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THE UNCERTAIN SEARCH
FOR HIDDEN VALUE

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Bernard Black & Reinier Kraakman***

ABSTRACT

It is easy sport to criticize the Delaware takeover cases as inconsistent with the empirical evidence, each other, and a sensible allocation of power between managers and shareholders. We in fact believe all of these things. Here, however, we offer a more sympathetic account of the core Delaware takeover cases. We argue that they reflect an often unstated "hidden value" model, in which a firm's true value is visible to corporate directors but not to shareholders or potential acquirers. We explore the assumptions needed to make the hidden value model internally consistent, and contrast those assumptions to those that underlie to a "visible value" model in which shareholders and potential acquirers are well informed about firm value or can be made so through disclosure by the target's board. (One outcome of carefully stating the hidden value model's assumptions is to expose the model's problems.) We also address and reject to a "control premium" theory, sometimes invoked by the Delaware courts, in which control is a corporate asset that the law protects by imposing Revlon duties on the target's board. Assuming that the Delaware courts continue to embrace hidden value, we argue that takeover decisions should, at a minimum, be governed by a bilateral decision-making structure, in which a target board's initial decision to approve an acquisition, block a takeover bid, or choose one bidder over another must be approved or rejected by shareholders. Under this approach, target boards could adopt modest deal protections and say "no" to a takeover bid by adopting a poison pill, but could not say "never" by using a staggered board to block a bid after the bidder wins a proxy contest. The courts must also strictly limit efforts by target boards to stuff the ballot box or otherwise alter shareholder vote outcomes.

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I. INTRODUCTION

It is good academic fun to trash the Delaware takeover cases as inconsistent with the empirical evidence, each other, and a sensible allocation of power between managers and shareholders. We in fact believe all of these things. In this Article, however, we offer a more sympathetic account that links the core Delaware takeover cases to an often implicit "hidden value" model of the stock market, in which a firm's true economic value is visible to well-informed corporate directors but not to the company's shareholders or to potential acquirers. Our thesis is that this model underlies the principal Delaware takeover cases, including both those governing defenses against hostile takeover bids, beginning with *Unocal v. Mesa Petroleum*,¹ and those governing friendly corporate "sales," starting with *Smith v. Van Gorkom*² and *Revlon v. MacAndrews & Forbes*.³

At first glance, *Van Gorkom*, *Unocal*, and *Revlon* appear to involve three distinctive fact patterns and at least two different areas of corporate law. On its face, *Van Gorkom* is a business judgment rule case, which found corporate directors to be were grossly negligent in approving an arms-length sale of the company. By contrast, *Unocal* is a hostile takeover case that addresses the board's discretion to deploy defensive tactics to defeat a hostile takeover bid, while *Revlon* is a friendly takeover case which limits the target board's discretion to favor a "white knight" buyer over a competing hostile bidder, and holds that a board of directors must maximize shareholder value when it sells the company.

In fact, however, *Van Gorkom* should be seen not as a business judgment rule case but as a takeover case that was the harbinger of the then newly emerging Delaware jurisprudence on friendly and hostile takeovers, which included the almost contemporaneous *Unocal* and *Revlon* decisions.⁴ *Van Gorkom*'s unforgiving scrutiny of the Trans Union board's casual sale of their company anticipates *Revlon*'s holding that a target company's board

¹ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

² 488 A.2d 858 (Del. 1985).

³ *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

⁴ This point was articulated by Jon Macey and Geoffrey Miller. See Jonathan R. Macey & Geoffrey P. Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 135-40 (1988). The Macey-Miller view of *Van Gorkom* was a minority view at the time. See, e.g., Eric A. Chiappinelli, *Trans Union Unreconsidered*, 15 J. CORP. L. 27 (1989) (arguing that *Van Gorkom* is a business judgment rule case with application to all board decisions).

must maximize shareholder value once it decides to sell the company.⁵ Less obvious is that *Van Gorkom* also introduced the core justification for board discretion that was developed in the takeover defense cases, beginning with *Unocal* and continuing through *Moran v. Household International, Inc.*,⁶ *Paramount Communications. v. Time*,⁷ *Paramount Communications. v. QVC Network*,⁸ and *Unitrin. v. American General*.⁹ These cases all rely on *Van Gorkom*'s concept of intrinsic or "hidden" value that a hard-working board can assess, but that remains invisible to shareholders and potential acquirers.

Crucially, this hidden value must be not only unknown to shareholders and acquirers, but *unknowable*—it cannot credibly be disclosed by the board. For, if hidden value were disclosable to shareholders, a simpler approach to takeover regulation would be to give the board a reasonable period of time to disclose what it knows and then let the shareholders decide whether the company should be sold. Even if hidden value is not always disclosable to shareholders, if acquirers can both see and capture this value, the target board, in most cases, would not need the power to reject all bids over shareholder objection, but only sufficient time to obtain a full price for the company in the takeover market.

We are obviously not the first to comment on Delaware's concept of hidden value. Under different labels, hidden value is a commonplace in discussions of Delaware's takeover jurisprudence. For example, it is closely related to the Orwellian notion of "substantive coercion," a term which one of us now regrets having introduced more than a decade ago to describe how a court might (by squinting) conclude that shareholders who wished to accept a tender offer were coerced into doing so, merely because the target's board considered the offer price to be too low.¹⁰ We believe, however, that the full import of the hidden value model as a loose judicial theory of finance remains unexplored, particularly its relationship to the disparate treatment that the Delaware courts accord to directors' duties in cash and stock acquisitions. The hidden value model merits analysis not because it is right – we don't think it is – but because it is the only paradigm that makes sense of the broad outlines of the Delaware case law. The model's twists and turns are those of the doctrine, and the model's failings are the weaknesses of the law.

⁵ *Revlon*, 506 A.2d at 175-76.

⁶ 500 A.2d 1346, 1357 (Del. 1985).

⁷ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1142 (Del. 1990).

⁸ *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1993).

⁹ *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995).

¹⁰ See Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 259-65 (1989). The term "substantive coercion," introduced in this article, was adopted by the Delaware Supreme Court in *Paramount v. Time*, 571 A.2d at 1153 n.17. Hidden value and substantive coercion can be viewed as two sides of the same coin. Hidden value is what the board sees; substantive coercion is what the shareholders would suffer, if the board allowed them to, because the shareholders don't see the firm's hidden value.

In this Article we begin by offering a descriptive account of the hidden value model on its own terms. We explore the extent to which it can—and cannot—justify Delaware's takeover jurisprudence, especially Delaware's acceptance of defensive tactics that prevent shareholders from selling their shares to a takeover bidder at a mutually agreeable price. We also address (and reject) an alternative "control premium" theory that the Delaware courts have invoked to justify some key takeover holdings, under which target shareholders must be compensated with a control premium whenever a board-sanctioned transaction installs a new controlling shareholder. We argue that the control premium theory is of little use in justifying Delaware's core takeover cases.

Our analysis proceeds as follows. Part II of this Article undertakes to define a minimum set of assumptions that are needed to support the hidden value model. We develop the strong assumptions that are needed to make the hidden value model internally consistent. We contrast these assumptions with those that underlie a "visible value" model, in which shareholders and potential acquirers are either well informed about firm value or can be made so through disclosure by the target's board of initially hidden value. The visible value model is the empirical predicate for an approach to takeover regulation that relies on shareholder choice -- the approach that we and many other academics prefer.¹¹ Part II also explains why the hidden value model can, while the control premium theory cannot, explain important elements of Delaware's takeover law.

Next, Part III explores the logic and limits of the hidden value model, as a justification for core Delaware takeover doctrines, especially the cash versus stock (or control versus noncontrol) distinction that divides strict scrutiny under *Revlon* from relaxed review under *Unocal/Unitrin*. We argue that the hidden value model can explain why *Revlon* should not apply to a merger of rough equals, but that *Revlon* should apply when a large company buys a smaller target, using stock as consideration.

In the remainder of this Article, we move from exposition of the hidden value model to critique. In Part IV, we discuss the model's internal inconsistencies and dubious empirical support. We also explain why investment banker "fairness" and (even more so) "inadequacy" opinions do not merit the respect that *Van Gorkom* and later cases accord them, as a check on the board's claim of hidden value.

Finally, in Part V, we offer "second best" policy suggestions, which are based on the assumption that the Delaware courts will continue to em-

¹¹ The classic example is the British City Code regime, which denies target boards the power to implement defensive tactics after a hostile bid is made. See PANEL ON TAKEOVERS AND MERGERS, THE CITY CODE ON TAKE-OVERS AND MERGERS (1993) [hereinafter CITY CODE]. The City Code prescribes detailed ex ante regulation for tender offers and mergers that contrasts sharply with the common law regulation of takeovers under U.S. corporate law. The Takeover Panel is a self-regulatory body that enforces the City Code. Its rules and decisions are binding because companies that do not comply will be delisted from the London Stock Exchange.

brace the hidden value model, and reject the shareholder-centered approach to takeover regulation that we prefer. Even accepting the hidden value model, we argue that takeover decisions should, at a minimum, be governed by a bilateral decision-making structure, in which a decision to approve an acquisition (whether cash or stock), reject a takeover bid, or choose one bidder over another is made first by the board, but must then be approved or rejected by shareholders. This bilateral structure is familiar, as the way that Delaware and most other corporate statutes assign decision-making rights for critical decisions where board and shareholder interests may conflict, including mergers, sales of all or substantially all assets, and charter amendments.¹²

The bilateral decision-making approach leads to policy recommendations that differ only modestly from Delaware's current course. But this modesty may be useful, given that the Delaware courts are unlikely to endorse the restrictions on target board discretion that we and many other academics would prefer. For example, the bilateral approach provides a middle road under which target boards can adopt modest but not preclusive deal protections, can "just say no" to a takeover bid by employing a poison pill defense, but cannot say "never" by using a staggered board plus a poison pill to block a hostile bid for another year after the bidder wins a proxy contest. To preserve the shareholders' right of review, the courts should vigorously protect shareholder votes from board efforts to manipulate voting outcomes.

II. THE HIDDEN VALUE MODEL: ORIGINS AND ASSUMPTIONS

The hidden value model is anything but hidden in the case law. It is described first, and to our minds most strikingly, in *Van Gorkom*. But virtually every subsequent Delaware Supreme Court opinion involving defensive tactics implicitly refers to or elaborates on the hidden value model, although not by this name. Because the leading Delaware cases are well known and thoroughly written about, we will not ground every assertion we make with citations to cases or to the secondary literature.¹³ We begin with an overview of the model as it operates in *Van Gorkom*, and then discuss more generally the assumptions underlying the model.

¹² See DEL. CODE ANN. tit. 8 §§ 242 (1991) (charter amendments), 251 (mergers), 271 (sale of all or substantially all assets). Our advocacy of bilateral decisionmaking is similar to a position long held by Marcel Kahan, although we offer this position with less enthusiasm and base it on a very different analysis of the Delaware takeover cases. See Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994).

¹³ For a sampling of the academic and practitioner commentary on *Van Gorkom*, see the other articles in this Symposium and also R. Franklin Balotti & Mark J. Gentile, *Commentary from the Bar: Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL J. CORP. L. 5 (1987); Chiappinelli (1989), *supra* note 4; Leo Herzel & Leo Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAWYER 1187 (1986); Macey & Miller (1988), *supra* note 4; and E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 DEL. J. CORP. L. 503 (1986).

A. *Van Gorkom and the Hidden Value Model*

Van Gorkom is an unusual case in many respects, but one of its most remarkable features is its implicit theory of “intrinsic corporate value.” In *Van Gorkom*, the Trans Union board of directors approved the cash merger of their company with a subsidiary of Marmon Group at \$55 per share, a 50% premium to Trans Union’s pre-announcement market price. The Trans Union board ensured that the sale price was subject to a serious market check for whether someone else might pay more, including an effort by Trans Union’s investment bankers to seek potential buyers. The merger was overwhelmingly approved by a shareholder vote after ample disclosure.¹⁴ Nevertheless, the Delaware Supreme Court found that the board was grossly negligent in approving the merger, principally because the directors acted too casually in evaluating the merger price.¹⁵ They decided too quickly (in a single two-hour meeting), relied on their collective knowledge of the company rather than the advice of an investment banker, and, critically (as we see it), allowed themselves to remain “uninformed as to [Trans Union’s] intrinsic value.”¹⁶

Van Gorkom’s surface message—that a board planning to sell its company must diligently seek the best price for shareholders—is the same message that *Revlon* reiterates and refines.¹⁷ The subtext of *Van Gorkom*, however, is that the board of directors, and no one else, must determine the company’s intrinsic value. The board cannot rely on shareholder approval to discharge its duty, nor may it rely principally on prices set by the stock market or the takeover market. Because others may miss the company’s hidden value, the board must value the firm itself, preferably with an investment banker’s assistance. The importance that *Van Gorkom* places on the board’s efforts to value the firm sets the stage for the hidden value model and the three principal pillars of Delaware’s current law of corporate takeovers: deferential to a board’s decision not to sell the company and install takeover defenses, yet willing to closely examine the board’s decision to sell the company for cash, yet again deferential (by pretending that the company is not being sold) if the board sells the company for stock instead of cash.

The logic behind this two-track structure is straightforward. On the one hand, only the board can discern the company’s hidden value. For this reason, a board that fails to take its role seriously—that relies on values set by the market or its shareholders instead of determining value itself—abdicates its statutory responsibility in a way that easily shades into gross

¹⁴ The court complains about the adequacy of the market check and the disclosure preceding the shareholder vote, but both seem ample to us and to most of the commentators who have written about the opinion. Reading the opinion as a whole, we think it unlikely that a stronger market check would have changed the court’s decision.

¹⁵ *Smith v. Van Gorkom*, 488 A.2d 858, 877-78 (Del. 1985).

¹⁶ *Id.* at 874.

¹⁷ *See Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 182 (Del. 1986).

negligence. On the other hand, the courts will not allow anyone, especially not shareholders, to second-guess a board that hires expert professionals and acts diligently to value the company. Thus, if such a board concludes that a hostile bid is too low, its judgment trumps shareholder preferences even if the hostile bidder offers a large cash premium over the target's market price.

Similarly, if a diligent board deems a stock-for-stock offer more valuable than a cash offer, its opinion controls even if the acquirer offers shares with a market price far below the cash offer. The reason is again the potential for hidden value. The board knows best how to discern hidden value both in the target's standalone value and in its synergies with the acquirer. The board may even know best how to value the acquirer's stock. This hidden value will emerge eventually and benefit long-term shareholders who continue to hold the acquirer's shares. The board's insight into hidden value justifies its discretion to accept or reject deals.

B. *The Hidden Value Model and Shareholder Primacy*

In two important respects, the model of hidden value that emerges from *Van Gorkom* and later cases is conventional. First, it assumes the primacy of shareholder interests. In *Van Gorkom*, as in *Revlon* and its progeny, the board's duty is to maximize shareholder value without regard to the interests of other corporate constituencies such as creditors or employees. *Revlon*, in particular, commands that the sale of a solvent company must be structured to serve the interests of the firm's shareholders and no one else.¹⁸ To be sure, language in other cases appears to sanction board consideration of other concerns.¹⁹ But logic compels the conclusion that the board cannot pursue these interests at the expense of long-term shareholder value. Were the law otherwise—were boards permitted to defeat tender offers that benefit shareholders but harm employees in the long run, for example—it would make no sense to prevent boards from considering employee interests in selecting cash buyers for their firms. Yet *Revlon* instructs us that boards *must* maximize short-term shareholder value when companies are sold, so boards must also have a duty to maximize long-term shareholder value at other times. Any other result would undermine director accountability and create perverse incentives for directors, shareholders, and stakeholders alike.

We believe that this inference from *Revlon* is good policy -- that directors *should* seek to maximize long-term shareholder value. But we seek here to make a point of logic, not to replay the debate among corporate law

¹⁸ *Id.* at 185.

¹⁹ See, e.g., *Unocal*, 493 A.2d at 955 (in considering whether to implement takeover defenses, a target board may consider, inter alia, the impact of a bid "on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally . . .)"); *Paramount v. Time*, 571 A.2d at 1155 (quoting this language from *Unocal*); *id.* at 1152 (noting with approval the Time board's "zealousness . . . in seeing to the preservation of Time's 'culture'").

scholars over the corporation's proper goals. The point is that under Delaware law, the board must always maximize shareholder value. The real import of the distinction between cash and stock transactions is that the hidden value model gives the board many more degrees of freedom in determining how to pursue shareholder interests in a stock transaction.²⁰ Thus, the board can consider intangible factors such as corporate reputation, or it can favor what it believes to be long-term value over short-term shareholder returns. Viewed in this light, judicial permission to weigh nonshareholder interests is not a license to ignore shareholder interests; it simply recognizes the broad sweep of the board's discretion to decide what actions will maximize long-run shareholder value. For example, a company's board is well within its powers to decide against layoffs, which will increase this year's earnings, if it believes that this action will maximize shareholder value in the long run.

A second way in which the hidden value model is conventional involves the broad deference judges give to board decisions about value. The board's decision about the company's true value, if adopted with an investment banker's advice and after procedures that satisfy *Van Gorkom's* standards, is treated like other business judgments that boards make. The decision must be manifestly crazy before the Delaware courts will reject it. As with other types of business judgments, one searches in vain for cases that reject the board's valuation decision on the merits, even when, as in *Paramount v. Time*, an objective observer would likely conclude that the Time board's decision was, in fact, crazy.²¹

²⁰ The Delaware Supreme Court has signaled both long-term shareholder primacy and the broad scope of board discretion by observing that

Unocal is not intended to lead to a simple mathematical exercise: that is, of comparing the discounted value of Time-Warner's [the target company's] at some future date with Paramount's [the hostile bidder's] offer and determining which is higher. Indeed, in our view, precepts underlying the business judgment rule militate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders.

Paramount Communications, Inc. v. Time, 571 A.2d 1140, 1153 (Del. 1990).

²¹ This Article is not the place to analyze *Paramount v. Time* with care. Suffice it to say that the Time board's original stock-for-stock merger with Warner, which gave 62% of Time's post-merger shares to Warner shareholders and would have produced a Time share price of around \$100, could not have been better for shareholders than a sale to Paramount at the \$200 per share Paramount had offered, let alone the higher price it had signaled its willingness to pay, unless one assumes that the market made errors of implausible size in valuing Time, Warner, or the synergy between the two companies.

Assume, for example, that Warner's market value was correct (Time's board had little unique insight into Warner's value), and that the expected synergy was just enough to compensate for the premium that Time would pay for Warner shares (a high level of synergy was implausible because much of Time had little overlap with much of Warner). Time would then have to be worth an astonishing \$363 per share for shareholders to do as well in the initially proposed merger as they would with the \$200 Paramount offer. This number is so high because the merger would convey 62% of Time's hidden value to Warner's shareholders. For Time's shareholders to receive \$100 per share in hidden value, the actual hidden value per share would have to be $\$100 / (.38) = \263 . For further discussion of *Paramount v. Time*, see RONALD GILSON & BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* ch. 1 (2d ed. 1995); Jeffrey Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931 (1991). For a

C. *The Assumptions Underlying the Hidden Value Model*

While the hidden value model embraces the primacy of shareholder interests and judicial deference to boards' business decisions, it takes a less conventional approach to capital market efficiency and corporate agency problems. Here, the hidden value model contrasts with an alternate model, more standard among legal and finance scholars who study takeovers, which we will call the "visible value" model. In particular, the hidden value model makes nine core assumptions that most financial economists and corporate law scholars (ourselves included) would contest. Our goal in this Section is not to criticize the assumptions underlying the hidden value model, but to clarify the model and how it differs from a more standard academic approach, which we term the visible value model. We defer critical analysis to Part IV.²²

First, the quality of the board's private information is very good. The hidden value model assumes that boards often see how to create corporate value that is invisible, at least in the near term, to both shareholders and potential acquirers. The board and senior management need no help in generating hidden value through ordinary business decisions. But when boards make merger and acquisition decisions, they are well advised to seek professional assistance. At least since *Van Gorkom*, the Delaware Supreme Court has suspected the judgment of boards that enter acquisition agreements or reject takeover bids without obtaining an investment banker's opinion that confirms their judgment. With a supporting fairness opinion, however, the board's judgment is nearly sacrosanct.

By contrast, the visible value model postulates that shareholders who are informed by public disclosure requirements are reasonably good at assessing a company's value. The visible value model concedes that the board can have nonpublic company-specific information. But this inside information is seen as limited in importance and offset by professional investors' countervailing advantages—including greater objectivity, greater industry expertise than most outside directors, and better comparative information about other companies. Moreover, potential acquirers can be given access to the confidential information that underlies the board's assessment of hidden value. Thus, given the available mix of public and private information, the hidden and visible value models draw sharply different conclusions about the relative abilities of boards, shareholders, and potential acquirers to value a company's shares.

retrospective analysis of Time-Warner's share price versus Paramount's offer, see Ronald J. Gilson, *Lipton and Rowe's Apologia for Delaware: A Short Reply*, DEL. J. CORP. L. (forthcoming 2002),

²² For an effort to develop a formal model that overlaps with the hidden value model, see Andrei Shleifer & Robert W. Vishny, *Stock Market Driven Acquisitions* (Nat'l Bureau of Econ. Research Working Paper No. 8439, Aug. 2001), available at <http://papers.ssrn.com/abstract=280292> (developing a model of takeovers in which managers are loyal and know firms' true value, while shareholders don't). For an effort to stress that academic skepticism about Delaware's takeover rules rests as much on concern about agency costs as on belief that market prices are efficient, see Gilson (2002), *supra* note 21.

Second, the board's ability to communicate its private information to shareholders and potential acquirers is poor. The hidden value model assumes that corporate value is often so well obscured that shareholders and potential acquirers not only do not know it, they cannot credibly be informed of it. This can be because the information is soft and cannot be effectively conveyed, it will not be believed, or the hidden value will be diminished by premature disclosure. If the board could credibly tell shareholders (even just sophisticated investors) what it knows about value, it would be hard to understand why the board's conflicted decision about value should trump the shareholders' unconflicted decision. Similarly, if the board could credibly inform potential acquirers about hidden value, it could capture this value by auctioning the firm. Given the risk of board disloyalty or error, this would leave scant justification for a just-say-no defense.

In contrast, the visible value model assumes that the board can usually inform shareholders and potential acquirers about the private information that it holds, and that shareholders and acquirers will rationally evaluate this information. Thus, informed shareholders who disagree with the board's decisions are usually right, and the board's contrary views are usually either self-interested or mistaken. Or, at least, the risk of board error or disloyalty outweighs the risk of shareholder error.

Third, the magnitude of the board's private information is often large. The hidden value model supposes that the divergence of true hidden value from market price can be extremely large. Both stock market and takeover market prices can be not only inefficient, but highly so, in a way that is immune from corrective disclosure. In *Paramount v. Time*, for example, the Delaware Supreme Court never questioned the Time directors' judgment that post-merger Time-Warner shares, which investors valued at \$100 or a bit more, were worth more than the \$200 in cash that Paramount had offered (let alone the higher price that Paramount had signaled it was willing to pay).²³ By contrast, a more standard view, reflected in the visible value model, is that the revelation of private information may sometimes affect stock prices, perhaps by as much as ten or even twenty percent of the firm's market value, but rarely by the amount of the premia at stake in most takeover battles.

Fourth, hidden value can remain hidden for long periods of time. The hidden value model assumes that corporate value can remain unseen by the market for extended periods of time. Of course, these periods must end sometime if hidden value is to be more than an empty promise. Hidden value must eventually flow into share prices and reward patient investors. But its latency period may be several years or more. By contrast, the visible value model assumes both that investors are generally well informed and that pricing errors, when they arise, are corrected with reasonable dis-

²³ See, e.g., ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 93-94 (1991). On the implausibility of the Time board's judgment, see *supra*, note 21.

patch. Hidden value, although possible, is likely to be both small in magnitude and short lived in duration—a matter of months or perhaps a year, rather than a number of years.

Fifth, most target boards are trustworthy, more so than shareholders believe. Even if information asymmetry were common and large, as the first four assumptions posit, we would still face a policy choice between relying on better-informed decisions by conflicted target boards, and worse-informed but unconflicted decisions by shareholders. In such a world, shareholders would understand their own limited information and would defer to the board's judgment, if they trusted it. To justify allowing the board's view on value to trump a contrary shareholder view, one must also believe that boards that reject takeover bids are usually trustworthy, and shareholders wrongly distrust these board decisions.

In contrast, the visible value model posits that shareholders are competent to assess the board's trustworthiness, and thus the board's claim that hidden value exists. Many academic proponents of shareholder choice also are more skeptical about target board motives. They might agree that most boards are loyal most of the time, but would likely differ on board motives in the cases of interest—where a target board rejects a takeover bid without seeking alternatives, or prefers a bid with lower visible value over a competing bid with higher value.

Sixth, an investment banker's opinion is a credible check on the target board's claim of hidden value. *Van Gorkom* and later cases virtually require the target's board to obtain an investment banker's advice before accepting or rejecting a takeover bid, by giving substantial weight to such an opinion. This weight rests on three potentially separate assumptions. First, the investment banker, informed by access to the target's confidential business information, can reliably measure hidden value. Second, the banker is sufficiently independent so that its opinion provides a credible check on the board's claim of hidden value. Third, shareholders wrongly distrust investment bankers, and thus wrongly fail to defer to the banker's judgment.

In contrast, the visible value model discounts how much the investment banker's access to nonpublic information matters. Visible value proponents also see investment bankers' opinions as little more than camouflage that is bought and paid for by the target's board. They observe that these opinions routinely assume the correctness of management's projections of future performance, without discounting for the risk that the projections won't be achieved. Visible value proponents believe that shareholders are right to heavily discount investment banker opinions.

Seventh, hidden value often cannot be captured in the takeover market. Investment banker opinions offer, at best, a questionable check on management's judgment. If hidden value can be captured in the takeover market, a better check will often be available. The target can give potential acquirers the same information they give to their bankers. Acquirers often have industry expertise, and can hire their own bankers. Acquirer should see the target's hidden value. If takeover markets are competitive and they

can capture this value, they should be willing to pay for it. Thus, one approach to the combined risks of board error or disloyalty on the one hand, and shareholder error on the other, would be to give the target's board time to auction the target, but not the power to block all bids. Hidden value proponents would respond that takeover prices are unreliable. Possible reasons include: acquirers may be overly skeptical about target prospects; the takeover market is often uncompetitive (with few likely bidders for each target); companies will be reluctant to tell their competitors (the most likely buyers) too much about their nonpublic plans and prospects; and if the target's managers are uniquely skilled, they can achieve greater value than an acquirer.

Visible value proponents would likely respond that: acquirers are rationally somewhat skeptical of management projections; the takeover market is reasonably competitive for most companies;²⁴ and, subject to a confidentiality and nonuse agreement, companies can disclose sufficient information to reasonably inform potential buyers about hidden value and do so routinely in friendly acquisitions. They would be doubtful about how often the target's managers can achieve more value (without the synergy from an acquisition) than an acquirer can achieve (with this synergy).

These seven assumptions are the minimum assumptions we think are needed to sustain the internal coherence of the hidden value model. However, the model is reinforced by two important supporting assumptions.

Eighth, long-term shareholders and short-term shareholders have different interests, and long-term shareholders' interests should control. The hidden value model implies that large differences may exist between short- and long-term corporate value—and that between the two, long-term value should control in setting company policy. The company's long-term shareholders matter; short-term shareholders do not; arbitrageurs who bet on merger completion deserve special disdain. Long-term shareholders suffer a real loss if they sell their shares before hidden value emerges. In contrast, if short-term shareholders sell their shares before hidden value finds its way into share prices, no harm is done, as this is merely a wealth transfer among fungible short-term shareholders. If short-term shareholders had greater power, they would neglect long-term value that they could neither see nor expect to receive.

The visible value model sees the asserted distinction between short-term and long-term investors as ill-specified (the cases never make clear who, besides arbitrageurs, counts as a short-term shareholder) and nonsen-

²⁴ There are surely cases where the target has unique synergy with a particular buyer. In this case, if all buyers know each others' reservation prices, the best buyer will offer just enough to beat the second best offer, and will capture the gains from the unique synergy. In more complex, imperfect information and bilateral negotiation models, the unique synergy gains will be shared between the target and the best buyer. Unique synergy can make the corporate control market imperfectly competitive, in a sense. But it is not apparent how unique synergy can justify the board in not selling to anyone, which ensures that the unique synergy will be lost.

sical. Under elementary principles of finance, even short-term investors have an incentive to maximize the firm's long-term value, because only by doing so can they maximize the price at which long-term investors will buy the shares that short-term investors will soon want to sell (the unity of long- and short-term shareholder interests is known as Fisher separation). Arbitrageurs, meanwhile, are mere intermediaries, whose preference for a quick sale mirrors the choice exercised by other shareholders who sold their shares to the arbs.

Ninth, the interests of undiversified investors count more than those of diversified investors. A long-term undiversified investor suffers a permanent loss if the company is sold for less than true value, including any hidden value. Diversified investors see the world differently. Ex ante, the diversified investor is as likely to hold the acquirer's as the target shares. The possible wealth transfer from one to another is a diversifiable risk, that to first order affects neither expected return nor systematic risk, and thus does not affect value. Hidden value can matter to a diversified investor for a number of reasons: some acquirers are privately held; the target's management may be better able than the acquirer's management to achieve the hidden value; one acquirer can achieve greater hidden value than another, perhaps due to unique synergy; managers and entrepreneurs are often undiversified, and ignoring hidden value when selling the company weakens their incentives to create value. Still, diversified investors care less about hidden value than undiversified investors, perhaps much less.

The hidden value model implicitly values the interests of undiversified investors, who care about obtaining the maximum price for this company, over those of diversified investors, who care less about this. In contrast, the visible value model assumes that shares are fairly priced, so sensible investors should diversify. This reduces the importance of hidden value. If the importance of hidden value is muted for many shareholders, the balance between the relative risks of error by shareholders and the takeover market on the one hand, and board error or disloyalty on the other, shifts against board discretion.

Taken together, these nine differences between the hidden value and visible value models imply a large difference in the board's role when the firm receives a takeover bid. In the hidden value model, boards should have great latitude to adopt decisions that benefit long-term, undiversified shareholders against selling too cheaply. The model recognizes that inside directors are conflicted because their jobs are at stake in a takeover battle, but responds by assigning the power to adopt takeover defenses to outside directors, who are assumed to have much weaker conflicts of interest.

In contrast, the visible value model implies a larger governance role for shareholders and the takeover market, and a smaller role for the board, in deciding when and at what price a company should be sold. Thus, either the board should maximize visible value, save perhaps when visible value is only modestly less than the board's belief as to true value, or shareholders rather than the board should decide whether to accept the offer (as they do

under the British City Code).²⁵ In most cases these two alternatives will lead to the same outcome.

D. The Control Premium Theory Is Not a Viable Alternative

The Delaware case law contain an alternative theory that often parallels the hidden value model. This is a “control premium” theory, first introduced by the Delaware Chancery Court in *Paramount v. Time*,²⁶ and subsequently adopted by the Supreme Court in *Paramount v. QVC*.²⁷ *Revlon* was adopted in the middle of the hostile takeover wave of the 1980s. As the wave continued and grew, the Delaware courts faced strong pressure from major corporations and their counsel to allow a broad range of takeover defenses and relax *Revlon*'s strict requirement that once a company was being sold, the board had to sell to the highest bidder.²⁸ One way to relax *Revlon* was to let the board favor one bidder over another, as long as the favoritism was not too gross. A second way was to narrowly construe when the company was being sold. The Delaware Supreme Court rejected the first approach, holding boards to a high standard of fair dealing between competing bidders, most notably in *Mills Acquisition Co. v. Macmillan, Inc.*²⁹ The Delaware courts instead narrowed the scope of *Revlon*, in varying amounts at varying times. The control premium theory has been a principal tool for narrowing *Revlon*.

A fair statement of current doctrine is that a board sells “control,” and thus triggers *Revlon* duties to seek the highest price and be rigorously fair between competing bidders, when it agrees to exchange a controlling stake in the company, either for cash or non-voting securities, or for voting shares in an acquirer with a controlling shareholder but *not* when it exchanges 100% of its voting shares for voting shares in a widely held acquirer, most commonly through a stock-for-stock merger. (Whether *Revlon* applies to the remaining possibility, exchange of a less than 100% stake for a widely

²⁵ General Principle 7 of the British City Code prohibits “any action to be taken by the board of the offeree company in relation of the affairs of the offeree company, without the approval of the shareholders in a general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits.” CITY CODE, *supra* note **Error! Bookmark not defined.** Rule 21 of the City Code expands upon this principle.

²⁶ *Paramount Communications, Inc. v. Time, Inc.*, 1989 WL 79880 at *18 (Del. Ch. July 14, 1989).

²⁷ *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42-43 (Del. 1993). In brief, the Delaware Supreme Court, in dictum in *Paramount Communications, Inc. v. Time*, 571 A.2d 1140, 1150-51 (Del. 1990), construed *Revlon* narrowly to apply only when a company auctions itself, or decides to break itself up into pieces. Four years later, after a change in personnel, the Delaware Supreme Court in *Paramount v. QVC* broadened the scope of *Revlon* to apply to any “change of control.” 637 A.2d at 48. *Paramount v. QVC* purports to interpret, but in practice overrules, the narrow reading of *Revlon* in *Paramount v. Time*, and reinstates much of the Chancery Court’s analysis in *Paramount v. Time*, which the Supreme Court had rejected at the time.

²⁸ For discussion of how this political pressure likely affected Delaware doctrine, see Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001); Gordon (1991), *supra* note 21.

²⁹ 559 A.2d 1261, 1264-65 (Del. 1989).

held acquirer's voting shares, isn't clear.)

The exchange of all of the target's voting shares for the voting shares of another widely held company is *not* a sale of control, and thus does not trigger *Revlon*, on the logic that control of the target company was before, and control of the combined company remains afterward, in a "fluid aggregation of unaffiliated stockholders."³⁰ As we discuss in Part III.D, the decided cases appear to apply this logic regardless of the relative sizes of the acquirer and target. Thus, in a stock-for-stock merger, control is deemed not to change. This result holds both for a rough merger of equals, when it may be hard to know who is the acquirer and who is the target, and when there is a clear acquirer and target. For present purposes the important point is that *Paramount v. Time* and *Paramount v. QVC* treat control as an asset that is owned by shareholders either collectively or individually. Control is either held "in the market," when a corporation is held diffusely, or held by a controlling shareholder or group if one exists.³¹

The heart of the control premium theory is the observation, frequently made by the Delaware courts, that public shareholders must be compensated with a control premium whenever a board-sanctioned transaction introduces a controlling shareholder and the company previously had no controlling shareholder. *QVC* articulates the reasoning behind the model: public shareholders in a company can sell control once and only once. Therefore, they are entitled to capture the value of control by earning a premium when control is sold.³² Transactions that sell control in diffusely held companies must maximize (short-term) shareholder value to ensure that shareholders receive full payment for these control rights. In contrast, stock-for-stock mergers where the acquirer is diffusely held leave control in the market and hold out the possibility that a future acquirer will pay a control premium for the combined company in the future.

There are, however, major problems with this argument. Let us accept, *arguendo*, the premise that control is a discrete asset that has value separate from the firm's other assets. Evaluating that premise is a complex exercise that is beyond the scope of this Article. We also accept *arguendo* the premise that control, separate from the firm's other assets, is a highly valuable

³⁰ *QVC*, 637 A.2d at 43 (holding that a change of control will be found in a stock-for-stock merger if the buyer has a controlling shareholder). *Revlon* duties are also triggered, as in *Paramount v. QVC*, if the acquirer has a controlling shareholder control after the acquisition.

³¹ For an early analysis of the scope of *Revlon*, see Ronald J. Gilson & Reinier Kraakman, *What Triggers Revlon?*, 25 WAKE FOREST L. REV. 37 (1990). Gilson and Kraakman proposed a form of the sale of control test in which a board sells control by either approving the sale of a controlling block of stock or relinquishing managerial control of the surviving company in a merger transaction. This test was motivated by the agency problems that arise during a management team's "final period" before leaving the company. Consistent with its general pattern of de-emphasizing managerial agency problems, however, the Delaware Supreme Court chose to look only to share ownership in framing its control test.

³² *QVC*, 637 A.2d at 43; see also Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 BUS. LAW. 919, 927 n.25 (2001) (amplifying *QVC*'s discussion of the control premium theory).

asset.³³

Even making these assumptions, we cannot see why a target board's decision to sell control should have different legal consequences than its decision to sell all of a firm's other assets through a stock-for-stock merger. Shareholders who deserve full value when the board sells control should also receive full value when the board sells the rest of the company (or anything else, for that matter). It just will not do to argue that shareholders deserve top dollar when an acquiring firm pays cash to buy the target's shares, but not when the acquirer pays with its own stock. The target's board should obtain the best deal for its shareholders in both transactions.

Nor can one argue that shareholders need the special protection of *Revlon* duties to ensure that they receive the maximum price when the target's board sells control, but not when the target's board sells all of the firm's other assets through a stock-for-stock merger. In both situations, the target's managers and board will likely lose their positions. They face a strong conflict of interest, yet they are in a final period where reputation and fear of future discipline lose their force as constraints on self-interested behavior. Thus, they face similar conflicts of interest. If those conflicts justify special scrutiny in sales of control, they justify similar scrutiny in stock-for-stock mergers.

To be sure, the form of scrutiny might be different in a stock-for-stock merger, because of the potential for hidden value in a stock-for-stock merger. But this difference simply underscores that hidden value can, while the control premium theory cannot, justify the distinction in the cases between cash and stock acquisitions.

A further problem with the control premium theory involves the thin dividing line between a transaction in which the courts consider control to shift, and a transaction in which control does not shift. Consider the following four transactions, all involving a diffusely held acquirer acquiring all or almost all of a diffusely held target's shares:

- (i) the acquirer buys 98% of the target's shares for cash (as many as it can buy without a freezeout merger), say through an any-and-all cash tender offer;
- (ii) the acquirer buys 100% of the target's shares for cash;
- (iii) the acquirer buys 98% of the target's shares in exchange for acquirer shares (as many as it can buy without a freezeout merger), say through an any-and-all exchange offer;
- (iv) the acquirer buys 100% of the target's shares in exchange for acquirer shares.

The first two transaction types undoubtedly transfer control; the fourth

³³ In fact, the low premium that investors accord to voting over nonvoting shares, for companies with two classes of voting shares, suggests that control, without more, has limited value. See Tatiana Nenova, *The Value of Corporate Votes and Control Benefits: A Cross-Country Analysis* (working paper 2000), available at <http://papers.ssrn.com/abstract=237809> (value of voting rights for sample of 39 U.S. companies with two classes of voting stock is about 2% of firm value).

does not. The third transaction type is rare, perhaps nonexistent, and no case addresses it, but the logic of the control premium theory compels the conclusion that *Revlon* should apply. Before the acquisition, control of the target is held in the market. After the acquisition, the now-98%-owned target has a controlling shareholder. The new parent can capture the benefits of control. Indeed, it can likely do so more easily than an individual shareholder, by transferring profits from subsidiary to parent through hard-to-police intercompany transactions.³⁴

Thus, under the control premium theory, if the acquirer buys a controlling but less than 100% interest in the target, the form of consideration does not matter. Either way, the target will have a new controlling shareholder (the acquirer). If the acquirer pays with cash, whether it buys all shares, or only a controlling interest, does not matter. But if the acquirer pays with its own shares and goes from acquiring 98% to 100% of the target's shares, suddenly the target's shareholders have no longer sold control, which magically vests in the acquirer's shares that the target's shareholders receive.

Yet, viewed *ex ante* from the target shareholders' perspective, transaction types (iii) and (iv) are nearly identical. Either way, the target's board faces a conflict of interest and shareholders want the target's board to negotiate for the highest possible price. Nor are there significant differences between the cash transaction forms and the stock forms, either in the conflict of interest faced by the target's board or in the shareholders' interest in maximizing the value of the consideration that the acquirer offers. The form of consideration simply should not matter, unless the target's board has information about hidden value in the acquirer's shares, which takes us back to the hidden value model. Thus, the control premium theory cannot explain the doctrinal distinction between sale-of-control and non-sale-of-control transactions.³⁵

³⁴ By contrast, transaction type (iii) might *not* trigger *Revlon* under the hidden value model. Instead, it might be analogized to paying target shareholders mixed consideration in a merger: 98% payment in acquirer stock—a currency with potential hidden value—and 2% payment in *minority* target stock—a currency *without* cognizable hidden value. A court might reason that the purchase of *nearly all* target stock with acquirer stock creates enough potential for hidden value to excuse *Revlon* duties. Nevertheless, *Revlon* duties would have to attach at some point in this class of transactions, as an acquirer purchases a progressively lower percentage of target stock. Cf. Part III.B *infra* (discussing the application of *Revlon* to change-of-control transactions). Were case (iii) to arise, the Delaware courts might be forced to choose between the hidden value model and the control premium theory.

³⁵ Much the same critique that we make of the control premium theory can be made of any theory that focuses on what an acquirer, armed with control, might do to minority shareholders in the future. A rational target board can anticipate future risks and demand that the target's shareholders be paid for bearing them *ex ante*. The issue here, as in every transaction, is whether the target shareholders have been paid enough. For example, Marcel Kahan has proposed that *Revlon* duties should apply when, because of the sale of a controlling stake, target shareholders lose the ability to reverse a board decision to reject a takeover bid for the firm. See Kahan (1994), *supra* note 12, at 595. But if target shareholders are paid enough for selling control—if they take their premium up front, so to speak—there remains no good reason why transactions that transfer control should be treated differently, doctrinally, than stock-for-stock mergers that do not, but do transfer all of a firm's other assets.

III. HOW HIDDEN VALUE (OFTEN) EXPLAINS DELAWARE LAW

The discussion in Part II hints at how the hidden value model has shaped the evolution of Delaware takeover law. The principal implication of this model is that in most circumstances, the board and its advisers—as opposed to shareholders, the takeover market, or the courts—are uniquely qualified to evaluate major corporate transactions. The risk of self-interested decision-making by the board is a problem, as the Delaware courts readily acknowledge. After all, without this risk, takeover decisions, like other business decisions, could be governed by the business judgment rule, and we would not need a specialized takeover jurisprudence. This risk, however, is not a large enough problem to offset the board's unique competence to evaluate the firm's true value, as long as the board's decision is numerically controlled by formally independent directors.³⁶ It follows that the default regime of corporate governance should be one in which a majority-independent board decides which transactions the company will accept and which it will reject. By contrast, courts should avoid second-guessing business decisions, and shareholders who are unhappy with the board's actions should look to proxy contests rather than the courts to press their claims.³⁷

To be sure, the proxy contest outcome may be driven by the same mistaken beliefs that would lead shareholders wrongly to reject management's claim of hidden value. But at least the target gains some time for hidden value to emerge -- generally four months to a year, depending on when, relative to the target's annual meeting, a bid is commenced. More centrally, there must be some mechanism for shareholders to choose boards, lest agency costs multiply out of control. Shareholder ability to elect new directors emerges as an uneasy compromise between the logic of hidden value and the need to limit agency costs.³⁸

Moreover, even within the hidden value model, the board's discretion should have some limits. There are transactions in which a board's claim to special knowledge of hidden value is implausible and others in which the target's shareholders may not benefit from any hidden value that may exist. In either circumstance, the board should maximize visible value over hidden value. There are also transaction types where hidden value is not plausible in the amount needed to justify the target board's decision.

We discuss below the contexts in which *Revlon* should apply, either

³⁶ See *Unocal*, 493 A.2d at 955 (deference to the board's decision to resist a takeover bid "is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors").

³⁷ See Gilson (2001), *supra* note 28, at 499 (describing Delaware's acceptance of takeover defenses, under *Unocal* and its progeny, as reflecting an unexplained preference for takeover contest decisions to be decided through elections rather than markets).

³⁸ For an effort to take distrust of shareholder decisions to its logical conclusion by restricting their power to remove directors to once in five years, see Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187 (1991).

because hidden value is unlikely or because only an implausible amount of hidden value can justify the target board's decision. We focus here on transaction *types* that *Revlon* should and should not apply to. We consider in Part IV how courts should respond when a claim of hidden value is plausible for the transaction type in general, but implausible in the amount claimed by the target board.³⁹

A. Cash Sales

The most common port of entry into *Revlon*land is a cash sale of all of the company's shares, as in *Van Gorkom* and *Revlon*. It is not surprising that the Delaware Supreme Court chose all-cash sales as the core class of transactions in which to limit board discretion. If an all-cash sale is regarded *ex post*, hidden value cannot exist. Cash is worth what it is worth. It follows that a loyal target board must always prefer more cash over less cash.

The board should still retain some discretion to prefer one offer over another, to the extent that it can assess better than shareholders can the discount factor to apply to reflect financing risks, antitrust risks, and other regulatory risks that may block completion of the transaction. Moreover, as we discuss in Part IV.A, the target's hidden value can also justify giving the target board some discretion to offer deal protections to bidders, including bustup fees and lockup options, to induce a higher offer price.⁴⁰ In both of these situations, the board's duty should still be to maximize the expected cash consideration that the target shareholders will receive. At issue is only how best to achieve that goal.

But if a cash sale of a company triggers *Revlon*, what happens when a company is sold for a mix of cash and stock, or for securities other than the surviving corporation's common stock? Here, the hidden value model is ambiguous. For example, suppose a friendly bidder offers target shareholders part cash and part stock, say in a cash-election merger. Presumably at *some* point between an all-stock and an all-cash deal, *Revlon* duties kick in because the prospect of hidden value can no longer justify board discretion. Yet, the common law is likely to resist drawing a bright line at, say, the

³⁹ We address in this Article the implications of the hidden value model for the decision by the board of the target company. The *acquirer's* board may also rely on hidden transactional value, usually prospective synergies, to justify paying a large premium over the target's pre-announcement market price, however negatively the market views the acquisition. An acquirer can also potentially gain from its own negative hidden value, by acquiring another company using its overpriced shares as consideration. See Shleifer & Vishny (2001), *supra* note 22 (suggesting AOL's acquisition of Time-Warner as a possible example of this fact pattern).

⁴⁰ Discussion of the implications of the hidden value model for analysis of deal protections is beyond the scope of this article. In brief, within the visible value model, granting a first-bidder lockup option will not change the expected price that target shareholders will receive. The first bidder is induced to pay more, at the same time that higher second bids are dissuaded. The two effects on expected price precisely offset each other. If hidden value exists, deal protections can potentially increase or decrease the expected price that target shareholders will receive.

50% mark (where target shareholders receive in cash half of the visible value of the total consideration). If so, the case law will continue to leave us unsure about when *Revlon* applies in mixed-consideration deals. At best, it could adopt a sliding scale approach that grows increasingly skeptical when the board rejects a deal with higher visible value, as the cash component of the board's preferred transaction becomes larger, and the potential importance of hidden value in the acquirer's shares correspondingly shrinks.

For a transaction with debt consideration, the board's potential for private information about the acquirer's value can also affect the value of the debt. But hidden value will have a significantly smaller effect on the value of debt than on the value of shares. Moreover, as we discuss in Part IV, to ascribe to the target's board significant private information about the acquirer's value, rather than the target's value or acquirer-target synergy, stretches the hidden value model quite far. Thus, the current doctrine, which treats the acquirer's debt as equivalent to cash and denies a role for hidden value, seems correct.⁴¹

B. Change-in-Control Transactions (with Cash or Non-cash Consideration)

Cash sales of the entire company are an easy case for limiting the target board's discretion, since the selling shareholders receive no hidden value, and the risk remains that the target's board will act less than independently, even if formally majority-independent. In 1989, three years after *Revlon*, the Delaware Supreme Court first indicated, in *Mills Acquisition Co. v. Macmillan, Inc.*,⁴² that a board of directors might be bound by *Revlon* duties in a second class of transactions, namely, those that subjected public shareholders to the mercies of controlling shareholders. The Delaware Court of Chancery developed this logic behind this class of *Revlon* transactions in dictum in *Paramount v. Time*.⁴³ After initially rejecting this approach in *Paramount v. Time*, the Delaware Supreme Court embraced it four years later in *Paramount v. QVC*.

⁴¹ An exception to this general rule is a leveraged buyout, where the acquirer is a shell (or much smaller than the target), so that the target's business provides the principal source of cash to repay the debt. Here, the target's board could plausibly have significant information that bears on the value of the acquirer's debt securities. But note a twist. The target's board typically claims that hidden value is positive, to justify resisting a takeover bid or preferring a stock bid to an apparently higher cash or debt offer. But if the target's shares have positive hidden value, debt whose repayment relies on the target's cash flow will also have positive hidden value. Despite *Unocal's* endorsement of this precise move by Unocal's board (which claimed simultaneously that Unocal shares were worth much more than Mesa's \$54 offer price, and that the junk bonds Mesa was offering were worth far less than the \$54 Mesa claimed they were worth), see *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985), the target's board cannot simultaneously maintain that the market undervalues the target shares and overvalues the debt securities that a leveraged buyout acquirer offers in exchange for the target's shares.

⁴² 559 A.2d 1261, 1287-88 (Del. 1989).

⁴³ *Paramount Communications, Inc. v. Time, Inc.*, 1989 WL 79880 at *18-*25 (Del. Ch. July 14, 1989).

The surface rationale employed in *Paramount v. QVC* is the control premium theory. If control vests in a new controlling shareholder, the remaining shareholders have no further power to cause the company to engage in a merger or other transaction in which they might receive a control premium. Moreover, Delaware law imposes no general duty on a controlling shareholder to share any control premium with minority shareholders. The target's board can try to negotiate a control premium in a freezeout, but the controlling shareholder can replace the board if it tries too hard.

However, as we argued in Part II.D, the control premium theory cannot justify imposing stricter duties on the target board in a cash acquisition, or another transaction in which control changes hands, than in a stock-for-stock merger. Instead, only hidden value can explain why *Revlon* is triggered by a change of control. The main idea is this: If there is no controlling shareholder, long-term target shareholders will receive any hidden value in due time, through a future takeover or ordinary business activities. In contrast, if there is a controlling shareholder, target shareholders risk being frozen out of the company before they can benefit from hidden value. Given this risk, the target's shareholders may be better served if the board maximizes visible value, as *Revlon* requires, rather than total value. Indeed, *QVC* sketches such an argument, while relying mostly on the control premium theory.⁴⁴

Applying *Revlon* to these transactions is akin to presuming either that the target's shareholders will *not* realize any hidden value or judging that, given the risk that the target's shareholders will not benefit from hidden value, the gain to shareholders from allowing target boards to favor transactions that preserve this value is outweighed by the risk that a disloyal board will improperly favor one bidder over another. It was likely important to this doctrinal development that the core cases, *Macmillan* and *QVC*, provide strong evidence that some apparently independent target boards do not act that way.

Put differently, the merger between Viacom and Paramount proposed in *QVC* was just as likely to generate hidden value as the merger considered in *Paramount v. Time*. Nevertheless, because Paramount's public shareholders would receive as merger consideration shares in Viacom, which would be controlled by Sumner Redstone, Paramount's board was not entitled to weigh this hidden value in choosing between Viacom's and *QVC*'s offers. As prospective Viacom shareholders, Paramount shareholders would enjoy a formal claim to a pro rata share of the synergy gains or other hidden value that might accrue from a Viacom-Paramount merger. In the view of the Delaware Supreme Court, however, this minority claim might be expropriated by Sumner Redstone. Thus, the Paramount board was under an obligation to maximize visible value—and only visible value.

⁴⁴ See *Paramount v. QVC*, 637 A.2d at 43 (“Irrespective of the present Paramount Board’s vision of a long-term strategic alliance with Viacom [the acquiring company], the proposed sale of control would provide the new controlling stockholder with the power to alter that vision.”).

This same logic implies that *Revlon* should, in theory, apply to a rare transaction form that the Delaware courts have not yet faced—a diffusely held acquirer buys a controlling but less than 100% interest in a target company and pays with its own shares. The new parent company will have the power to capture its subsidiary's hidden value. Thus, *Revlon* should apply even though stock in a widely held acquirer is used as consideration.⁴⁵

C. A Leveraged Recapitalization and Break-Up of the Target

In addition to circumstances in which hidden value does not exist (cash sales) or may exist but not benefit shareholders (sales of control), there is a third circumstance in which *Revlon* duties follow from the hidden value model. This involves a breakup of the target. Many breakup transactions, including *Revlon* itself, involve cash acquisitions, which trigger *Revlon* whether the target will be broken into pieces or not. We address here whether *Revlon* should apply to a leveraged recapitalization, sponsored by the target's managers as an alternative to a hostile takeover bid, where most of the company's businesses will be sold to finance the recapitalization.⁴⁶ *Revlon* would not apply to a leveraged recapitalization absent a breakup plan. Still, the rhetoric of *Revlon* and *Paramount v. Time* suggests that a breakup of the target is a sufficient basis for *Revlon* duties to attach. It is worth explaining why this rhetoric is consistent with the hidden value model.

Suppose that a target has four businesses, and plans to sell three for cash (the usual form of payment in a divestiture) and keep one. The three

⁴⁵ One can construct numerical examples of partial stock-for-stock acquisitions, in which target shareholders who become acquirer shareholders gain more from hidden value than the remaining target shareholders lose, relative to visible value. Assume, for example, that a target has 100 shares outstanding, a market price of \$40 per share, visible value in the corporate control market of \$50 per share, and total value of \$60 (including both stand-alone value and synergy with the acquirer); an acquirer has 150 shares outstanding, which trade for \$45 each; the acquirer buys 90 target shares for 1 acquirer share each (thus delivering apparent value of \$45 per target share), and after the transaction closes, the target's remaining shares will be worth \$45, with the acquirer appropriating all target value over \$45 per share. After the transaction, the acquirer will have 240 shares outstanding. The total value of the combined firms will be acquirer value + target value = \$6750 + \$6000 = \$12,750. The target's 20 remaining minority shares will receive value of \$45 per share, or \$450 total, leaving \$12,300 (\$51.25 per share) for the acquirer's shareholders. Former target shareholders who sell their shares will have shares worth \$51.25/share x 90 shares = \$4,612.50. The remaining target shareholders will have shares worth \$450, for total value to all target shareholders of \$5,062.50 (a blended value of \$50.63/share), which exceeds the visible value of \$50 available from the alternative transaction. Put differently, the target shareholders who sell their shares gain more, relative to visible value, than the target shareholders who keep their shares lose. In our judgment, the Delaware courts are unlikely to engage in this sort of refined analysis, in order to exclude from *Revlon* scrutiny an unknown but small number of stock-for-stock acquisitions by widely held acquirers of a controlling but less than 100% interest in a target. Thus, the best view is that stock-for-stock acquisitions of a controlling but less than 100% interest should trigger *Revlon*, just as cash acquisitions do.

⁴⁶ *AC Acquisitions Corp. v. Anderson, Clayton & Co.* involves this fact pattern, 519 A.2d 103 Del. 1986), but was decided under *Unocal*, with the court holding that a structurally coercive defensive self-tender was an unreasonable response to an any-and-all hostile tender offer.

businesses will be sold for their visible value (since if value is hidden, acquirers will not pay for it). Thus, hidden value that will benefit the target's shareholders can derive only from the business that will not be sold. This limits the amount of hidden value, relative to the target's total value.⁴⁷

Some additional reasons suggest that hidden value is likely to be small. First, by acceding to a breakup, the target's board implicitly concedes that its past business plan has failed. This makes it less likely that there is substantial hidden value in the business that the acquirer will retain, and less likely that the target's board is skilled enough to identify accurately any hidden value that may exist. The combination of limited hidden value (relative to the target's size), lower likelihood of hidden value in the business that the acquirer will keep, and doubts about the board's ability to identify any hidden value suggest that *Revlon* duties are in order.

D. When Whales Swallow Minnows

A fourth candidate for *Revlon* duties under the hidden value model, stock-for-stock mergers between large and small companies, remains in some doubt. The usual doctrinal view is that the relative sizes of the acquirer and the target are irrelevant to triggering *Revlon* duties. The case most nearly on point is *Arnold v. Society for Savings Bancorp.*,⁴⁸ where Bank of Boston acquired Society for Savings in a stock-for-stock merger. Although Bank of Boston was many times larger than its target, the Delaware Supreme Court never mentioned the relative sizes of acquirer and target, and cursorily rejected a *Revlon* claim on the grounds that the merger did not produce a change of control.⁴⁹ These observations by the court manifestly invoke a legal fiction. Everyone in the outside world understands that—and speaks as if—Bank of Boston bought Society for Savings and Society for Savings shareholders sold their shares in exchange for Bank of Boston shares. The control premium theory invoked by the court cannot rescue the decision, for the reasons we discussed in Part II.D. The remaining question is whether the hidden value model can justify this legal fiction.

In our view, the hidden value model must be stretched unreasonably far to justify a sale of a minnow to a whale at a lower visible price, paid in the whale's shares, than was available from another acquirer. The core problem is that the minnow's shareholders will receive only a small fraction of any hidden value that arises from the minnow's stand-alone value or minnow-whale synergy. Their share of that value will be diluted by the whale's other shareholders. For example, if the whale issues new shares

⁴⁷ The same logic would apply to a stock-for-stock acquisition, where the acquirer plans to break up the target. The acquirer will expect to obtain only visible value for the target businesses it plans to sell, and thus will be willing to pay only visible value for these businesses.

⁴⁸ 650 A.2d 1270, 1289-90 (Del. 1994). For background on this transaction, including the relative sizes of buyer and target, see *Arnold v. Society for Savings, Again*, CORP. CONTROL ALERT, Sept. 1995, at 11.

⁴⁹ *Society for Savings*, 650 A.2d at 1290.

equal to 5% of its outstanding post-transaction shares, the minnow's shareholders will receive only 5% of any hidden value attributable to the minnow or to minnow-whale synergy. In contrast, the risk that a disloyal board will not maximize shareholder value, hidden or otherwise, is not affected by the relative size of the acquirer and the target.

To be sure, the minnow's shareholders will also receive 5% of the whale's stand-alone hidden value. But it is unlikely that the minnow's board has any special expertise in recognizing such hidden value. If the whale cannot credibly disclose the sources of hidden value to its own shareholders, it is not apparent how it can do so to the target's board. In a true merger of equals, each company's board can commission an investment banker to conduct an in-depth investigation of the other company, which may uncover hidden value. But such a claim is not available in most whale-minnow transactions, where the minnow makes little if any investigation of the whale's business and the whale makes minimal representations, mostly that its public financial and other disclosures are not materially misleading. Unless it conducts due diligence on the acquirer, the target board's claim of hidden post-transaction value begins to look like an excuse for not maximizing value of any sort, hidden or otherwise.

A distinction between stock and cash as consideration faces a further problem in the whale-minnow context. The parties board can readily manipulate transaction form to escape legal scrutiny. Posit the situation that *Revlon* was designed to prevent: a disloyal target board wants to sell the company to a favored bidder at a low price, when a higher price is available from another bidder. All the minnow's board must do to achieve this goal is convince the favored bidder to pay with stock rather than cash. Moreover, from the acquirer's perspective, the form of consideration is just that—mostly form rather than substance. Some acquirers will be indifferent between using cash and stock as consideration, and others will prefer to use stock. The interesting case is where the acquirer prefers to pay with cash, while the target board wants a stock acquisition to avoid *Revlon*. All the acquirer needs to do is issue shares to buy the target, and then repurchase an equal number of its own shares in the market. This is easily accomplished if the number of acquirer shares to be issued is a small fraction of the acquirer's outstanding shares. To be sure, the acquirer will incur some modest transaction costs, but it may recover these costs by offering the target a lower price. Thus, when a small company is sold to a much larger company, the stock-for-stock exception largely eviscerates *Revlon*.

For these reasons, we believe that minnow-whale stock-for-stock mergers should, and perhaps one day will, trigger *Revlon* duties. Perhaps the case law has not yet reached this conclusion because the issue has not been clearly argued to a Delaware court in terms of the hidden value model. The courts will then have to decide when the size disparity between acquirer and target is large enough so that *Revlon* should apply. But a rough standard is available. When an acquirer issues shares equal to at least 20% of its previously outstanding shares, New York Stock Exchange rules (and

similar NASDAQ rules) require the acquirer to obtain a shareholder vote to approve the merger. A transaction smaller than this is unlikely to contain enough hidden value to justify the stock-for-stock exception to *Revlon*.

IV. DECONSTRUCTING THE HIDDEN VALUE MODEL

Thus far we have described the implications of the hidden value model for legal doctrine. Although this model does not predict the full evolution of Delaware law on defensive tactics and when *Revlon* applies, it charts the principal direction in which this law has evolved, and provides guidance to the courts on how to resolve several unresolved cases, including stock-for-stock acquisition of a controlling but less than 100% stake, a leveraged recapitalization/breakup transaction, and a stock-for-stock whale-minnow acquisition. We turn in this Part to evaluating the core of the hidden value model and the doctrinal uses to which it has been put. This analysis has three aspects. First (Section A), are there internal inconsistencies in the doctrinal implications that the courts have drawn from the hidden value model? Second, what are the tensions and inconsistencies between the model's assumptions and the available evidence on shareholder returns in takeovers (Section B) and on the credibility of investment banker opinions (Section C)? Third (Section D), are the doctrinal implications of the hidden value model consistent with the broader normative structure of corporate law?

A. Internal Consistency

The hidden value model is broadly consistent with Delaware case law. Moreover, we have defined it in Part II to be as internally consistent as we can make it (glossing over, in the process, some inconsistencies in the cases). Still, there are arguable lapses of consistency in a number of areas.

1. *Deal Protections*.—One arguable lapse concerns deal protections. Here the case law is not entirely clear, but often imposes significant limits on deal protections for both cash and stock bids.

Consider cash bids first. Under the hidden value model, cash bids trigger *Revlon* because they do not carry hidden value. When it comes to cash, what you see is what you get. But this observation is only correct *ex post*, after a cash bid has been made. Bidders often demand deal protections (bust-up fees, lock-up options, no-shop clauses, and no-talk clauses) and sometimes cash inducements to make a cash bid in the first place. The target's board must assess what deal protections to offer to procure a bid or induce a higher bid. For example, a board might rationally offer deal protections for an initial cash bid, even though it suspects a second bidder will pay a higher cash price after the first bidder has performed due diligence, made a public offer, and committed its reputation. Deal protections offered to the first bidder reduce the probability of a second bid. But the board may also believe that the first bidder will not bid, or will bid less, without deal protections. Without a first bidder, there will be no second bidder.

Thus there is a kind of hidden value in this all-cash scenario. By offering moderate deal protections, which appear to discourage an auction, the board may in fact make an auction more likely. By offering deal protections, the board will reduce the price a second bidder will pay and reduce the first bidder's willingness to increase its bid if a second bidder emerges.⁵⁰ At the same time, the deal protections may induce the first bidder to offer more. The board may appear not to be maximizing visible value, even though it is in fact maximizing ex ante expected value to the best of its ability.

The hidden value at issue in this auction scenario is different than the hidden value in a stock-for-stock merger. In this case, the hidden value is the difference between the first bid price and the expected price the target's shareholders would receive if the target's board refused to grant deal protections, offered a different deal protection package, or chosen a different way to sell the company—for example, an explicit auction with deal protections offered to the winning bidder. Moreover, the board sees the potential for this deal-based hidden value through its insight into the price that the target might fetch in the takeover market, rather than its insight into the merged companies' prospects. But these distinctions seem too minor to support a radical difference in the board's duties between the two contexts.

More directly, the two types of hidden value are related. A loyal board's willingness to offer deal protections to a first bidder will depend on the extent to which the price the first bidder offers represents full value. *Van Gorkom* illustrates. The Trans Union board understood that Marmon Group's offered price might not be the highest price available. To increase the chance of a higher bid, it offered no deal protections, insisted on the right to seek other bids, and ensured time for other bids to emerge, through a long delay between the announcement of the merger with Marmon Group and the shareholder vote on the merger. At the same time, if Marmon Group had been willing to offer a higher price, contingent on deal protections, a value-maximizing board might have agreed to this. The board couldn't know which course to take unless it understood Trans Union's true value. Thus, the hidden value model, if fully accepted, would grant target boards broad discretion in choosing the means of sale, including discretion over which deal protections to offer.⁵¹ Yet Delaware case law has not gone in this direction. Instead, deal protections are closely scrutinized. Bust-up fees and lock-up options must be limited in amount; no-shop provisions are acceptable, but no-talk provisions often are not. Crucially, after a period of ambiguity in the 1990s, when it seemed possible that stronger deal protections would be permitted for acquisitions that do not trigger *Revlon* than for acquisitions that do, the current trend is to apply similar limits to all acqui-

⁵⁰ See Ian Ayres, *Analyzing Stock Lock-Ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?*, 90 COLUM. L. REV. 682 (1990).

⁵¹ For an argument that target boards should have this discretion, see Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739 (1994).

sitions.

We do not suggest that the Delaware courts should relax their current limits on deal protections. These limits impose important practical constraints on the extent to which the target's board can prefer one bidder over another, and thus implicitly impose limits on how much hidden value the target's board can assume. To oversimplify, if the target's value to a second bidder sees exceeds the sum of the first bid's visible value plus the cost of the deal protections, the second bidder has an incentive to bid. If it does, the shareholders will generally prefer whichever bid offers the highest visible value to them, whatever the board's views about hidden value. If one has—as we do—doubts about board error or loyalty and about the extent of hidden value, these practical limits on target boards' power can be valuable to retain. Moreover, strong deal protections would rob the shareholders of a meaningful opportunity to say no to a deal blessed by the board. For example, a large bustup fee payable by the target to the acquirer, if the target's shareholders reject the acquirer's offer, coerces shareholders to accept the offer the board prefers.

Our point instead is that the Delaware courts should confront more directly the justifications for limiting deal protections, and the interplay between those assumptions and the hidden value model. Ideally, the courts might assess the limits on the amount of hidden value that can plausibly exist, both when reviewing stock-for-stock acquisitions (where there are no explicit limits on the target board's claim of hidden value) and when reviewing deal protections (where the limits on deal protections effectively limit the amount of claimed hidden value the target's board can sustain over shareholder objection).

2. *Stock-for-Stock Acquisitions.*—The hidden value model also cannot justify fully releasing the target board from *Revlon*-like duties in stock acquisitions. The hidden value model implies that the target board in a stock acquisition can see value that others miss, and therefore should be able to prefer one acquirer over another, regardless of market prices and shareholder preferences. However, the target board should still have the duty, which follows from *Revlon*, to maximize long-term shareholder value as the board perceives it. In our view, this duty should require the board to explicitly compare the long-term value available from its preferred merger partner with the long-term value available from other possible partners.

The courts can police an obligation to maximize long-term value in several ways. First, they can give greater deference to the board's judgment, including a decision to award deal protections to a favored bidder, if the board has “shopped” the company, thus obtaining a market check on the transaction.⁵² Without a market check, the board cannot know whether it

⁵² For a recent example of added deference when a board conducts a market check, see *In re Pennaco Energy Inc. Shareholder Litigation*, 2001 WL 115341 (Del. Ch. Feb. 5, 2001); Charles Richards & J. Travis Laster, *The Return of the Market Check*, INSIGHTS, June 2001, at 20.

has selected the best deal, because it can only guess what other bids that may be available. An explicit auction is not always the best way to sell a company, so we do not propose that the courts require a market check, only that they give the target board greater deference if it conducts one. If the board shops the company, the courts could require that the board affirmatively conclude that the bid it accepts involves the highest long-term shareholder value. If the board does not shop the company, the courts could require the target's board to conclude that, in their business judgment, the transaction they endorse will maximize long-term shareholder value. There is prophylactic value to such a requirement, even if it only matches what boards should be doing anyway. Second, the courts could extend *Van Gorkom's* de facto requirement that the target's board obtain an investment banker's fairness opinion before selling its company for cash, by requiring the target's board to obtain an investment banker's opinion that the long-term shareholder value obtainable from the favored bidder exceeds the visible value offered by another bidder. As discussed in Part IV.C, we are skeptical about the value of investment banker opinions. But if they have even a fraction of the value the Delaware courts ascribe to them, the justification for extending their use to claims of hidden value is compelling. Even if these opinions have the smaller value we attribute to them, they can instill some additional discipline into the sale process, especially if the courts police these opinions in the ways we propose in Part IV.C.⁵³

Without due diligence on the acquirer, the target board's claim of private knowledge about post-transaction value begins to look like an excuse for the target board not to maximize value of any sort, short- or long-term.

Third, before the courts accept a claim of hidden post-transaction value, they should ensure that the target has a reasonable basis for that belief. That requires due diligence, directly or through advisers, and a resulting documented basis for believing that there is enough hidden value to justify the transaction. The need to investigate and reach a reasoned conclusion should produce better decision-making, for precisely the reasons that the procedures outlined in *Van Gorkom* are likely to produce better board decisions in transactions where *Revlon* applies.

The courts can adopt these proposals without second-guessing a target board's valuations. They need to monitor only verifiable information: whether the board had shopped the firm, whether the board has explicitly concluded that the deal it favors maximizes long-term shareholder value, whether a suitable investment banker opinion had been procured, and whether due diligence on the acquirer has been conducted.

⁵³ Given the risk that the board will err or act disloyally, plus the plasticity of investment banker opinions, we believe the courts should require the investment banker to affirmatively conclude that a transaction with lower visible value has *higher*, not just equal, value compared to the available alternatives, before the board can accept the offer with lower visible value. If the most an investment banker is willing to say is that the two alternatives are equal, the courts should require the board to accept the higher visible value transaction.

Fourth, the courts should insist that the hidden value needed to justify the board's decision be reasonable in amount, in light of what we know about market efficiency. The courts will be reluctant to second-guess board decisions at the margin. But the effort to assess plausibility will still let them reject transactions, like Time-Warner, where the Time board's claim that the merger with Warner was better for its shareholders than Paramount's offer fails the laugh test.⁵⁴

3. *Just Say No*.—The hidden value model also cannot justify fully releasing the target board from *Revlon*-like duties when the board rejects a takeover proposal. The board should still be obliged to maximize long-term shareholder value, as the board perceives it. Meeting this duty would require the board to explicitly compare the long-term value available by remaining independent with the company's expected value in the takeover market.

As is the case for stock-for-stock mergers, the courts can police an obligation to maximize long-term value in several ways, without second-guessing board decisions. They can give greater deference to the board's judgment if the board has "shopped" the company, thus obtaining a market check on its judgment that remaining independent is the best course. They can require the target board to expressly conclude that its chosen course will maximize long-term shareholder value. And they can require the target's board to obtain an investment banker's opinion that the long-term shareholder value obtainable by remaining independent exceeds the value obtainable in the takeover market.

Beyond this, the courts should insist that the amount of hidden value claimed by the board is plausible, and that the board explain, with specific reference to sources of hidden value, why remaining independent is the right course. Without some scrutiny of plausibility, the target board's claim of private knowledge about post-transaction value can become an excuse for the target board not to maximize value at all.⁵⁵

B. Consistency with the Empirical Evidence

1. *Available Event Study Evidence*.—The hidden value model is, among other things, a positive theory of corporate finance and governance. Its principal claims are that hidden value is pervasive, significant in size relative to visible value, long-lived, and visible to target boards, yet incapa-

⁵⁴ On the amount of hidden value needed to justify the Time board's preference for the Warner merger it approved, over the Paramount offer it rejected, see note 21 *supra*. On the plausible amount of hidden value for companies generally, see Part IV.B.3 *infra*.

⁵⁵ On the amount of hidden value that is plausible, see Part IV.B.3 *infra*. We are not holding our breath waiting for the courts to impose meaningful procedural and plausibility discipline on target boards. One of us has made such a proposal before, in the article that coined the term "substantive coercion." The Delaware courts adopted the term but ignored the proposals therein for imposing some discipline on hidden value claims. See Gilson & Kraakman (1989), *supra* note 11, at 266-71.

ble of being credibly disclosed to the market.

In principle, it should be possible to test at least some of these claims, jointly if not individually. What might such a test look like? One possibility would be to examine contested stock-for-stock mergers where one of the merging companies has spurned a higher valued cash offer. We might compare the returns earned by target shareholders over a several-year period with the risk-adjusted returns those shareholders would have earned had they accepted the higher offer and then reinvested the proceeds in the target's industry or the market as a whole. A second set of tests could examine failed hostile tender offers, where the target remains independent, and compute what the target's shareholders might have made had the hostile offer succeeded and they reinvested their money in the target's industry or the market as a whole.

In addition, the time period for cumulating returns might be varied. After all, the long run must come sometime. We believe that five years is a reasonable maximum time period, given that the management projections on which target boards and investment bankers rely rarely extend beyond five years, and even then are speculative in the further-out years. Under elementary finance theory, the current price reflects investors' estimates of future returns, so an argument for waiting longer is implicitly a claim that hidden value not only isn't realized for five years, but doesn't become visible during that period.

Studies of this precise sort have not been undertaken, and would face methodological issues if they were. The core problems are (1) long-term share price returns are volatile, so it will take a large effect to produce a statistically significant result; and (2) choosing a good market model is important, because the results of long-term event studies are more sensitive than short-term studies to model choice, but it is not yet clear what model of market returns to use.⁵⁶ Still, the existing evidence that we detail below, although gathered over shorter post-event time periods, suggests that such studies, if they could be conducted, would be unlikely to support the hidden value model.

The available empirical studies of failed takeover attempts reach a uniform conclusion. Defeat of a hostile bid is, on average, bad for the target's shareholders. Unsuccessful hostile bids that are followed by successful second bids result in better prices for target shareholders than the first bidder offered. But when target boards defeat first bids and no second bid follows, share prices for target firms gradually return to pre-bid levels,

⁵⁶ On the sensitivity of long-run event studies to model specification, see Brad M. Barber & John D. Lyon, *Detecting Long-Run Abnormal Stock Returns: The Empirical Power and Specification of Test Statistics*, 43 J. FN. ECON. 341 (1997); Brad M. Barber & John D. Lyon, *Detecting Abnormal Operating Performance: The Empirical Power and Specification of Test Statistics*, 41 J. FN. ECON. 359 (1996); S.P. Kothari & Jerold B. Warner, *Measuring Long-Horizon Security Price Performance*, 43 J. FN. ECON. 301 (1997).

imposing heavy opportunity costs on target shareholders.⁵⁷ Thus, if targets that remain independent have hidden value on their own, there is no evidence of this over the two to three year period that the available studies cover.

Moreover, when the target defeats a first bid and later agrees to a higher second bid, there is no reason to think that an auction of the target, at the time of the first bid, could not achieve similar results. This evidence justifies giving target boards a reasonable time to find the best offer, but does not justify giving target boards the discretion to block the first bid and refuse to even see if a higher bid is available.

Equally revealing, an extensive empirical literature suggests that the shareholders of acquiring corporations break even at best in merger transactions. Long-term acquirer returns are, if anything, even worse than the short-term returns.⁵⁸ This suggests both that the takeover market is often reasonably competitive, and that on average, the visible value available in the takeover market equals or exceeds the target's actual value. This evidence is not reassuring to those who believe that the target's board is uniquely capable of evaluating company value and, often, rejecting altogether a bid at a significant premium to the target's market price. Moreover, agency costs are important. Target boards that reject all bids impose large costs on shareholders on average, measured by the premiums foregone. Any one board's claim of hidden value might be right, but the evidence shows that most such claims are wrong.

2. *How Much Will Courts Care About the Evidence?*—Another question is whether the Delaware Supreme Court would be moved by definitive empirical results that were adverse to the hidden value model. Would such results lead the court to abandon the model? We suspect not, for two reasons. First, the court would disclaim the institutional expertise to evaluate econometric studies.⁵⁹

⁵⁷ This general pattern is reported by two major studies. See Michael Bradley, Anand Desai & E. Han Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy?*, 11 J. FIN. ECON. 183 (1983); Richard S. Ruback, *Do Target Shareholders Lose in Unsuccessful Control Contests?*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 137 (Alan J. Auerbach ed., 1988). Bradley, Desai, and Kim examined 26 targets of failed tender offers that were not subsequently acquired by a second offeror. They found that, over a two-year period, the shareholders of these targets lost all gains associated with their offers. Bradley, Desai & Kim, *supra*, at 194. Ruback confirmed these results in a second study extending over a three-year period. Ruback, *supra*, at 147-50. For additional discussion, see John Pound, *Takeover Defeats Hurt Stockholders: A Reply to the Kidder Peabody Study*, MIDLAND CORP. FIN. J., Summer 1986, at 33 (criticizing an investment banker's study that claimed to reach the opposite conclusion).

⁵⁸ See, e.g., MARK L. SIROWER, *THE SYNERGY TRAP: HOW COMPANIES LOSE THE ACQUISITION GAME* (1997); Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

⁵⁹ On the one occasion where the Delaware Supreme Court cited evidence on the gains or losses to target shareholders from defeated takeover bids, it cited academically disreputable studies by investment bankers and lawyers and ignored the contrary academic studies. See *Unocal Corp. v. Mesa Petroleum*

Second, these studies, even if taken at face value, would likely suggest that granting discretion to the target's board beats the relevant comparison set in a minority of the cases. These divergent results, the court might claim, do not permit a court of equity to override a target board's claim, when the board can plausibly argue that its preferred alternative will generate more long-term value than the offer it has rejected.

An empirical financial economist would respond that *ex post*, some firms will always perform better than others. This evidence does not support the hidden value model, but merely shows random divergence of future performance from investor expectations. At the same time, the economist would concede that stock markets are imperfectly efficient and that hidden value may sometimes exist.⁶⁰ There is evidence from other sources, including excess returns earned by insiders who trade in their own company's shares, and the importance that bidders attach to access to a company's internal projections, that insiders often have better information than the market about company value.⁶¹ Sometimes this information is soft and cannot easily be conveyed to shareholders. Moreover, a target board faces a credibility problem when it discloses information in the face of a hostile takeover bid. Investors know that the board wants to defeat the offer. Thus, they will discount the positive news that the board conveys.

The financial economist would likely observe there is no reason to believe that investors make valuation mistakes on average and over time, so overvaluation should be as common as undervaluation. For every company with positive hidden value, another should have negative hidden value. He might also observe that takeover waves usually correspond to strong stock markets, and large amounts of hidden value are less plausible when stock markets and takeover markets are jointly hot.⁶² Finally, the financial economist would recognize that investors value a company based on both its expected cash flows and their beliefs as to how well the managers will reinvest that cash flow. If a company has made bad investments in the past, its shares can trade at a significant discount to the present value implied by its expected cash flows, *if not wasted*.⁶³

A board-discretion advocate could argue that these rational discounts justify board discretion to value the company at the full present value of its

Co., 493 A.2d 946, 956 n.11 (Del. 1985).

⁶⁰ See, e.g., ANDREI SHLEIFER, *INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE* (2000); ROBERT J. SHILLER, *IRRATIONAL EXUBERANCE* (2000).

⁶¹ On the returns to insiders, see, for example, Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555-56 n.27 (1984) (collecting studies).

⁶² On takeover waves and their correspondence to stock market prices see, e.g., BLACK & GILSON (1995), *supra* note 21, ch. 1; Bernard S. Black, *The First International Merger Wave (and the Fifth and Last U.S. Wave)*, 54 U. MIAMI L. REV. 799 (2000).

⁶³ See, e.g., Black (1989), *supra* note 58; Reinier Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891 (1988); Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence*, in KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 314 (John Coffee et al. eds., 1988).

expected cash flows. A skeptic could respond that rational discounts do not just saying no to a takeover bid, because the target's board can realize the value of the expected cash flows by selling the company, and perhaps also through a leveraged recapitalization, in which the target borrows funds and pays them to shareholders, thus bonding the board's commitment not to waste those cash flows.

Putting these pieces together, we suspect that even well-conducted studies of the long-term returns to target shareholders who must accept the target board's views on value will not dramatically change current doctrine. There will still be arguments for board discretion, and a minority of cases where the board's judgment looks correct *ex post* and might have been so *ex ante*. For us, though, the relevant question is who makes better decisions most of the time -- boards on the one hand, or shareholders and the takeover market on the other. Today, the Delaware courts aren't asking this comparative question. We believe that they should be.

3. *How Much Hidden Value is Plausible?*—Granting that boards have systematic insight into hidden value, the hard question remains: How much hidden value is plausible? Our own judgment is that a target board's claim that an offer at a 10-20% premium undervalues the target can sometimes be plausible. In contrast, a claim that a 50-100% premium undervalues the target is usually implausible. Value discrepancies of that magnitude, that cannot be narrowed through disclosure, should be rare. There may be exceptional cases, perhaps involving new, hard-to-value technology, where a larger amount of hidden value could be plausible. But in these rare cases, the target board should be able to articulate firm-specific reasons why its value judgment is plausible.

The Delaware courts, however, do not scrutinize claims of hidden value for plausibility. They do not show increasing skepticism as the divergence between market price and claimed true value increases. They do not question large hidden value claims by companies whose assets are mostly "hard" (verifiable), and thus easy for shareholders and acquirers to value. They do not show greater skepticism when the target board claims hidden value, not in the target but in the acquirer shares (for which the target board's expertise is questionable). They accept inconsistent claims--for example, the claim that the market undervalues the target's shares but simultaneously overvalues the acquirer's debt securities, which will be repaid from the target's cash flow.

Of course, Delaware judges might respond that once one concedes that hidden value may exist, the courts lack the expertise to determine its amount. But this response is not compelling. The courts can require internal consistency without second-guessing value. The procedural checks on claims of hidden value that we suggest in Part IV.A would help. And much can be done to test the plausibility of extravagant claims about hidden value

short of a full-scale valuation proceeding.⁶⁴

4. *The Efficiency of the Takeover Market*—To sustain Delaware's hands-off attitude toward takeover defenses, one must believe that hidden value is invisible not only to shareholders, but to potential acquirers as well, or else that target companies won't receive a fair price for their hidden value in the takeover market. Even a financial economist who recognizes the potential for inaccurate share prices might argue that much of the information asymmetry that leads to imperfect stock market prices can be cured through due diligence by potential acquirers. The economist would likely also assert that the takeover market is reasonably competitive much of the time.

The case for preferring auctions is not ironclad. The economist would concede that the takeover market can be thin for companies in distress, whose true value may be hard for an acquirer to discern, and also in particular industries. He might acknowledge the theoretical possibility that the target's current management is uniquely able to capture its hidden value.

Still, the availability of a market check on the board's claim of hidden value suggests that when a board wants to just say no, without determining what price another acquirer might pay, the courts should insist that the board and its investment bankers offer credible evidence why the takeover market is unusually thin, or full value is otherwise unattainable, for this company. In many industries, including those where takeover activity is concentrated, such evidence will often be unavailable.⁶⁵

C. *The Doubtful Value of Investment Banker Opinions*

Another response the courts might make to the criticism that they are too credulous regarding hidden value claims is that such claims are generally supported by investment banker opinions. Indeed, *Van Gorkom* began a trend in Delaware case law of signaling that a decision to sell or not sell a company should be justified by an investment banker's opinion, as a kind of judicially fortified best practice.

In reality, however, investment banker fairness opinions are not a serious check on hidden value claims. Investment bankers have responded to the market opportunity that *Van Gorkom* handed to them in two ways. First, when a client wants to complete a merger, they will opine that the merger consideration is "fair to [the target's] shareholders from a financial point of view." A fairness opinion can be offered to the acquirer also, but our concern here is with the target.

Second, when a takeover target wants to oppose a hostile bid, the in-

⁶⁴ For discussion of how courts might elicit truthful valuation information, see Gilson & Kraakman (1989), *supra* note 11, at 271-73

⁶⁵ For evidence on the concentration of takeover activity within particular industries, usually due to economic or regulatory shocks, see Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, J. ECON. PERSPECTIVES 103 (2001).

vestment banker will offer instead an opinion that the price offered is “inadequate.” Crucially, this does not mean that the price is “unfair.” It means only that the investment banker believes that by holding out or selling to someone else, the target can probably obtain a higher price. Since no hostile bidder ever puts its best offer on the table first, investment bankers can solemnly declare that every hostile offer, no matter how high the premium, is “inadequate.” Yet the Delaware courts have only occasionally noticed, and never focused on, this difference between a fairness opinion and an inadequacy opinion.

When a target's board receives an offer it wants to reject, it is careful *not* to solicit a fairness opinion. After all, it would be embarrassing in court, and would have to be disclosed to shareholders, if the investment banker were to conclude that the offer was fair, even though “inadequate.” Even if the investment banker will say that the offer is unfair, that too is often undesirable. The target's board may want to reject a \$50 offer, but later accept a face-saving increase to \$50.50, if the alternatives are worse. That may be embarrassing if an investment banker has advised the board that \$50 is unfair. Finally, the worst faux pas of all is to ask the investment banker what price *is* fair. Because then, if the acquirer raises its bid to within the range of fairness, the target's board has a tougher time continuing to say no (though target boards have sometimes done so).

Third, when a hostile bidder surfaces after an investment banker has already blessed the target's favored transaction as fair, and offers a higher price, the banker cannot finesse the issue of fairness. In this situation, investment bankers often simply raise their fairness range, and then proclaim the hostile bid unfair. Sometimes the cycle is repeated, as the hostile bidder raises its bid and the banker again raises its fairness range.

A nice illustration of the distinction between a fairness opinion and an inadequacy opinion, and the plasticity of both, comes from *Mills Acquisition Co. v. Macmillan, Inc.*⁶⁶ Here, two investment bankers—Wasserstein Perella and Lazard Freres—blessed as “fair” a management-led recapitalization that they valued at \$64.15 and later jointly opined that Macmillan had a “maximum breakup value of \$80.”⁶⁷ They then rejected as “inadequate” ever-increasing hostile offers from the Bass Group, first of \$64, then \$73, and then \$80. By the time the bidding got to \$80, the bankers were willing to say that \$80 was not only inadequate, but “unfair” as well!⁶⁸

It is dubious enough for the courts to give substantial weight to an investment banker's bought-and-paid-for fairness opinion. This opinion typically assumes that management's optimistic projections for future performance will be achieved, constrained only by the investment banker's belief that the projections are plausible. Relying on management's projections, *without* discounting for the risk that the projections will not be

⁶⁶ 559 A.2d 1261 (Del. 1989).

⁶⁷ *Id.* at 1273.

⁶⁸ *Id.* at 1270-73.

achieved, allows investment bankers to find unfair a price that a hypothetical perfectly informed investor would happily accept.⁶⁹

Investment banker conduct shows no signs of improving. A recent example is a 2001 transaction between two companies controlled by Ron Perelman. One company, M&F Worldwide, bought Perelman's 83% stake in a second company, Panavision, for \$17 per share, when Panavision's market price was around \$4. Even the \$4 price reflected mostly option value, because Panavision was nearly bankrupt, with its subordinated debt trading at around 30¢ on the dollar. This transaction caused a 45% net-of-market decline in the buyer's shares when it was announced.⁷⁰

How can such a transaction be blessed as fair by an investment banker and then approved by independent directors? The reasons include the banker's uncritical acceptance of management's projections, compounded by the availability of investment bankers who will give "soft" fairness opinions that other bankers might refuse to give, and the tendency for some independent directors to swallow insiders' value claims.

Anecdotes like Macmillan and M&F Worldwide can easily be multiplied. The uncomfortable truth is that investment banker fairness opinions often say almost whatever their client wants them to, the facts be damned.⁷¹ For the Delaware courts to take the additional step of allowing a target board to reject a hostile takeover bid based on an *inadequacy* opinion, which gives the investment banker even greater latitude than a fairness opinion to reach the answer the client wants, is wholly unsustainable.

In short, investment banker opinions seems to us to do little more than create a smokescreen that target boards can hide behind. A cynic might say that fairness opinions are beyond rescuing. We believe, however, that these opinions can have modest value, if the courts vigorously police them. The courts can do so in a number of ways.

First, they can insist on fairness opinions, rather than inadequacy opinions, as a basis for a target board to reject a takeover bid. Second, they can reject an unfairness opinion, in response to a hostile bid at a higher visible price than a friendly bid that the banker has already blessed as fair, unless

⁶⁹ For skeptical accounts of the weight that investment banker fairness opinions deserve, see Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27; William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523 (1992).

⁷⁰ See Andrew Barry, *Ron Strikes Again: Another Perelman Plan Leaves Shareholders Steaming, This Time at M&F Worldwide*, BARRON'S, Apr. 2, 2001, at 22. Bernard Black was an expert witness for a plaintiff in a Delaware lawsuit claiming breach of fiduciary duty by the M&F Worldwide board of directors, which was settled.

⁷¹ See, e.g., *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 106-07 (Del. Ch. 1986) (First Boston values a management-led leveraged recapitalization at \$43-47/share, but raises its estimate to \$50-55/share after a hostile bidder offers \$54); William F. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 523-24 (collecting other horror stories); Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27.

the banker persuasively explains why the first transaction truly has a higher value. For the banker to simply raise its fairness range to above the hostile bid should be unacceptable, whatever the banker's purported excuse. Third, the courts can require fairness opinions to explicitly address and adjust for the risk that management's projections will not be achieved, just as investors would. Fourth, the courts can value an opinion by a major investment bank more highly than an opinion by a smaller bank. This can help weed the use of soft fairness opinions from lesser banks.

To be sure, a target board, faced with a fair offer but believing it can negotiate for more, should have some latitude to do so. (How much latitude is a hard question that is beyond the scope of this Article.) But the way to provide latitude is not to invoke hidden value and allow the board to just say no, but to confront directly the hard question of how much negotiating power a board should have to reject a fair offer, ostensibly to obtain an even better offer, when we cannot fully trust the board's faithfulness. For present purposes, we note only that our suggested constraints on investment banker opinions will not stop a target board from initially resisting a fair offer, in an effort to obtain a higher offer from this or another bidder.

D. Normative Consistency

Even if large claims of hidden value are dubious, they retain some plausibility in individual transactions. Moreover, the Delaware Supreme Court has discouraged judicial review of these claims. But if claims of hidden value are often suspect, and the courts neither screen them nor impose procedural constraints that might make these claims more plausible, we are led back to a familiar question: Why is the hidden value model the default principle of our corporate law? If the possibility that a controlling shareholder might cash out minority shareholders without sharing hidden value with them disqualifies the hidden value model in change-of-control transactions, why does the risk that a target's board will be either disloyal or simply wrong in its claim of hidden value not have the same effect?

This question is not merely rhetorical. Other jurisdictions empower shareholders to decide the fate of tender offers—that is, they endorse a visible value model. The European Union last year came within an inch of adopting a similar rule—a 273 to 273 tie vote in the European Parliament where the opposition was led by German managers who were interested in entrenchment rather than shareholder value—and seems likely to adopt a slightly modified rule.⁷²

The answer is found not in finance but in law. Vice Chancellor Leo

⁷² See European Union, Proposal for a 13th European Parliament and Council Directive on Company Law Concerning Takeover Bids, Doc. No. 595PC0655 (1996); *Pull up the Drawbridge*, ECONOMIST, July 7, 2001 (reporting 273-273 split vote on the 13th directive). For the revival of this approach, see REPORT OF THE HIGH LEVEL GROUP OF COMPANY LAW EXPERTS ON ISSUES RELATED TO TAKEOVER BIDS (Jan. 10, 2002), at http://europa.eu.int/comm/internal_market/en/company/company/news/hlg01-2002.pdf.

Strine argues that in the mid-1980s, the Delaware Supreme Court felt compelled to choose between “two competing models as to how the corporation law should address contests for corporate control.”⁷³ The court rejected the British City Code approach, which lets shareholders decide the outcome of control contests, and chose a “director-centered” approach that vested discretion over control contests in the board of directors. It also rejected (over time, though this was not evident at first) a regulatory approach in which courts would review the reasonableness of takeover defenses.⁷⁴ We suspect that the hidden value model arose to reconcile this director-centered approach with another deeply rooted and apparently contradictory norm of Delaware law—the conviction that corporations must be governed in the interests of their shareholders. Thus we conjecture that the hidden value model followed, rather than preceded, the rise of Delaware’s director-centered vision of takeover law. The centrality of this director-centered vision is implicit in the Delaware Supreme Court’s repeated citations to the wide discretion granted by Delaware General Corporate Law §141(a), under which boards manage the “business and affairs of the corporation.”⁷⁵

Nevertheless, as Vice Chancellor Strine implies, Delaware was not compelled to embrace either a director-centered vision of corporate law or the hidden value model. At least two alternatives were available, both of which would let the courts avoid an active valuation role. One of these is shareholder choice. A second alternative is a regime in which the board and its shareholders decide bilaterally, with the board initiating a course of action and shareholders voting to ratify or reject it.

American corporate law supports bilateral decision-making by shareholders and the board on decisions that are fundamental to the corporation’s identity and existence, especially decisions that place managers and directors in a final period problem, where agency costs are likely to be high. Every corporation statute in the United States (and every company law statute in the world that we know of) reserves a small number of basic corporate decisions for shareholder ratification—and often provides additional shareholder protections, such as appraisal rights. Acquisition transactions (such as mergers and sales of all or substantially all assets) are precisely the kinds of decisions for which corporate law generally requires a shareholder vote. A mandatory shareholder vote on mergers and sales of all or substantially all assets, and the appraisal remedy for mergers, belie the assumption that the law should always presume that the board knows best.

To be sure, hostile takeover bids are a relatively recent arrival, that the corporate statutes leave unaddressed. Control contests and board decisions to reject all bidders raise final period problems similar to those that arise in

⁷³ Strine (2001), *supra* note 32, at 925.

⁷⁴ See Gilson (2001), *supra* note 27. For an effort to persuade the courts to take seriously the regulatory approach that *Unocal* seemed to promise, see Gilson & Kraakman (1989), *supra* note 10.

⁷⁵ DEL. CODE ANN. tit. 8 §141(a) (1991); see, e.g., *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

mergers and sales of all or substantially all assets, and could plausibly call for similar regulatory treatment. A director-centered approach may have seemed sensible when the courts were confronted with an unprecedented wave of hostile takeovers in the mid-1980s, combined with public distrust of these takeovers and fierce pressure from corporate managers to permit strong defenses. However, this choice was not compelled by either financial theory or the core values of American corporate law.

Director-centered takeover decisions require a strong form of the hidden value model to serve as ideological ballast and support. But the hidden value model cannot bear so much weight. The court should lighten this load by adopting a bilateral decision rule that shifts some merger and acquisition decisions back to the shareholder meeting.

V. THE MIDDLE ROAD NOT TAKEN: A BILATERAL DECISION RULE

A. *A Proposed Bilateral Decision Framework*

If we could design a legal framework to govern control contests under Delaware law, we would choose visible value and shareholder choice, and let shareholders accept or reject hostile bids, after a period of perhaps six weeks for the target board to negotiate a higher offer, solicit competing bids, or convince the shareholders to reject the bid in hand.⁷⁶ We understand that the less extreme uses of the hidden value model have not been completely defeated, and perhaps cannot be, by empirical studies. Nor has the scientific literature established beyond cavil that today's leading takeover defenses reduce shareholder welfare.⁷⁷ Nevertheless, our judgment, based on the available evidence and the preferences of institutional investors (who mostly oppose staggered boards, conventional nonchewable poison pills, and other defenses that let the board control the decision to sell the firm), is that control contests are best decided by shareholders. We prefer imperfectly informed but unbiased shareholder decisions to better informed but sometimes biased decisions by target boards.

However, the Delaware courts are unlikely to abandon almost twenty years of jurisprudence, beginning with *Van Gorkom*, that make the hidden value model a powerful arbiter of Delaware law. Nor are they likely to reverse a long history of empowering boards over shareholders, which arguably began when Delaware law removed shareholders' unilateral power to amend the company's charter, more than a century ago.⁷⁸

⁷⁶ We had the opportunity to draft a corporate law statute for the Russian Federation substantially from scratch, and followed this strategy. See Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1960-63 (1996).

⁷⁷ For a survey, see John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000). For recent evidence that staggered boards likely reduce shareholder welfare, see Robert Daines, *Do Classified Boards Affect Firm Value? Takeover Defenses After the Poison Pill*, J. FIN. & QUANT. ANALYSIS (forthcoming 2002)

⁷⁸ See 21 Del. Laws ch. 273, § 135 (1899). For our own view that shareholders should be able to

As a second-best substitute for shareholder choice in control transactions, we propose a return to the bilateral decision-making that has long been traditional in the corporate law of Delaware and other jurisdictions. A bilateral decision structure straddles the fence between the hidden value and visible value models. The board may act on its own insights, but it must ultimately obtain shareholder approval of its actions. Shareholders, meanwhile, cannot unilaterally accept or reject a takeover bid. They must wait for the board to act, and then ratify or reject the board's decision.⁷⁹

Academics disagree on whether shareholder purchase and sale decisions in markets or shareholder voting decisions are a better guide to value.⁸⁰ But either way, a shareholder voting decision, to endorse or veto the target board's decision, is far better than unfettered board discretion, and can usually block a truly bad board decision.

B. Implications for Delaware Takeover Law

1. *Approving Fundamental Transactions.*—For fundamental transactions, a bilateral decision structure is already in place, through the statutory procedure that governs mergers and sales of all or substantially all assets.⁸¹ The board proposes a transaction and shareholders ratify it, after the passage of enough time to let third parties intervene as competing acquirers. Thus, we would merely affirm the existing provisions of the Delaware statute for these transactions.⁸² For other similarly fundamental transactions that are now outside the voting requirements under Delaware law, we would encourage the courts or the legislature to extend shareholder voting rights. For example, a shareholder vote to approve an acquisition or a large share issuance to a friendly acquirer might create a rebuttable presumption that a target board has met its duty to maximize long-term value, even if the board does not conduct an explicit auction.

2. *Takeover Defenses: No, but Not Never.*—One could also impose a bilateral decision structure on fundamental transactions the board rejects—that is, on hostile takeover bids—as well as transactions the board accepts. If the board has the sole right to initiate fundamental transactions, it must also have the right to reject takeover bids—as it does, thanks to the poison pill. But how can shareholders participate in a *negative* decision by the board—for example, a decision to reject a tender offer? Currently, they

unilaterally amend the charter, see Black & Kraakman (1996), *supra* note 76, at 1943-45.

⁷⁹ As we noted earlier, Marcel Kahan has advocated a similar position, based on a different reading of the Delaware takeover cases. See Kahan (1994), *supra* note 35.

⁸⁰ Compare Ronald J. Gilson & Alan Schwartz, *Sales and Elections as Methods for Transferring Corporate Control*, 2 THEORETICAL INQUIRIES IN LAW 783 (2001), with Lucian Arye Bebchuk & Oliver Hart, *Takeover Bids v. Proxy Fights in Contests for Corporate Control* (Oct. 2001) (Harvard L. & Econ. Discussion Paper No. 336), available at <http://papers.ssrn.com/abstract=290584>.

⁸¹ 2 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS* §§ 253 (mergers), 271 (sales of all or substantially all assets) (3d ed. 1998).

⁸² DEL. CODE ANN. tit. 8 § 251 (1991) (mergers); §271 (sales of substantially all assets).

participate by voting ex post either for, or against, the directors who made the decision. This, then, is the most important point at which a bilateral decision rule requires a change in the law. Today's antitakeover cocktail of choice—a poison pill plus a staggered board—does not let the shareholders vote on the board decision to reject a takeover bid. The multi-year delay that this tactic can impose on hostile offers lets the target board continue to block a bid even after shareholders vote to reject this course.⁸³

Neither the finance literature nor the norms of corporate law support vesting such unbalanced power in the hands of the board. The remedy is straightforward: The Delaware courts should strike down as “preclusive” (under the *Unitrin* reformulation of the *Unocal* standard for judging takeover defenses⁸⁴) any pill that blocks an active takeover bid and remains in place after it is rejected by a shareholder vote. This vote would ideally be a direct shareholder vote on redemption of the pill, but an acceptable substitute is a shareholder vote on the board that rejected the takeover bid. If the shareholders reject the pill (or the board that adopted it), the board must become a *Revlon* auctioneer—it can keep the pill in place only long enough to maximize visible value.

Within the hidden value model, the issue can be framed in terms of the risk that the company will be sold for too low a price, versus the risk that the board will be disloyal or simply wrong in rejecting the offer. When the board's view has been rejected by shareholders, and the board still refuses either to negotiate with the bidder or to conduct an auction to see whether this or another acquirer will offer an acceptable price, the risk of board disloyalty or error, if the company isn't auctioned, almost surely exceeds the risk of takeover market error if it is.

The issue, in effect, is whether the target's board can “just say no” to a takeover bid, subject to shareholder veto at the next shareholder meeting, or whether it can “just say (almost) never” by hiding behind a staggered board and requiring two consecutive annual shareholder votes to veto its decision. Our recommendation—“no” but not “never”—is not novel.⁸⁵ But perhaps we have come to it in a way that the Delaware courts will find persuasive.

⁸³ For approval of this defense by the Delaware District Court, see *Moore Corp. v. Wallace Computer Services*, 907 F. Supp. 1545 (D. Del. 1995). No Delaware state court decision directly blesses keeping a poison pill in place after losing an election. However, many practitioners believe that target companies may do so, and there are occasional cases where target boards have done so. For evidence on the antitakeover potency of a poison pill plus a staggered board, see Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Antitakeover Power of Classified Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. (forthcoming 2002).

⁸⁴ *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).

⁸⁵ See, e.g., Lucian Arye Bebchuk, *The Undistorted Shareholder Choice Approach to Corporate Takeovers*, xxx U. CHI. L. REV. (forthcoming 2002); Jeffrey N. Gordon, “Just Say Never?” *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997). But see Martin Lipton, *Pills, Polls and Professors Redux*, xxx U. CHI. L. REV. (forthcoming 2002) (agreeing that boards should not be able to just say never, but arguing that no change in Delaware case law is needed because “the incidence of a target's actually saying ‘never’ is so rare as not to be a real-world problem”).

The counterargument—that Delaware law permits staggered boards and shareholders have approved these boards—is weak. First, public shareholders today reject most staggered board proposals (therefore, few are made). Most existing staggered boards were put in place before the potency of the pill-staggered board combination became apparent, or were adopted prior to the firm going public, which weakens the claim that they are sensible governance rules.⁸⁶ Second, Delaware law does not allow shareholders to waive their right to approve a fundamental transaction, so it should not indirectly let them waive the right to approve the board's rejection of such a transaction. We need not consider here whether the courts should respect a direct shareholder vote to allow a company with a board to keep a poison pill in place, even if a later transaction-specific shareholder vote rejects this defense. It is unlikely that target boards would conduct such a direct vote, or that shareholders would vote favorably if boards did so.

A related issue under Delaware law is whether shareholders can adopt an antipill bylaw, which requires the board to redeem a poison pill or restricts the pill's potency.⁸⁷ On both policy and statutory analysis grounds, we support these bylaws. In contrast, our bilateral decision approach would permit the board to keep a poison pill in place over shareholder objection. Letting shareholders remove the pill, in advance of a particular offer, would give shareholders first-mover power to accept a bid by tendering their shares, instead of second-mover power to ratify or veto the board's decision on the offer.

3. *Choosing Between Alternative Transactions.*—Under our bilateral approach, if the board wants to accept one transaction and reject a second transaction offering higher visible value, that decision should be subject to shareholder ratification. Allowing shareholders to vote on a preferred merger, when a competing bid is outstanding, complies with our proposed norm. Conversely, allowing a favored bidder to complete a takeover bid, while using the pill to block a second bidder, violates this norm.

The 1995 bidding contest between Burlington Northern and Union Pacific to acquire Santa Fe Southern Pacific offers a good example of the distinction between a shareholder-choice approach, the bilateral decision approach, and a pure board-choice approach. Santa Fe signed a merger agreement with Burlington. Union Pacific interceded with a series of hostile bids, which caused Burlington to progressively raise its offer. Santa Fe had given Burlington only modest deal protections. The Santa Fe shareholders then voted to approve what had become (to oversimplify a complex transaction structure), a two-step, part-cash, part-stock Burlington transaction. Burlington and Santa Fe completed a front-end joint cash tender offer

⁸⁶ On when and how today's public companies adopted staggered boards, see Bebchuk, Coates & Subramanian (2002), *supra* note 83; John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Provisions in IPOs*, 17 J.L. ECON. & ORG. 83 (2001).

⁸⁷ See, e.g., Gilson (2001), *supra* note 28; Gordon (1997), *supra* note 21.

after the shareholder vote.⁸⁸ Here:

(i) A shareholder choice approach would let shareholders decide directly which bid they preferred.

(ii) The bilateral decision approach matches the actual outcome. The Santa Fe shareholders voted on the board's preferred deal, and chose to accept it. If they had rejected the Burlington merger, they could hope, but not ensure, that the board would accept the Union Pacific proposal.⁸⁹ However, we believe that in making its choice, the Santa Fe board should have been explicitly obliged to maximize long-term shareholder value.

(iii) It would have violated the bilateral decision norm if Santa Fe and Burlington completed their tender offer before the Santa Fe shareholder vote, thus precluding the Union Pacific offer and giving the Santa Fe shareholders no real choice but to approve the back-end merger with Burlington.

4. *Deal Protections.*—A corollary of shareholder power to accept or reject the board's approval of a merger (when no competing bid is made), or the board's choice between alternative bids (when a competing bid emerges) is restricting the strength of the deal protections that the board can adopt. This Article is not the place to assess the proper scope of deal protections. However, our rough sense is that the Delaware courts have the rules about right—permitting some deal protections, but not protections so strong or expensive that they effectively deprive shareholders of the power to accept or reject the board's initial choice.

The bilateral decision approach can explain, in a way that the leading cases on lockup options have not, why limits on the size of lockup options are appropriate.⁹⁰ The core point is *not* that strong lockups cannot be the best way for a loyal board to sell a company. They can be. The point is instead that the board exceeds its authority when, by adopting strong deal protections, it—in effect—unilaterally decides to sell the company or chooses between two bidders.

In all of these situations—the board's effort to just say never, prefer one bidder over another, or definitively lock up a transaction with a favored bidder—*someone* must be able to review the board's potentially conflicted decision. Today, that someone is the courts, who engage in the task with great reluctance, because they disclaim the expertise to second guess the board's business judgment. It is fully in keeping with that reluctance for the courts to turn the review task over to shareholders. And, just as litigants cannot relitigate their case before a second judge after losing before a first

⁸⁸ See *In re Santa Fe Pacific Corp. S'holder Litig.*, 669 A.2d 59 (Del. 1995).

⁸⁹ See *id.* at 68 (“In voting to approve the Santa Fe-Burlington merger, the Santa Fe stockholders were not asked to ratify the board's unilateral decision to erect defensive measures against the Union Pacific offer. The stockholders were merely offered the choice between the Burlington Merger and doing nothing.”).

⁹⁰ The principal cases are *Paramount v. QVC*, which rejected a bust-up fee and lock-up option that conveyed about 7% of the transaction's value to the first bidder, and *Brazen v. Bell Atlantic Corp.*, 695 A.2d 43 (Del. 1997), which upheld a \$550 million bust-up fee, which was only 2% of transaction value.

judge, target boards should not be able to use staggered boards to block a takeover bid for another year after losing an election contest, hoping to persuade a second group of shareholders to vote differently than the first or simply to wear out the bidder.

C. Implications for Proxy Contests Incident to Takeover Bids

The bilateral decision-making approach has important implications for proxy contests that are incident to a takeover bid. If the core check on director power is shareholder review, then the courts must vigorously police the board's efforts to control the voting outcome by putting shares in friendly hands, repurchasing shares to increase the insiders' stake, manipulating meeting dates, imposing conditions on a proxy contest, and so forth.

After an early hint of strict scrutiny in *Blasius Industries v. Atlas Corp.*,⁹¹ the Delaware courts have allowed relaxed scrutiny of takeover defenses under *Unocal* to trump stricter scrutiny under *Blasius* when a proxy contest accompanies a takeover bid. For example, in *Unitrin*, they allowed the target to repurchase its shares, thus increasing insider ownership and making it harder for the bidder to win a proxy contest, as long as this defense did not make the bidder's proxy contest success "mathematically impossible or realistically unattainable."⁹²

If we take seriously the bilateral decisionmaking approach, a target board should not be permitted to hide behind a poison pill while conducting share transactions or taking other actions that bias the outcome of a proxy contest. Instead, target boards should be held to a *Revlon*-like standard of strict neutrality, which a broad reading of *Blasius* promised, but later cases never delivered.

The key to such a test is to focus on the effect of the board's actions, not its intent. Strict scrutiny under *Blasius* applies only when the board's "primary purpose" is to frustrate a shareholder vote. That test is no more workable than the "primary purpose" test for whether takeover defenses fall under the duty of loyalty, announced by the Delaware Supreme Court in 1964 in *Cheff v. Mathes*,⁹³ and de facto abandoned in 1985 in *Unocal*, after no target board in the intervening two decades ever failed the test.

Under an "effects" test, *Unitrin* is wrongly decided. No matter how pure the Unitrin board's motives, the share repurchase increased insider holdings and tilted the proxy fight outcome toward the incumbents. More generally, when a takeover defense also affects a shareholder vote, strict scrutiny, perhaps using *Blasius*' "compelling justification" standard, should trump more relaxed scrutiny of other defenses under *Unocal*

⁹¹ 564 A.2d 651, 661 (Del. Ch. 1988) (board actions taken for "the primary purpose of impeding the exercise of stockholder voting power" must have a "compelling justification"). *Blasius* is a Chancery Court opinion, but the Delaware Supreme Court has "accepted [its] basic legal tenets." *Stroud v. Grace*, 606 A.2d 75, 91 (Del. 1992).

⁹² *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361, 1388-89 (Del. 1995).

⁹³ 199 A.2d 548 (Del. 1964).

VI. CONCLUSION: TOWARD COHERENCE AND PLAUSIBILITY

In choosing between a target board's claim of hidden value, and the shareholders' preference for visible value, we must balance risks of error on both sides. Markets are imperfect, but boards err too, because they are disloyal, or perhaps more often, because they convince themselves, aided by their own cognitive biases, that their actions are good for shareholders.⁹⁴

The relevant risk of board error or disloyalty is not the background risk, that shareholders face whenever they invest in a company. Rather, it is the heightened risk that emerges for that subset of boards who reject an offer and refuse to canvass the market for better offers, accede to extraordinary deal protections, or favor a stock-for-stock offer with lower visible value over a competing offer with higher visible value. Sometimes, it is the further heightened risk, when a target board refuses to sell or canvass the market even after losing one election.

Instead of weighing the risk of error on both sides, the Delaware courts have abdicated, pretending that board decisions are right and shareholder decisions wrong when the two conflict, when the evidence points strongly the other way. The courts pretend that investment banker opinions are meaningful checks on the board's judgment in the face of compelling contrary evidence. The courts maintain this stance while refusing to impose meaningful procedural and other plausibility checks on board or investment banker claims of hidden value. They do all this even when the target board's claim is so extreme as to be almost surely wrong. Perhaps a good closing question, then, is not whether the hidden value model is coherent or empirically plausible, but how much the Delaware courts care about coherence or plausibility. The evidence thus far is not encouraging, but one can always hope for better.

⁹⁴ See Gilson (2002), *supra* note 21 (arguing that the cognitive biases that could explain market inefficiency also predict board error).