exist when the costs of seeking out information about a corporation exceed the returns that even a large shareholder could expect to receive from such efforts. *Id.* at 118.

> large shareholder for information to be provided to itself and to other shareholders.[221]

The federal securities law's mandatory disclosure regime would therefore allow bidder firm shareholders to use their voting franchise to oust incumbent management who do not maximize shareholder wealth. This safeguard, along with the others mentioned in this Note, provide a persuasive case against altering the status quo to provide bidder firm shareholders with extraordinary legal protections.

*c. Federalism, Interstate Competition and Corporate Governance*—Principles of federalism and the resultant interstate competition, also provide bidder firm shareholders with additional protection from any inappropriate acquisition decisions. Due to interstate competition, any particular state's standard of review for managerial decision making will be set at the *socially optimal level.* Jurisdictions in the U.S. compete among each other for the prize of having corporations choose to incorporate within their boundaries because:

> The location of a firm can lead to the creation of jobs, and thus to increases in wages and taxes—important benefits for a state. As a result of this additional factor, competitive jurisdictions will consider the potential benefits, in terms of inflows of industrial activity, of setting standards [concerning the fiduciary duties owed by a board of directors to a corporation's shareholders] that are less stringent than those of other jurisdictions, and, conversely, the potential costs, in terms of

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221. *Id.* at 119. *But cf.* Mark A. Sargent & Dennis R. Honabach, *Proxy Regulation and the Corporate Governance Debate, in* PROXY RULES HANDBOOK § 1.1. Sargent and Honabach argue that it is possible that the interests of institutional shareholders will not be aligned with the interests of individual shareholders. They state:

> It is far from clear that the interests of institutional shareholders are aligned with the interests of John and Jane Doe. Some critics of the institutional shareholder activism question the underlying belief that institutional shareholders will continue to employ activists strategies. They note that a number of different types of institutional shareholders fall within the larger heading of 'institutional shareholder,' including pension funds, mutual funds, banks, insurance companies, educational institutions, religious orders and others. While public pension plans have been quite active, other categories have been less so. Critics . . . suggest that many institutional shareholders will be compelled by the risk adverseness of their own investors to restrain from taking active roles in corporate governance.

Sargent & Honabach, *supra.*

outflows of industrial activity, of setting more stringent standards.[222]

In other words, the standard of review used to assess a board's decision to acquire a target, will be such that the marginal benefits from the standard of review will be equal to the marginal costs (harms suffered by bidder company shareholders as a result of bidder overpayment). As Richard Revesz demonstrates, "interstate competition can be seen as competition among producers [the states] of a good—the right to locate within the jurisdiction."[223]

For example, let us assume a model consisting of two states—State A and State B. Both states compete to attract the most corporations to incorporate within each state's respective borders in order to reap the benefits described above. Assume further that the residents of State A and B will be the only investors to invest in any corporation that incorporates within the borders of the two states. Now assume that each state's legislature has the choice of establishing a standard of review for managerial decisions; the intrusiveness of the standard of review may from a level of 1 to 10, 1 being the least intrusive and 10 being the most intrusive. Finally, assume that both the residents of State A and State B, as well as any corporation, can move from one state to another without incurring costs.[224]

In such a competitive environment, the intrusiveness of the standard of review chosen by each jurisdictions should be at the socially optimal level. That is, the level of corporate-governance laws that either state would enact for the protection of its respective residents should result in benefits that are equal to the harms suffered by the investing public due to any breach of fiduciary duty by a corporation's managers.[225] If any one state imposes a standard of review at a level of intrusiveness, which is *above* the optimal level, that state will experience a loss of industry: corporations will migrate to, or initially incorporate in the state that sets its laws at the optimal or below the optimal level of corporate governance. On the other hand, a state attempting to lure more corporations within its borders by enacting a standard of review at a lower than optimal level will experience two problems. First, residents will begin to migrate to the state that has enacted a standard of review at

222. Richard Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation* 67 N.Y.U. L. REV. 1210, 1215 (1992).

223. *See id.* at 1233.

224. This is an adaptation of the model used by Revesz. *See id.* at 1216.

225. *See id.* at 1238.

the optimal level. Second, corporations will migrate due the relatively small number of residents living in the state who can contribute capital and labor to the corporation. Accordingly, competition among the various state jurisdictions will produce the socially optimal level of protection for bidder firm shareholders.[226]

*d. The Market for Corporate Control*—The market for corporate control also protects bidder firm shareholders from imprudent and financially unsound acquisitions.[227] The imprudent or self-dealing decisions of management will presumably cause a decrease in the firm's profits.[228] This decrease in the firm's profits "causes the price of the corporation's stock to decline to a level consistent with the corporation's reduced profitability."[229] According to Gilson, a decrease in the price of a firm's stock due to imprudent or self-dealing management:

> [C]reates an opportunity for entrepreneurial profit. If shares representing control can be purchased at a price which, together with the associated transaction costs, is less than the shares' value following displacement of existing management, then everyone—other than the management to be displaced—benefits from the transaction.[230]

If one accepts the rationale underlying the theory of a corporate control market, then one must also accept the proposition that

226. This model assumes that corporations, as well as citizens, consider State A to be an adequate substitute for State B and vice versa. Whether the two states are adequate substitutes is important in determining whether an increase in the strictness of any state's corporate governance laws above the socially optimal level, will have the effect described above. In other words, the response to an increase in the strictness of the state's corporate governance laws depends on the elasticity of demand—the ratio of percentage change in the quantity of the good demanded (in the above example, the right to locate within a state) to the percentage change in price leading to the quantity change. For example, if State A enacted corporate governance laws above the socially optimal level, and State B was an adequate substitute for State A, then State A would experience a migration of the corporations incorporated within its borders. This assumes, however, that corporate governance laws offer the only opportunity for State A and State B to compete for corporations. Tax law and environmental regulation, for example, present two more opportunities for competition among the states. A corporation may choose to stay in State A , despite the fact that the corporate governance laws are above the socially optimal level in State A, if the costs of State A's corporate governance laws are less than the cost that the corporation would incur from the tax and/or environmental regulation of State B.

227. *See* Gilson, *supra* note 204, at 841 (stating that "it is now commonly acknowledged that the market for corporate control is an important mechanism by which management's discretion to favor itself at the expense of shareholders may be constrained").

228. *Id.*

229. *Id.*

230. *Id.* at 841–42.

managers who make acquisitions for reasons other than maximizing shareholder wealth could not exist in such a market. As stated earlier, the primary—if not sole—evidence used to demonstrate that bidder firms overpay for targets is the negative cumulative abnormal returns experienced by the bidder firm's shares at different points in time in relation to the imprudent purchase. If these negative abnormal returns were truly the result of an imprudent or self-dealing acquisition, then other firms in the market for corporate control would acquire the bidding firm. If, however, the negative abnormal returns experienced by the bidder firm's shares can be traced to some other cause, then the bidder firm's management will not be displaced by the market for corporate control.[231] Therefore, there can be but one result—inefficient or self-dealing mangers will not exist where there is a market for corporate control.[232]

## IV. ALTERNATIVES TO THE BUSINESS JUDGMENT RULE

### A. *Requiring Bidder Firm Shareholder Approval of Acquisitions*

In order for a publicly traded firm to obtain the approval of a group of dispersed shareholders, the bidder firm will have to engage in a proxy solicitation. A firm attempting to acquire a target through the use of a tender offer will naturally desire to prevent the disclosure of its acquisition plans.[233] Requiring bidder firms to first obtain the approval of its shareholders before making an acquisition would decrease the likelihood that the acquisition would

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231. In order for the market for corporate control to successfully displace inefficient or self-dealing management, "[t]wo important conditions [must be satisfied]. . . . First, *the market price of the corporation's stock must accurately reflect incumbent management's inefficiency or greed.* Second, there must be mechanisms available for displacing corporate management." *Id.* at 842 (emphasis added).

232. Richard Booth asserts that:

> [I]nvestors seem clearly to prefer that management refrain from conglomerate diversification over various lines of business as a way to smooth out income, presumably because investors themselves can diversify their holdings virtually costlessly. The proof is that stocks of conglomerate companies tend to trade at a discount from asset value, making such companies attractive takeover targets because the pieces can be sold off at a gain by the acquirer.

Booth, *Stockholders, Stakeholders, and Bagholders*, *supra* note 117, at 435–36.

233. *See* Staffin v. Greenberg, 672 F.2d 1196, 1206 (3d Cir. 1982).

occur, or at the very least, would make acquisitions more costly to the bidder firm. This increase in cost can occur for two reasons.

Assume that a bidding firm wishes to acquire a particular target based on the belief that the target's shares are undervalued by the market.[234] If the news that the shares of this particular target are undervalued were to reach the investing public, there would be an upswing in the price of the target's shares.[235] Such an upswing would make the target a much less attractive acquisition to the bidding firm because it would decrease the profit that the bidding firm could have realized had the information not been made public.[236]

Secondly, as Coffee points out in his article, it is highly likely that information concerning a bidding firm's plans to acquire a target will be leaked to the investing public.[237] Coffee argues that securities information, because it is a public good, displays the key characteristic of non-excludability, meaning that the information "seldom can be confined to a single user because many people have a motive to leak it."[238] Shareholders of the bidding firm, upon learning of the upcoming acquisition of a target, will purchase shares of the target in preparation for the upcoming acquisition. However, the use and divulgence of the upcoming acquisition will not stop there.

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234. A target may be undervalued due to inefficiencies in the market. An inefficient market is one in which "the prices of publicly traded common stocks do not correctly reflect all information available to investors." *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 135. Conversely, the use of the term "efficient market" refers to a market that is efficient in the "semi-strong form," meaning that "at any point in time, market prices *are an unbiased forecast of future cash flows that fully reflects all publicly available information.*" *Id.*

235. *See* Coffee, *supra* note 211, at 725.

236. Hechler, who advocates the use of the shareholder voting franchise to approve corporate acquisitions, concedes that such a requirement would result in bidders paying more for targets. She states that in order for to obtain shareholder approval for an acquisition:

> Presumably, management would be expected to issue proxy statements providing information about the terms of the proposed acquisition. If . . . shareholders accepted the deal, further complications would arise if another corporation offered the target a higher bid. [If management is] forced to reissue proxy statements every time it raises its bid . . . [there will be] a significant increase in the cost of bidding and presumably a reduction in the number of bids. . . . *[A]ll* bidders would be affected by the voting rights mechanism. 'Good' bidders might abandon bids because of the added expense of administering a potentially complicated voting process.

Hechler, *supra* note 7, at 381.

237. Coffee, *supra* note 211, at 725–26.

238. *Id.* at 725.

> "In fact, it [will] generally [be] in the [shareholder's] interest, once he has traded, to inform others to create excitement and induce a market upswing. Otherwise, the [shareholder] achieves only the dubious victory of owning an undervalued security, and as the Wall Street Traders' credo says: 'A bargain that remains a bargain is no bargain.' "[239]

Accordingly, making shareholder approval a pre-requisite to a bidder firm's purchase of a target would most likely discourage many acquisitions from taking place.[240] This in turn decreases the effectiveness of the market for corporate control, which would leave inefficient managers in place to continue their inefficient use of the target's resources.[241]

One possible way to ease the conflict between the hostile bidder's desire for a speedy and silent takeover and the shareholders' desire for an *ex ante* opportunity to vote for or against a hostile acquisition is the internet voting mechanism suggested by Professor Richard Painter.[242] Although Professor Painter discusses the internet voting mechanism as a way for target firm shareholders to approve or veto management's use of defensive tactics, the same voting method may be used to ease tensions between the managers and shareholders of bidder firms. Painter's model would allow a firm to proceed with its efforts to acquire a target, while providing a forum in which shareholders can vote against the transaction.[243] If a majority of the bidder firm's shareholders cast votes against the transaction via the internet, then the firm management must cease with its efforts to acquire the target.[244]

Although Painter's internet voting mechanism is suitable for enabling target firm shareholders to approve or disapprove management's use of defensive tactics, the model would be unworkable

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239. *Id.* at 725–26.

240. In Hechler's proposal—which is to "require a supermajority ratification of all proposed acquisitions"—many acquisitions that facilitate the market for corporate control will be *prevented*, not merely discouraged. *Id.* at 380. Furthermore, requiring a supermajority vote for all acquisitions would, in many cases, give institutional investors the sole power to prevent an acquisition. *Id.* Where the gains to be realized by a transaction outweigh the loses suffered by the disapproving institutional investor(s), and the institutional investor is allowed to veto the transaction through the use of supermajority voting structure, socially optimal transactions will be prevented.

241. *See infra* Part III.

242. *See* Christian Kirchner & Richard W. Painter, *European Takeover Law—Towards a European Modified Business Judgment Rule for Takeover Law*, 1 EUR. BUS. ORG. L. REV. 353, 382–83 (2000).

243. *Id.* at 382.

244. *Id.*

when employed to give bidder firm shareholders the opportunity to approve or disapprove a firm's acquisition decision. First, unlike a firm's decision to adopt defensive tactics, which usually consists of an agreement between management and the firm's shareholders, a firm's efforts to acquire a target often involve payments to and/or agreements with third parties.[245] Furthermore, the delay the bidder will experience while obtaining shareholder consent would not be significantly less than the delay experienced through the use of a proxy solicitation.[246] When it comes to approving defenses, Professor Painter is correct when he asserts that "[o]n-line tallying of votes would be speedy because, instead of using record ownership dates, a computer can invalidate a shareholder's vote as of the date the shares are sold."[247] The process, however, would be considerably slower in the case of hostile acquisitions. In order to approve the propriety of an acquisition, a shareholder would have to obtain, analyze, and verify all material information about the transaction. These efforts are costly and time consuming.[248] It is possible for a hostile bidder employing the multistep acquisition technique to have completed the first two steps of the process—purchasing a block of the target's shares and announcing a tender offer for the target—before enough shareholders analyze and verify all relevant information about the transaction and vote. It would cause problems for the bidder if, after a successful tender offer for the target's shares, the bidder learns that a majority of its shareholders disapproved the transaction. Accordingly, a bidder firm forced to seek the approval of its shareholders in this manner may actually deter acquisitions that create efficiency and maximize shareholder wealth.

245. *See supra* Part II(B) (discussing how the multi-step acquisition can decrease the uncertainty of a hostile bidder successfully acquiring a target).

246. Hechler's advocacy of the shareholder voting franchise as a protective measure stems from her proposition that if shareholders voted to ratify an acquisition that "later proved to be financially destructive," shareholders would have the option of suing managers based on the managers' use of false or misleading proxy statements. Hechler, however, automatically assumes that if an acquisition turns out in the future to be unprofitable and shareholders approved the acquisition, then the proxy statements used to solicit shareholder approval of the acquisition must have contained false or misleading information. *See* Hechler, *supra* note 7, at 388–89. This conclusion, however, is not warranted in many cases.

247. Kirchner & Painter, *supra* note 242, at 382–83.

248. The costs of obtaining the information may be zero, however, if the disclosure requirements found under the SEC's proxy rules apply.

### *B. Expanded Judicial Review*

Another reform proposal suggested by Hechler is the application of a heightened standard of review in cases where a shareholder challenges management's acquisition decision(s).[249] Hechler opines that the basis for the Delaware court's development of the intermediate standard of scrutiny applied in *Unocal*—the omnipresent threat that managers will, in defending against a takeover, act in their own interests instead of the interests of shareholders[250]—*may* apply to the same degree when managers acquire a target.[251] Before examining the specific proposals, this part will first explore the underlying basis for Hechler's proposals—that agency conflicts exist to the same degree for target acquisitions as for defenses against a takeover bid. This Note argues that the potential for manager/shareholder agency conflicts does not exist to the same extent in the case of managerial acquisition decisions as it does for managerial decisions to defend against a takeover bid.

To demonstrate this proposition, it is necessary to first examine the different explanations for why management would act to further its own interest, and not the shareholders, in deciding to acquire a target. Bernard Black asserts that managers will act in their own interests due to "[i]ncentives to increase size" and "[i]ncentives to diversify the firm."[252] According to Black:

> Incentives to increase size include managers' desire for greater prestige and visibility, the desire of the chief executive officer to leave a legacy and not be a mere caretaker, and compensation structures that reward growth in sales and profits. These incentives for growth may lead managers to overinvest, either by expanding their own business or by buying a new business.[253]

The threat that managers will disregard the interests of their shareholders to fulfill desires for prestige and visibility cannot be described as an "omnipresent specter." Black asserts that management would obtain the prestige and visibility it desires by

249. Hechler, *supra* note 7, at 383.

250. *Unocal*, 493 A.2d at 946.

251. Hechler, *supra* note 7, at 383 (stating that "[l]ike the target managers in *Unocal*, managers of acquiring firms often put their own interests before that of their shareholders").

252. *Bidder Overpayment*, *supra* note 7, at 627.

253. *Id.* (citation omitted).

over-investing—"expanding their own business or by buying a new business." However, management would unlikely take such actions due to restrictions imposed by the market for corporate control.[254] Mark Mitchell demonstrates this in a study where he observes the "stock price reactions" to acquisition announcements made by two groups of firms—firms that subsequently became targets in takeover attempts and firms that did not receive a takeover bid—during 1982–1986.[255]

Mitchell's study distinctly demonstrates the preventative effect that the market for corporate control has on the likelihood of management engaging in empire-building acquisitions. Mitchell summarizes the result of his study as follows:

> Estimates . . . reveal that the probability of becoming a target firm during 1982–1988 was significantly related to the stock price effects associated with the announcement of acquisitions made by the firms in our sample: the more negative these effects, the higher the likelihood of a subsequent takeover. The probability of becoming a hostile . . . target is especially related to these stock price effects.[256]

The implications of Mitchell's findings for the assertion that the market for corporate control makes empire-building acquisitions unlikely are two-fold. First, if firms that make acquisition decisions based on prestige or visibility become takeover targets in the end, shareholders that experienced a stock decrease due to management's imprudent acquisition decisions will recover those loses by receiving a premium for their shares from a subsequent hostile bidder.[257] Second, Mitchell's study demonstrates that there are "good" and "bad" bidders. One should not lose sight of the dangers of modifying the current standard used for reviewing managerial decisions to acquire a target: such modification may have a chilling effect on the managers of both good and bad acquirers, which will in turn result in a less effective market for corporate control.[258]

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254. *See supra* Part I(C).
255. OFFICE OF ECONOMIC ANALYSIS, *supra* note 10, at 5.
256. *Id.*
257. *See id.* Because of the Delaware Supreme Court's mandate in *Revlon*, which requires a firm's board of directors to obtain the highest possible price for the firm's shareholders, shareholders are almost assured of recovering any economic loss they suffered due to the actions of incumbent management. *See Revlon*, 506 A.2d at 182.
258. *See supra* Part I(C).

The threat that managers will put their interests before those of shareholders by diversifying the firm's portfolio, also falls far short of an ubiquitous threat. First, the possibility that risk averse managers will *over*-invest by buying a new business can be dealt with through the use of *ex ante* agreements between management and shareholders. By offering its managers options, a firm can make managers less risk averse and thereby lessen the likelihood that managers will acquire new businesses to diversify the firm's portfolio.[259] Dealing with risk averse managers *ex ante* is preferable to litigation that would be drawn out, costly and harmful to the firm—even if such litigation takes place under a modified business judgment rule. Second, the market for corporate control sufficiently deters managers from any harmful diversification of the firm's portfolio. Mitchell asserts that the hostile takeovers during the mid-1980s demonstrated how the market for corporate control eliminated firms that made unwise acquisitions—conglomerate mergers—during the 1970s and early 1980s. He states:

> Generally, the evidence reviewed above pertains to takeovers during the 1970s and early 1980s. A unique feature of hostile takeovers during this period is that many of these transactions were motivated by the acquiring firms' desire to sell a substantial portion of the target firms' assets. To the extent that these 'bust-up' takeovers prune target firms of 'poorly' performing assets which the target firms had acquired in earlier takeovers, then these transactions can be viewed, in part, as 'undoing' some of the unprofitable takeovers of the 1970s and early 1980s.[260]

Third, even diversification strategies that result in a decrease in the acquirer's stock price may serve the economic interests of the acquirer's shareholders. As indicated in Part II.C. of this Note, Shleifer and Vishny argue that the conglomerate mergers of the 1970s furthered the interests of long- and short-term shareholders of the acquiring firm.[261] The resultant increase in efficiency from the conglomerate mergers produced positive abnormal returns to the benefit of short-term shareholders. Although abnormal returns were negative in the long-term, Shleifer and Vishny argue that the

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259. *See* THE LAW AND FINANCE OF CORPORATE ACQUISITIONS, *supra* note 7, at 249 ("Options will also enhance the profit incentive, and can make the managers more willing to accept risk.").

260. OFFICE OF ECONOMIC ANALYSIS, *supra* note 10, at 10.

261. *See* SHLEIFER & VISHNY, *supra* note 3.

acquirers' stock prices would have suffered greater declines in the absence of these conglomerate acquisitions.[262]

Despite the fact that any managerial self-interest that may exist when a company is acquiring a target fails to rise to the level of the threat identified in *Unocal*, Hechler insists on the need for a more intrusive standard of review for acquisition decisions. Hechler's form of expanded judicial review would provide bidder company shareholders with a cause of action to challenge a proposed or completed merger or acquisition.[263] For a proposed acquisition, Hechler would allow bidder company shareholders to seek an injunction preventing the company's managers from completing the proposed transaction.[264] In the case of a completed transaction, shareholders would be permitted to bring an action for money damages, if the plaintiffs could show some loss resulting from the acquisition.[265] In either case, the plaintiffs would need to "plead a prima facie case that managerial self-interest was a primary motivation behind the proposed or completed merger or acquisition, which was in conflict with management's loyalty to shareholders."[266]

The problems with Hechler's form of expanded judicial review are readily apparent; indeed, Hechler herself recognizes her proposal's shortcomings. The first problem, discussed earlier in Part I of this Note, concerns the unproven connection between negative abnormal returns and the wealth-maximizing effects of an acquisition. As Hechler readily admits, "market inefficiencies may make it difficult for shareholders to show past or potential loss when challenging acquisitions."[267] The lack of an established or accepted connection between abnormal returns and the value of a particular transaction would make assessing plaintiffs' losses extremely problematic. A similar problem will exist in cases where plaintiffs' challenge an acquisition ex ante seeking injunctive relief. As previously stated, Hechler's proposal requires a prima facie showing of managerial self-interest as the primary motivation behind a challenged acquisition. In the absence of direct evidence of such self-interest, plaintiffs are likely to rely on circumstantial evidence as proof of managerial self-interest. Such circumstantial evidence would probably take the form of negative abnormal returns experienced by the bidder company's stock at some point

262. *See id.*
263. Hechler, *supra* note 7, at 386.
264. *Id.*
265. *Id.*
266. *Id.*
267. *Id.*

surrounding the announcement of the acquisition. However, for such evidence to have any probative value, one would have to assume that the stock market "perfectly reflects" information concerning a proposed transaction's wealth affects and that "judges will be able to distinguish material declines from temporary noise in the stock markets."[268] Neither assumption is likely to be true.

A more fundamental problem with Hechler's proposal for expanded judicial review concerns the proposal's effects on the corporate decision making process in general. In *Unocal*, where the Delaware Supreme Court adopted a standard of review more intrusive than the business judgment rule, the judicial determination required is relatively straight forward and simple. In Unocal-type cases, a court is faced with a situation where the stock of a potential target is trading at one price, a hostile bidder is offering a huge premium to the target's shareholders and target management is blocking the deal. In such cases, determining the propriety of target management's resistance to the deal requires a finding of fact as to the value of the target's shares and determining whether the hostile bid gives the target's shareholders the best price. Reviewing a managerial decision to acquire a target, however, is not so simple.

Acquisition decisions made on the basis of expected synergy gains and increases in the operating efficiency of the target embody time consuming, costly and complicated research and analysis by the bidder company. In deciding whether to grant a group of bidder company shareholders relief, a court would need to "ferret[] out 'good' from 'bad' bidder managements." As Hechler correctly observes: "on the target side, judges have not been terribly keen in choosing between loyal and disloyal target managers." As a result "[o]ne might wonder then, why judges would do such a better job ferreting out "good" from "bad" bidder managements."[269] Additionally, any judicial efforts to engage in this onerous and difficult task would "gut[] the business judgment rule entirely."[270] The business acumen and expertise of seasoned corporate managers would be replaced with what Black describes as the "meager" business acumen of judges.[271]

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268. *Id.* at 387.

269. *Id.*

270. *Id.* at 385–86.

271. *See Bidder Overpayment, supra* note 7, at 651 (quoted in Hechler, *supra* note 7, at 386 n.197). Opining on the expanding the business judgment rule for acquisition decisions, Bernard Black states:

### *C. Liability Rule Protection*

The next reform that Hechler suggests borrows from a protective measure for target shareholders proposed by Robert Daines and Jon Hanson, and is known as a "liability rule" regime.[272] Ultimately, the liability regime amounts to nothing more than making the acquirer's management insurers of the acquirer's stockholders. Hechler's proposal would require that the managers of an acquiring firm engage in what Hechler calls "acquisition bonding."[273] That is, Hechler's liability regime would require the acquirer's managers "to pay into an escrow account following the acquisition an amount of money up to the point necessary to make the stock move above the price it was trading at prior to the announcement of the acquisition."[274]

This proposal is problematic for a number of reasons. First, Hechler's liability regime requires the acquirer's management to pay into an escrow account an amount necessary to bring the price of the acquirer's shares back to the pre-acquisition announcement price. This requirement is based largely on two assumptions which were addressed earlier in this Note. First, it assumes that the negative abnormal returns earned after an acquisition announcement is made have enough probative value for managers to be held personally liable. This is questionable, as the investing public's reaction to the announcement may not reflect an unbiased view. Second, the requirement relies entirely on the cumulative abnormal return methodology's ability to demonstrate a clear connection between the movement in the price of the acquirer's stock and the acquisition announcement. As discussed earlier in Part I, both assumptions may be incorrect. Even if it was possible to definitively say that negative abnormal returns occurred as a result of the investing public's reaction to an acquisition announcement, it remains possible that enough members of the investing public

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> I would not change judges' reluctance, embodied in the business judgment rule, to second-guess takeover bids and other investment decisions. The costs of litigation are too high, and the business acumen of judges too meager, to make it likely that the benefits of greater judicial scrutiny will outweigh the costs.

*Id.*

272. Hechler, *supra* note 7, at 390 (citing Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law*, 102 YALE L.J. 577 (1992)).

273. *Id.* at 392.

274. *Id.*

overreacted hat, in the aggregate, public sentiment did not produce an equilibrium price for the acquirer's stock post-announcement.[275]

Finally, as stated above, applying the liability rule regime to corporate acquisitions reduces managers to insurers of the firm's stockholders. This is troublesome for two reasons. First, due to the corporation's separation of ownership from management, investors purchase equity positions in corporations fully aware of the risk of mismanagement.[276] Moreover, because the possibility that managers will engage in imprudent acquisitions is reflected in the price of the acquirer's stock,[277] and because many stockholders are able to eliminate company specific risk through diversification, using the liability regime, where the acquisition decision falls short of "an intentional infliction of loss" would give acquirer shareholders a windfall.[278]

In short, the liability rule regime will result in an externality: due to the liability rule regime's compensation scheme, shareholders will not take into account the costs of managerial negligence associated with the purchase of stock in a corporation. This resultant externality will prevent capital from being allocated to corporations in accordance with investor valuations.[279] Hence, the liability rule regime provides bidder firm shareholders with a windfall at the expense of overall economic efficiency.

### *D. Auction Reform*

Hechler also suggests auction reform as a potential protective measure for bidder shareholders.[280] Hechler asserts that the auction process, by its very nature, results in bidder overpayment. Hechler seeks to modify the auction process in such a way as to decrease bidder overpayment, while simultaneously avoiding the underpayment for targets.[281] Hechler's first suggestion is to limit

275. *See* Freund & Easton, *supra* note 93, and accompanying text.

276. *See Joy*, 692 F.2d at 886.

277. *See supra* note 83, and accompanying text.

278. *See* Booth, Stockholders, *Stakeholders, and Bagholders*, *supra* note 116, at 437 (stating that the intentional infliction of harm is different, because it cannot be protected against by diversification).

279. *See* S.E. RHOADS, THE ECONOMIST'S VIEW OF THE WORLD, GOVERNMENT, MARKETS AND PUBLIC POLICY 67 (1985).

280. Hechler, *supra* note 7, at 393.

281. *Id.* at 394.

the number of bidder allowed to participate in a target's auction. However, she is forced to note that limiting the number of bidders allowed to participate in an auction would exclude some bidders with unique synergies with a target resulting in an inefficient allocation of resources.[282] Alternatively, by preventing all willing participants from taking part in a target's auction, Hechler's proposal would have a prohibitive effect on the market for corporate control, the purpose of which is replace the target's inefficient management with management that is able to make the *most* efficient use of the target's resources.[283] When the number of auction participants is limited, the acquirer who is able to make the *most* efficient use of the target's resources may be excluded. An auction limited in such a way would result in the acquisition of the target by an acquirer who, while able to increase efficiency beyond the level of incumbent management, will not make the *most* efficient use of the target's resources.

Hechler also suggests that bidder shareholders will be better off if the uncertainty of the target's value is eliminated. To achieve this, Hechler proposes the elimination of sealed bids in the auction process.[284] However, this may create legal problems for the target company. Once a target engages in a transaction that will result in a change in corporate control or a break-up of the corporate entity, the target's management is obligated to seek the best value reasonably available to its shareholders.[285] Any perceived bias could result in a finding that the target's management breached its fiduciary duty to its shareholders. In *Paramount v. QVC*, for example, the Delaware Supreme Court found that Paramount's directors failed to seek the best value reasonably available to its shareholders when favorable treatment was extended to one auction bidder at the expense of another.[286] As a result of the holding in *Paramount v. QVC*, directors may feel obligated to use sealed bids to minimize their liability to shareholders based on allegations of disparate treatment of competing bidders. Hechler's proposal, therefore, should focus on loosening the judicially created protections afforded target shareholders during the auction process. Without

282. *See id.*

283. *See generally*, Mitchell & Lehn, *supra* note 73 (arguing that a motive for corporate takeovers is to discipline managers who operate their firms in ways that do not maximize profits).

284. Hechler, *supra* note 7, at 394.

285. *See* Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1993).

286. *See id.*

the threat of a shareholder suit looming over the heads of target management, the use of sealed bids may very well fall out of favor.

## CONCLUSION

The timing and characteristics of the next wave of mergers and acquisitions remain uncertain. However, the next epidemic of mergers and acquisitions will present the same host of legal problems that the courts have struggled with over the last three decades. Due to the increasing focus on the effects that corporate acquisitions have on bidder shareholder returns, judicial analysis will focus more on protecting the interests of bidder shareholders.

No one would deny that the acquisition decisions of management should be subject to some form of judicial review. The power of management to purchase targets, like any other power assigned to corporate managers, may be used to further the interests of management to the detriment of the firm's shareholders. The existing legal regime, however, adequately protects the interests of bidder shareholders while simultaneously allowing managers to engage in the day-to-day operations of the firm. The substantive and procedural arms of management's obligation to act with due care shape the corporate investment decision making process. Moreover, market mechanisms, interstate competition, and federal securities laws provide additional protections for bidder shareholders.

When managers use company assets to acquire a target, the business judgment rule obligates them to make only those acquisitions that hold out the prospect of at least a market rate of return. Acquisitions promising anything less would expose management to shareholder liability on the basis that the acquisition decision lacked substantive due care, because shareholders could have done better for themselves by investing dividends in the market. Additionally, shareholders have the option of suing management based on allegations that management did not inform itself of all material information and, as a result, unjustifiably believed that an acquisition would produce a market rate of return. Management should, of course, be allowed to challenge both allegations. After-the-fact litigation is an execrable way to review corporate investment decisions, which by their very nature are made under uncertainty. Using uncertain methodologies and theories such as the cumulative abnormal returns method and the efficient capital markets hypothesis as triggers for managerial strict liability would have a chilling effect on managerial decision making and the market for corporate control.