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# Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers

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# Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers

JAMES A. FANTO†

## ABSTRACT

*This Article articulates a legal reform that is designed to rein in the number of value-decreasing stock-for-stock mega-mergers—the signature transaction of the 1990s and the beginning years of the new millennium—by causing board members to question more critically a mega-merger proposal when they are asked to approve it and even to continue to reevaluate their approval of a merger until its closing. The Article first describes the current merger wave and highlights reports of emerging problems in mega-mergers and the relevant economic data indicating that a majority of the transactions are value-decreasing for shareholders both in the short and long term. It next examines why these transactions are occurring and why they have been little criticized, focusing on their economic and business justifications, the recognizable psychological tendencies (exacerbated in today's merger climate) affecting chief executives, board members and investors and motivating them to propose and approve the transactions, and the journalistic celebration of (and a general political silence on) the mega-mergers. The Article then analyzes the legal foundations of the mega-mergers and observes that merger jurisprudence developing from cases involving hostile takeovers encouraged (i) management to engage in (and*

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† Professor, Brooklyn Law School. J.D., Univ. of Pennsylvania, Ph.D., Univ. of Michigan. I would like to thank my colleagues, Professors Roberta Karmel, Arthur Pinto, Norman Poser, Spencer Waller, as well as Professor Jeffrey Gordon, who all offered me insightful comments on earlier drafts of this Article. I am also grateful to Dean Joan Wexler for a summer stipend that funded my research.

*boards to approve with little court review) stock-for-stock mega-mergers and (ii) the corporate law bar to reinforce contractual provisions in merger agreements intended to "tie the hands" of boards that enter into the mergers. Finally, the Article proposes a new intermediate standard of court review for board decisions approving stock-for-stock mega-mergers, which should produce a new standard of board conduct in these transactions, addresses several possible criticisms of the standard, and advocates additional nonlegal and legal reforms that would make the standard more effective.*

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## I. INTRODUCTION

We are living in the middle of one of the most important merger “waves” of recent history.<sup>1</sup> In 1998, the number of, and the size of the parties involved in, major mergers surpassed even the records for such transactions set in 1997, and then the same occurred in 1999.<sup>2</sup> A week does not seem to pass without the announcement of a new “blockbuster” merger that exceeds in size and dollar value the preceding recordholder.<sup>3</sup> The media has greeted the wave with euphoria, celebrating the new titanic companies and the reasonableness of these “strategic combinations,” as well as lionizing the Chief Executive Officers (“CEOs”) who undertake them as courageous visionaries.<sup>4</sup> Politicians have

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1. There have been four major merger waves in U.S. business history: the first at the end of the nineteenth century, the second in the 1920s, the third in the 1960s and the fourth beginning in the 1980s until the present. See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 941 (5th ed. 1996). On the first great U.S. merger wave, see Ajeyo Banerjee & E. Woodrow Eckard, *Are mega-mergers anticompetitive? Evidence from the first great merger wave*, 29 RAND J. ECON. 803, 804-06 (1998). On the conglomerate merger wave of the 1960s, see R. Glenn Hubbard & Darius Palia, *A Reexamination of the Conglomerate Merger Wave in the 1960s: An Internal Capital Markets View*, 54 J. FIN. 1131 (1999) (discussing explanations for value creation in some conglomerate mergers).

2. See Thompson Financial Securities Data, *Surging Mergers!*, [http://www.tfsd.com/news\\_room/archive](http://www.tfsd.com/news_room/archive) (Jan. 6, 1999) (“[T]otal announced domestic M&A transactions exceeded \$1.62 trillion from more than 11,400 deals. That’s in contrast to last year’s then-record volume of \$907 billion from 11,148 deals and more than the combined total of all announced domestic M&A deals in the six-year period between 1990 and 1995.”); Thomson Financial Securities Data, *The World is Not Enough... To Merge*, [http://www.tfsd.com/news\\_room/archive](http://www.tfsd.com/news_room/archive) (Jan. 5, 2000) (“Announced M&A activity in the United States ended the year on a record note as more than \$1.75 trillion in announced deals were recorded.”).

3. One has only to compare the largest 1999 and 1998 transactions with the transaction receiving the most attention in the 1980s, the leverage buy-out of RJR-Nabisco for \$31 billion, to see that transactions today are of a different order of magnitude altogether. See Geoffrey Colvin, *The Year of the MegaMerger*, FORTUNE, Jan. 11, 1999, at 62-65 (listing the top ten 1998 mergers all but one of which exceeded the value of the RJR-Nabisco transaction); *Top 50 U.S. M&A Transactions of 1999*, THE DAILY DEAL, at [www.thedailydeal.com/features/special/A14286-2000Jan26.html](http://www.thedailydeal.com/features/special/A14286-2000Jan26.html) (Mar. 1, 2000) (presenting data showing that six of the ten top 1999 mergers equaled or exceeded the value of that transaction). The year 2000 saw the announcement of the largest merger ever: the approximately \$156 billion merger between AOL and Time Warner. See Martin Peers et al., *AOL, Time Warner Leap Borders to Plan A Mammoth Merger*, WALL ST. J., Jan. 11, 2000, at A1.

4. See, e.g., Rebecca Blumenstein, *Armstrong Steers AT&T Into Uncharted*

generally been silent and unconcerned about the phenomenon.<sup>5</sup> Corporate and securities law scholars have all but ignored the merger wave.<sup>6</sup>

One acquisition form clearly characterizes this merger wave, much in the same way that the “bust up” leveraged-buyout (“LBO”) transaction typified the 1980s. This is a merger in which enormous companies, generally of comparable size, combine in a strategic “merger of equals,” usually through a stock-for-stock exchange.<sup>7</sup> It is important

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*Waters*, WALL ST. J., Apr. 23, 1999, at A3 (discussing strategy of AT&T CEO C. Michael Armstrong with his major acquisition of MediaOne); Carol Hymowitz, *Will AOL's Bosses Team Up to Create a Management Model?*, WALL ST. J., Jan. 18, 2000, at B1 (discussing respective CEOs in AOL/Time Warner merger); Karen Lowry Miller & Joann Muller, *The Auto Baron*, BUS. WK., Nov. 16, 1998, at 83-90 (celebrating Daimler-Chrysler CEO Jürgen Schrempp); Joann S. Lublin & Mark Maremont, *A CEO with a Motto: "Let's Make a Deal!"*, WALL ST. J., Jan. 28, 1999, at B1 (celebrating deal-making of Dennis Kozlowski, CEO of Tyco International); David Rocks et al., *The Main Event: Bernie vs. Mike*, BUS. WK., Oct. 18, 1999, at 35-38 (discussing “battle” for telecom control between CEOs of AT&T and MCI WorldCom).

5. There may be at least one exception in the politically-charged financial services industry. Because banks have traditionally had a “quasi-public” role of providing the essential economic functions of payment services and payment services, and have had close—indeed, too close—ties to politicians, politicians are particularly vigilant to transactions in banking and other financial services. See generally JONATHAN R. MACEY & GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 72-74 (2d ed. 1997) (discussing bank politics and “special” nature of these financial institutions); Anthony M. Santomero, *Bank Mergers: What's a Policymaker to do?*, 23 J. BANK. & FIN. 637, 641-42 (1999) (discussing potential for political interference with current financial consolidation). Nevertheless, in 1999 Congress recently passed, and the President signed, a law eliminating the barriers among banking, insurance and securities firms, which may spur merger activity across these areas. See Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338 (1999).

6. For recent legal scholarship on mergers, see Steven A. Bank, *Federalizing the Tax-Free Merger: Toward An End to the Anachronistic Reliance on State Corporation Law*, 77 N.C. L. REV. 1307 (1999) (discussing proposal to end dependence on state law for tax treatment in mergers); Steven A. Bank, *Mergers, Taxes, and Historical Realism*, Social Science Research Network, at <http://papers.ssrn.com/sol3/results.cfm> (Dec. 28, 1999) (exploring historical justification for tax free mergers); John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of Lockups: Theory and Evidence*, Social Science Research Network, at <http://papers.ssrn.com/sol3/results.cfm> (Feb. 3, 2000) (presenting theoretical basis for lockups in mergers); Celia R. Taylor, *"A Delicate Interplay": Resolving the Contract and Corporate Law Tension in Mergers*, 74 TUL. L. REV. 561 (1999) (discussing respective role of corporate and contract law in mergers).

7. See EDWARD D. HERLIHY ET AL., *FINANCIAL INSTITUTIONS MERGERS AND ACQUISITIONS 1999: CONVERGING TOWARDS THE DAWN OF THE NEW MILLENNIUM* 10-11, 110-18 (1999).

to emphasize each feature of this kind of merger at the outset, for this transaction is the focus of the Article. Certainly, all mergers are strategic, insofar as they reflect the business planning of the acquiring and acquired (or "target") firms, and reasons for mergers vary from industry to industry. These enormous mergers, however, often evidence bold strategies of combining different kinds of firms and technologies or significantly expanding businesses geographically, whether domestically or internationally. Because, moreover, the mergers involve huge established firms, the parties involved often present them as "mergers of equals." This means that the companies are roughly equal in market capitalization and that the resulting firm will be almost in the nature of a partnership between the two firms. That, in reality, one firm may emerge as the dominant party in a transaction is not important for the argument, which will focus on the justification for the mergers. Finally, the stock form of these transactions is significant: in these stock-for-stock exchanges, shareholders of one company receive shares of the other.<sup>8</sup> The numerous reasons for this transaction form will be explored below, but a standard justification for it is that, given the sheer size of the companies, it would be difficult for one company to raise the money to do a cash merger and, in any event, a cash transaction would suggest a "sale" as opposed to a "merger of equals."<sup>9</sup>

Occasionally in the business press, a note of caution has been struck as to this kind of transaction in the current merger wave.<sup>10</sup> Expressions of concern come from

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8. See Alfred Rappaport & Mark L. Sirower, *Stock or Cash? The Trade-Offs for Buyers and Sellers in Mergers and Acquisitions*, HARV. BUS. REV. 147, 147-48 (Nov.-Dec. 1999) ("What is striking about acquisitions in the 1990s, however, is the way they're being paid for. In 1988, nearly 60% of the value of large deals—those over \$100 million—was paid for entirely in cash. Less than 2% was paid for in stock. But just ten years later, the profile is almost reversed: 50% of the value of all large deals in 1998 was paid for entirely in stock, and only 17% was paid for entirely in cash.").

9. See RICK ESCHERICH, J.P. MORGAN SECURITIES INC., QUARTERLY FOCUS: STOCK-FOR-STOCK DEALS: BACKGROUND ON EXCHANGE RATIOS, COLLARS, AND WALK-AWAY RIGHTS 12 (Apr. 22, 1998).

10. See, e.g., Dennis Carey & Dayton Ogden, *A Match Made in Heaven? Find Out Before You Merge*, WALL ST. J., Nov. 30, 1998, at A22 ("If history is a guide, however, a substantial number of these [mergers] will become a great disappointment to both sides within months after the partnership begins."); Nikhil Deogun & Steven Lipin, *Cautionary Tales: When Big Deals Turn Bad*,

understandable quarters. From the important antitrust perspective, the mergers raise the specter of concentration and abuse of market power, and, as the merger wave has proceeded, federal antitrust authorities have increasingly scrutinized transactions for these problems.<sup>11</sup> The sheer size of the firms resulting from mega-mergers has raised other concerns, both tangible and intangible, relating to consumers, employees and citizens that have always been associated with large firms in America: for example, the impersonal service offered by these firms,<sup>12</sup> the alienation of working in these large enterprises, the ability of the firms to influence unduly everyday and political life,<sup>13</sup> and the creation of unseemly wealth disparities as the compensation of high executives in these firms dwarfs that

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WALL ST. J., Dec. 8, 1999, at C1 (reviewing recent merger failures); Nikhil Deogun, *Merger Wave Spurs More Stock Wipeouts: Acquirers' Shares Drop on Average*, WALL ST. J., Nov. 29, 1999, at C1; Greg Ip, *Big Deal, Big Return? It's a Little Complicated*, WALL ST. J., Oct. 11, 1999, at C1 (discussing general negative performance of large firms resulting from mergers); Mitchell Lee Marks, *Egos Can Make—and Unmake—Mergers*, WALL ST. J., Jan. 24, 2000, at A26 (“But when merging CEOs can’t agree on their roles, ego can be an obstacle to long-term success. That’s a big reason why less than 20% of all mergers and acquisitions are financially successful.”); George Melloan, *Corporate Marriages Aren’t Made in Heaven*, WALL ST. J., Jan. 5, 1999, at A23 (“But while mergers and acquisitions always are accompanied by logical-sounding arguments about synergies and efficiencies, the record shows that very often neither is achieved”); Steven Rattner, *Mergers: Windfalls or Pitfalls?*, WALL ST. J., Oct. 11, 1999, at A22 (discussing benefits of current mergers, but expressing concern about their high price); *How to Make Mergers Work*, ECONOMIST, Jan. 9, 1999, at 15 (discussing ways of avoiding failure in mergers); *The Trouble with Mergers, Cont’d*, ECONOMIST, Nov. 28, 1998, at 17 (“Indeed, the motivation behind many of the mergers is itself disturbing. All too often it is a case of imitation: somebody else has done it, so we should too.”). For a spoof on the mega-mergers, see *Let’s Make an Imaginary Deal!*, WALL ST. J., Dec. 3, 1998, at B1 (describing imaginary mega-mergers, such as “Wal-Buck” (between Wal-Mart and Sears) and “Poke” (Coca-Cola and Pepsi)).

11. See Dan Carney, *The New Math of Antitrust*, BUS. WK., Feb. 28, 2000, at 35 (discussing increased Federal Trade Commission scrutiny of mergers); Robert Pitofsky, *The Nature and Limits of Restructuring in Merger Review*, Address Before Cutting Edge Antitrust Conference, at <http://www.ftc.gov/speeches/pitofsky/restruct.htm> (Feb. 17, 2000) (clarifying FTC policy in merger review).

12. See Rebecca Blumenstein & Stephanie N. Mehta, *Lost in the Shuffle: As the Telecoms Merge and Cut Costs, Service is Often a Casualty*, WALL ST. J., Jan. 19, 2000, at A1.

13. See Michael J. Mandel, *All These Mergers are Great, but . . .*, BUS. WK., Oct. 18, 1999, at 48 (expressing concern about the political power of mega-firms).

received by lower-ranking employees.<sup>14</sup> The transactions also result in the same social consequences and “externalities”<sup>15</sup> (e.g., massive employee layoffs, exit of firms from communities) that so troubled policy-makers and members of the press in the earlier, but different, LBO merger wave of the 1980s.<sup>16</sup>

Yet others worry about mega-mergers for reasons that are internal to the transactions themselves because the mergers do not produce the success predicted by their initiators. Many of the mergers display problems almost as soon as their completion, or sometimes even after their announcement and before the closing, and the problems have not been limited in kind. There have been discoveries of massive fraud<sup>17</sup> and significant mismanagement<sup>18</sup> in one

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14. See, e.g., *Sanders v. Wang*, No. 16640, slip op. at 19 (Del. Ch. Nov. 8, 1999) (discussing compensation of senior executives at Computer Associates: “As a practical matter, my rough calculations indicate that even under the strictest reading of the Plan, the three Participants will together still receive nearly \$320 million. \$320 million is no mere bagatelle. I find it remarkable that defendants would have me believe that CA’s shareholders would consider that \$320 million for three individuals failed to ‘encourage, recognize, and reward sustained outstanding individual performance by certain key employees.”) (footnote omitted).

15. For a “plain English” definition of this term, see TODD G. BUCHHOLZ, FROM HERE TO ECONOMY: A SHORTCUT TO ECONOMIC LITERACY 93 (1995) (“An externality arises when someone acts in a way that impacts other people who have no control over the situation.”). The future success of so many of the recent mergers is explicitly based upon cost savings generated from employee layoffs and the closing of duplicate operations. See, e.g., Steve Liesman, *Exxon Mobil to Cut 14,000 Jobs, Sees Big Savings*, WALL ST. J., Dec. 16, 1999, at A3; James P. Miller, *Smurfit Set to Cut Up to 3,600 Jobs, Take Big Charge*, WALL ST. J., Nov. 25, 1998, at B13 (describing layoffs at company formed from merger between Jefferson Smurfit and Stone Container); Emily R. Sandler, *SPX Plans to Trim Sites, Jobs in Restructuring*, WALL ST. J., Dec. 29, 1998, at A4 (discussing plant closings of company formed from recent merger between SPX and General Signal); John Simons, *Despite Low Unemployment, Layoffs Soar: Corporate Mergers and Overseas Turmoil are Cited as Causes*, WALL ST. J., Nov. 18, 1998, at A2 (describing layoffs resulting from mergers). For an example of how CEOs rarely lose in mergers, see Jennifer Reingold, *Pay for Performance: One Step Backward at Citi*, BUS. WK., Mar. 29, 1999, at 40-41 (discussing growth in executive pay at Citigroup following merger despite less than stellar performance of company).

16. See *infra* notes 169-71 and accompanying text. On the media criticisms of the LBO transactions of the 1980s, see generally DANIEL FISCHER, PAYBACK: THE CONSPIRACY TO DESTROY MICHAEL MILKEN AND HIS FINANCIAL REVOLUTION 1-39 (1995) (criticizing, among other things, press and employee concerns about such effects as layoffs and unfair profits of leveraged-buyout financiers).

17. A prominent recent example is Cendant Corporation, which was formed



of the merger partners. Even more importantly—for fraud and mismanagement occur in companies not involved in mega-mergers—many of the transactions do not realize over the long term the goals that CEOs used to justify the mergers in the first place. Firms fail to overcome, and, in some cases, even to recognize, the difficulties arising from combining different corporate cultures, management and organizational structures.<sup>19</sup> CEOs' predictions on realizing "synergies" from a combination, whether, for example, by lowering production costs or applying expertise from one firm to another, often prove to be unfounded.

The existence of these problems in mergers should not be surprising, because the economic data and behavioral studies on recent mergers overwhelmingly indicate that mergers, particularly the strategic, stock-for-stock "merger of equals" that are the subject of this Article, are bad investments for most of the companies involved in them and thus value-decreasing transactions for the shareholders of the surviving firm (a group including shareholders of the acquired firm).<sup>20</sup> While empirical studies of the current

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from a 1997 merger between HFS Inc. and CUC International Inc. It appears that, for three years, CUC's management exaggerated the company's revenues, a fraud that neither the company's auditors nor HFS in its acquisition due diligence of CUC discovered. See Emily Nelson & Mark Maremont, *Cendant Cites Wider Accounting Fraud*, WALL ST. J., July 15, 1998, at A3; *infra* note 68.

18. See, e.g., Rick Brooks & Mitchell Pacelle, *BankAmerica Net Slides Unexpected 78%*, WALL ST. J., Oct. 15, 1998, at A3 (discussing unexpected significant income downturn in gigantic bank holding company that was formed from the 1998 mega-merger between BankAmerica and NationsBank); Rick Brooks & Greg Jaffe, *Coulter Quits BankAmerica President Post*, WALL ST. J., Oct. 21, 1998, at A3 (describing resignation of David A. Coulter, former CEO of pre-merger BankAmerica, resulting from disclosure of income downturn); see also *infra* note 72.

19. See, e.g., Thomas M. Burton & Elyse Tanouye, *Clash of Cultures Kills Monsanto, AHP Marriage*, WALL ST. J., Oct. 14, 1998, at B1 (describing how American Home Products and Monsanto called off their merger "under the strain of trying to blend two dramatically different corporate cultures and chief executives."); Jack Milligan, *"Fast Eddie" Pulls Up Lane*, THE DAILY DEAL, at [www.thedailydeal.com/features/insight/A13842-2000Jan20.html](http://www.thedailydeal.com/features/insight/A13842-2000Jan20.html) (Jan. 20, 2000) (describing problems of serial mega-mergers of First Union); Anita Raghavan & Paul Beckett, *How Jamie Dimon Became a Casualty of Citigroup's Travails*, WALL ST. J., Nov. 3, 1998, at A1 (detailing ouster of president of company formed in 1998 from merger between Citicorp and Travelers Group and attributing it to disagreements between executives of former companies).

20. See, e.g., Tim Loughran & Anand M. Vijh, *Do Long-Term Shareholders Benefit From Corporate Acquisitions?*, 52 J. FIN. 1765, 1775 (1997) ("The univariate evidence on mode of acquisition suggests that mergers underperform

merger wave are incomplete, for financial economists do not yet have all the relevant data about the long-term performance of merged companies, studies on past merger waves and available data on the current mega-mergers unmistakably establish that the majority of these transactions end up losing value for the surviving company's shareholders.<sup>21</sup> These studies also reveal that the same reasons for this value loss recur throughout many problematic mergers. The reasons include the overconfidence of CEOs about their ability to integrate efficiently one large firm into another and an accompanying failure to face dispassionately the well-known problems involved in the combination and the uncritical reliance of boards of directors, shareholders, and even market professionals on CEOs who have had success in smaller acquisitions. This behavior arises from recognizable psychological tendencies that are exacerbated by today's merger climate, which is characterized by rapid technological change, sudden shifts in industry strategy, and investor demands for high returns.

This Article articulates a legal reform that is designed to reduce the number of the value-decreasing mega-mergers by causing board members to question more critically the merger proposal when they are asked to approve it and even to continue to reevaluate their approval of a merger until its closing. A legal solution is needed for several reasons. First, market forces are simply not constraining the behavior of CEOs and compliant boards of directors regarding the mega-mergers. Capital markets have proved to be ineffective because market analysts and even sophisticated investors, rather than often criticizing these transactions, have generally been caught up in the same

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matching firms whereas tender offers outperform matching firms. . . . Mergers are usually friendly to the target managers, but our evidence suggests that, on average, they are not in the best interests of shareholders."); P. Raghavendra Rau & Theo Vermaelen, *Glamour, Value and the Post-acquisition Performance of Acquiring Firms*, 49 J. FIN. ECON. 223, 235-36 (1998) (presenting data that show underperformance of friendly acquisitions over three years following merger and better performance of tender offers); see also *infra* Part IIC.

21. See *infra* Part IIC; see also Paul A. Samuelson, *The Long-Term Case for Equities*, J. PORT. MGMT., Fall 1994, at 15, 17 (cautioning that, while in economics history is no predictor of the future, it is also not irrelevant: "You are a fool if you wake up each morning and say the universe was born anew today with new rules. You are also a fool if you think that history can be read to teach necessitous lessons").

psychological momentum sweeping over executives and board members and are desirous of ever-increasing stock returns promised by the transactions. The product market works at too slow a pace to police these transactions because industry competition reveals the inefficiencies in the merged firm often only months and years after the transaction. Second, there has been little popular opposition to the mega-mergers that could help put pressure on boards to think critically about, and to resist, the transactions, as opposed to rushing headlong into them. Even if laid off as a result of the merger, employees have found other positions in a tight labor market. United States journalists and politicians have generally expressed little concern about the mega-mergers.

Third and most importantly, legal reform is necessary because corporate law and practice have not restricted, but have promoted, these transactions. The legal standard governing the conduct of the board of directors, whether of the acquiring or target company, in a merger is the duty of care, with the accompanying well-known business judgment doctrine.<sup>22</sup> Under this doctrine, courts essentially defer to a board decision to enter into a merger recommended by management (as it would to any board decision), provided that the board satisfied its duty of care in arriving at the decision.<sup>23</sup> This deferential standard of review and the standard of board conduct that it encourages, however, are simply not adequate to make a board critically question the value of an industry-shaking mega-merger in the face of a powerful and successful CEO proposing it, in uncertain technological and business circumstances and with investment professionals and financial journalists caught in the merger's momentum and supporting the transaction. Even more importantly, case law about board fiduciary duties in mergers, which developed in response to very different economic circumstances and to the LBOs of the 1980s and which generally focuses on board behavior in "target" firms, has indirectly "sanctioned" the strategic stock-for-stock merger of equals as the appropriate way for mega-transactions to be structured. And, following courts' guidance, sophisticated corporate lawyers have developed

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22. See, e.g., 1 DENNIS J. BLOCK ET AL., *THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS* 631-32 (5th ed. 1998).

23. See *id.* at 5.

contractual provisions to “lock” a board into, and thus to make it very difficult for board members to reconsider, a merger decision once the merger agreement has been signed.

Part II first describes in more detail the merger wave of the late 1990s and its characteristic transaction—and the focus of the Article—the strategic merger of equals between enormous firms conducted as a stock-for-stock exchange, and summarizes several standard reasons for the transaction form. It then highlights the emerging reports of problems in these transactions that are resulting in significant value losses for shareholders of the surviving company. The Part next discusses relevant economic data from previous merger waves, and the existing data from the current wave, indicating that a majority of these transactions are value-decreasing for shareholders both in the short and long term.

Part III examines why these transactions are occurring and why they have been little criticized. The Part’s first section refers to, and acknowledges the reasonableness of, the many economic and business justifications for mergers, such as the need for consolidation in certain industries so as to attain a critical size to lower marginal product costs, to further expansion of product lines<sup>24</sup> or to apply one firm’s resources or capabilities to a different business. The uncertain global business environment of the present wave particularly explains the prevalence of these transactions. This has been a time of rapid industrial change and “shocks,” often occasioned by startling technological advances in communications.<sup>25</sup> These advances are upsetting established industries and in many cases reconfiguring them, or at least suggesting possibilities for reconfiguration, sometimes at a bewildering pace.

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24. See, e.g., ALFRED D. CHANDLER, JR., *SCALE AND SCOPE: THE DYNAMICS OF INDUSTRIAL CAPITALISM* 17 (1990) (describing the benefits of “economies of scale,” which are “those that result when the increased size of a single operating unit producing or distributing a single product reduces the unit cost of production or distribution,” and of “economies of scope,” which are “those resulting from the use of processes within a single operating unit to produce or distribute more than one product”).

25. See Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 841 (1993) (classic statement describing reasons for restructuring activities beginning in the 1980s).

Moreover, the worldwide elimination or lowering of trade barriers promotes competition and restructuring in each industry, or in an industry in formation, that are no longer domestic, but global. In firms and industries, it is therefore difficult for managers and board members to know how best to act and to react amid this constant change and uncertainty, and there is an almost irresistible pressure for them to do something, lest they be left behind. From a psychological perspective, this pressure has exacerbated in CEOs the common human reactions to uncertainty, such as imitation of apparently successful behavior in others, and the well-known CEO tendencies, such as overconfidence and self-aggrandizement.<sup>26</sup>

Part III next explores the lack of critical assessment of, and in fact the benign perspective on, the mega-mergers by board members and investors, even the institutional investors<sup>27</sup> who should know better because of their familiarity with the historical economic performance of firms. The Part argues that a board member's experience of the same uncertainty facing a CEO makes him or her sympathetic to the decision-making plight of executives, willing to overlook their weaknesses, ready to accede to their optimistic merger visions, and likely to ignore the real possibility that a mega-transaction proposed by the CEO will result in failure. It also contends that investors in the securities markets are generally not penalizing mergers and their decision-makers until after the damage has occurred and are thus not applying well-known lessons about the problems with mergers to other transactions.<sup>28</sup> Investors, even more so than executives, do not know the correct response to uncertain economic and business times. The continuation of the mega-mergers also owes much to the "investor capitalism," which was much heralded as making firms and managers more responsive to the production of shareholder value.<sup>29</sup> So great now is the

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26. See *infra* notes 118-29 and accompanying text.

27. See generally Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) (describing the importance of institutional investors in the public markets). See also James A. Fanto, *We're All Capitalists Now: The Importance, Nature, Provision and Regulation of Investor Education*, 49 CASE WES. RES. L. REV. 105, 121-23 (1998) (describing growing importance of retail investor in securities markets).

28. On investor irrationality, see *infra* notes 144-47 and accompanying text.

29. See generally MICHAEL USEEM, *INVESTOR CAPITALISM: HOW MONEY*

investor pressure on, and expectations regarding, managers and boards to make their firms industry leaders and to turn in stellar financial results that they must gamble on blockbusting transactions, lest they be quickly punished with a fall in their share price and with the explicit or implicit message that their firms are takeover candidates.<sup>30</sup> The very riches now apparently made on a daily basis in the stock markets have made investors exceedingly demanding on company performance.

Part III next explains why there has been a journalistic “celebration” of (and a general political silence on) the mega-mergers, as opposed to the criticism that had greeted past restructuring, which has not provided boards of directors with a critical counterweight to the “momentum” for these transactions. On a simple political level, because the mega-mergers have occurred mainly during a Democratic administration and because many journalists are generally sympathetic to Democrats, the media ignored or downplayed business excesses, particularly the mega-mergers—a situation in sharp contrast to what usually occurred during the business restructuring under Republican executive control in the 1980s.<sup>31</sup> More significantly, while investment bankers and Wall Street lawyers are profiting greatly from the current merger “boom,”<sup>32</sup> even beyond the levels of the 1980s, there has been no natural “Wall Street” villain for the media to identify as a target of envy and condemnation in the recent, generally good economic times. The CEOs engineering the transactions (even those in financial services) are of a “Main Street” character and have their bases of support throughout the country where their firms are located, not

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MANAGERS ARE CHANGING THE FACE OF CORPORATE AMERICA 15-37 (1996) (describing the shift of focus of top corporate management to maximizing shareholder value).

30. See, e.g., Nikhil Deogun & Robert Langreth, *P&G Walks Away From Merger Talks*, WALL ST. J., Jan. 25, 2000, at A3 (discussing Proctor & Gamble’s abandonment of merger talks with Warner-Lambert and American Home and concern among investors: “In the end, P&G may have given its investors the jitters without accomplishing much, aside from signaling that it has a hearty appetite for a big deal, and suggesting to some investors that perhaps it feels it needs one in order to expand”).

31. See FISCHER, *supra* note 16, at 4.

32. See, e.g., Thompson Financial Securities Data, *supra* note 2, at 4-5 (describing activity of investment banks and securities law firms in current merger wave); see *infra* note 170.

just in financial centers. Because, moreover, stock market investing has become so popular, even Wall Street figures (who include prominent former Democratic administration figures and government officials)<sup>33</sup> are increasingly esteemed and envied, not despised, and Wall Street is not seen to be the bastion of a narrowly-defined elite. The monumental transactions (some of the largest of which involve media companies themselves) with their visionary CEOs also make good "copy" and even entertainment for an audience that includes an ever widening group of investors. Without any media "prodding" regarding the mega-mergers, politicians have taken a "hands off" approach to the transactions.

Part IV analyzes the legal foundations of the mega-mergers. It first explains why merger law, which is primarily a subject of state corporate law,<sup>34</sup> has traditionally placed little burden on directors, particularly those of the acquirer, to justify "friendly" transactions, except in special circumstances.<sup>35</sup> It then observes that recent merger jurisprudence developing from cases involving hostile takeovers encourages management to engage in (and boards to approve with little court review) strategic, stock-for-stock mega-mergers. That is, Delaware case law (the most relevant law for corporations involved in mega-

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33. See *infra* note 166.

34. Because a corporation is itself a creature of state corporation law, its combination with another corporation, either through the formation of an entirely new legal person (a "consolidation") or with one of the merging corporations disappearing (the traditional "merger"), is similarly governed by this law. See JAMES D. COX ET AL., CORPORATIONS 583-84 (1997). Federal securities law is applicable in mergers of publicly-traded firms, with the relevant law depending upon the structure of the transaction. See 15 U.S.C. § 78n(a), (d) (1998) (requiring a firm to follow proxy rules when it solicits shareholder votes on a matter, such as a merger transaction, and to follow tender offer rules when it makes a public offer for securities of another firm for cash); 17 C.F.R. § 230.145 (1999) (requiring registration of securities in business combinations where acquirer offers securities to target shareholder in a merger).

35. These are circumstances involving a change of control of a firm. See *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34, 46 (Del. 1994) ("The decisions of this Court following *Revlon* reinforced the applicability of enhanced scrutiny and the directors' obligation to seek the best value reasonably available for the stockholders where there is a pending sale of control, regardless of whether or not there is to be a break-up of the corporation."); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985); *infra* Part IV(B).

mergers) imposed upon boards of targets of hostile transactions a higher standard of review than the business judgment deference. In this jurisprudence, the courts held out, as an ideal, the "friendly" strategic stock-for-stock merger. Part IV next studies how the corporate law bar, taking their guidance from court decisions, reinforced contractual provisions in merger agreements intended to "tie the hands" of a board that entered into a strategic merger so as to prevent it from engaging in any reconsideration of a deal, once, freed from the pressure and momentum of a transaction, its members would have the time to rethink it.

Part V proposes a new intermediate standard of court review for board decisions to enter into stock-for-stock mega-mergers, which should produce a new standard of board conduct in these transactions. Under the proposed standard, a board must bear the burden of establishing that it has reasonable grounds, supported by particularized findings, for believing that (1) the mega-merger will maximize shareholder value and (2) the transaction is the best alternative among those currently available to the company, most particularly not engaging in the mega transaction and remaining an independent firm. That a board is composed primarily of independent directors will enhance the likelihood that a court would find that the board satisfied this standard in entering into a merger. The standard is designed to give the board a legal incentive to resist the momentum of a transaction that the CEO, and even the investment community and business media, support, to bring to the forefront of their decision-making the real possibility of the merger's negative consequences and to create an opposition group within the board to the euphoria surrounding the mega-merger. The Part emphasizes that the standard will thus assist the board in many cases to act against the immediate wishes of both the executives and even the shareholders, but with the goal of protecting long-term shareholder value. The standard, moreover, would apply on a continuing basis so that, until the consummation of the merger, boards would have to reevaluate the existing value of the transaction and to consider terminating the merger. The standard might thus limit the "lock-in" devices currently used to bind parties to mega-mergers, which limitation echoes a developing trend in Delaware merger jurisprudence.



Part V then addresses several possible criticisms of the standard by arguing that it is neither unduly vague nor intrusive on company decision-making. Indeed, the enhanced standard finds support in corporate law jurisprudence because the reasons for enhancing board duties that courts have found persuasive in other circumstances, such as the need to compel directors to guide shareholders and to address their possible self-interest in a major transaction, are particularly true in the mega-merger. The proposal is simply trying to enhance the fiduciary role of the board as an independent actor against management, as well as, in some cases, against the shareholders. The Part then argues that adoption of the standard may better bring about its goal, if it is combined with the following reforms: addressing the issue of decision-making on a mega-merger in consensual codes of board behavior,<sup>36</sup> elimination of "pooling" accounting treatment for mergers,<sup>37</sup> as is currently proposed,<sup>38</sup> and enhanced scrutiny by the staff of the Securities and Exchange Commission (the "SEC") of disclosure in merger proxy statements concerning boards' articulation of reasons for mergers and

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36. An alternative to law is a code of best practices, as, for example, those developed by various professional organizations. *See, e.g.*, THE CONFERENCE BOARD, COMMUNICATING CORPORATE PERFORMANCE: A DELICATE BALANCE, A RESEARCH REPORT 1997 (describing "best practices" that companies could adopt in communicating their performance to investors); *see also infra* notes 323-25.

37.

Under the "pooling" method of accounting for a business combination, the combination is treated not as a purchase but as a joining or 'marriage' of two previously separated entities. The amounts (roughly, historical cost) at which assets and liabilities are recorded on the books of the acquired company are carried forward without change in the accounts of the acquiring company. Neither the fair value of the acquired company's assets nor the value of its good will, is recognized. As a consequence, the income of the combined enterprise is not changed by the increased depreciation allowance that would result from a revaluation of tangible assets nor by amortization of an amount attributable to the acquired company's good will.

VICTOR BRUDNEY & WILLIAM W. BRATTON, CASES AND MATERIALS ON CORPORATE FINANCE A-10 to A-11 (4th ed. 1993); *see also infra* note 56.

38. *See* FINANCIAL ACCOUNTING STANDARDS BOARD, PROPOSED STATEMENT OF FINANCIAL ACCOUNTING STANDARDS: BUSINESS COMBINATIONS AND INTANGIBLE ASSETS (Financial Accounting Series No. 201-A, Sept. 7, 1999) (proposing to phase out the "pooling" method in favor of a uniform use of the "purchase" method); *see also* L. TODD JOHNSON & BRYAN D. YOKLEY, SPECIAL REPORT: ISSUES ASSOCIATED WITH THE FASB PROJECT ON BUSINESS COMBINATIONS (Financial Accounting Series No. 174-A, June 1997); *infra* Part V(B).

decision-making under the new standard.

## II. PROBLEMS OF THE MEGA-MERGERS

### A. *The Mega-Merger Phenomenon*

The current U.S. merger wave dates from the end of the recession in the early 1990s<sup>39</sup> and continues until the present. In the last few years, the volume of merger activity has been significant and has been steadily growing each year. In 1997, there were 11,148 merger transactions, with a total value of \$907 billion.<sup>40</sup> This titanic number was surpassed in 1998, with a \$1.62 trillion in value of mergers and 11,400 transactions.<sup>41</sup> Mergers in 1999 continued at this record pace, with \$1.75 trillion in value and 10,800 transactions.<sup>42</sup>

An identifying characteristic of the current merger wave is the sheer size of many transactions. The wave is breaking records on deal size, both in the overall largest deal and the largest transaction in specific industries. Nine of the ten largest transactions in 1998 were the largest of any deals involving a U.S. target company in any preceding period,<sup>43</sup> and several 1999 deals pushed themselves onto the top ten chart.<sup>44</sup> In the first quarter of 2000, the largest merger in size ever was announced, with the proposed \$156 billion combination of AOL/Time Warner.<sup>45</sup> Exxon/Mobil

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39. This wave may in effect be part of a larger wave of restructuring that began in the 1970s. See BREALEY & MYERS, *supra* note 1, at 941.

40. See Thomson Financial Securities Data, *supra* note 2, at 1. The value here refers to the value of the consideration offered to the shareholders of the acquired or "target" company in the merger.

41. *See id.*

42. *See id.*

43. *See id.* These included (with a listing of the acquirer/target and transaction value): Exxon/Mobil, \$86 billion; Travelers/Citicorp, \$73 billion; SBC Communications/Ameritech, \$72 billion; Bell Atlantic/GTE, \$71 billion; AT&T/TCI, \$70 billion; NationsBank/BankAmerica, \$62 billion; British Petroleum/Amoco, \$55 billion; Daimler-Benz/Chrysler, \$40 billion; Northwest/Wells Fargo, \$34 billion; Banc One/First Chicago, \$30 billion. See *The Top Ten Deals of 1998*, FORTUNE, Jan. 11, 1999, at 68.

44. See *Top 50 U.S. M&A Transactions of 1999*, *supra* note 3 (MCI WorldCom/Sprint, \$111 billion; Pfizer/Warner-Lambert, \$84 billion; AT&T/Media One, \$57 billion; Qwest Communications/US West, \$48 billion) (discussing AT&T bid to buy MediaOne Group).

45. See Peers, *supra* note 3, at A1.

(1998) was the largest oil industry merger,<sup>46</sup> Travelers Group/Citicorp (1998) the largest financial services merger, NationsBank/BankAmerica (1998) the largest bank merger, AOL/Time Warner (2000) the largest media/entertainment merger, MCI WorldCom/Sprint (1999) the largest telephone/communications merger, Pfizer/Warner-Lambert (1999) the largest pharmaceutical merger.<sup>47</sup> The list could go on and on.

Many—and the most prominent—of these enormous business combinations are characterized by their participants as “strategic” “mergers of equals” and are conducted through a stock-for-stock merger. “Strategic” has a special meaning here because it suggests more than everyday business strategy, but bold vision, which proposes to link together huge companies in different industries or to create a behemoth in a particular industry. The “merger-of-equals” aspect of the strategic combination suggests that two well-established, enormous firms of comparable size are really forging a partnership or alliance.<sup>48</sup> As a result, merging firms often pay considerable attention to the management and “social” aspects of the combined firm: management and the board of directors from each firm are often united in more or less equal ways, as are headquarters and operating facilities.<sup>49</sup> Indeed, the egalitarian nature of the transaction is in harmony with its typical structure. With a few notable exceptions,<sup>50</sup> the

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46. See Colvin, *supra* note 3, at 62.

47. See *id.* at 62-64; see also Leslie Cauley et al., *AT&T Makes \$54 Billion Unsolicited Bid For MediaOne, in Challenge to Comcast*, WALL ST. J., Apr. 23, 1999, at A3.

48. See *supra* note 7.

49. See MARTIN LIPTON ET AL., *MERGERS AND ACQUISITIONS AND TAKEOVER PREPAREDNESS* 68 (1995) (“To achieve a true [merger of equals] structure, neither company should gain too much of an upper hand in the combined company. Instead, after agreeing on the overriding business goals and means to enhance shareholder value, partners to an MOE must seek to achieve a fair balance in key management and operational areas.”). Cf. Gregory L. White & Brian Coleman, *Daimler-Benz and Chrysler Plan to Run Main Operations Separately After Merger*, WALL ST. J., Nov. 4, 1998, at B8 (providing example of how resolving these “social” issues may become particularly difficult in cross-border mergers, as in the mega-merger between German and U.S. automakers).

50. Recent large cash transactions often involve a foreign company acquiring a U.S. company because the former cannot use its stock as acquisition currency, since there may be no U.S. market, or no significant U.S. market, in the securities. See, e.g., Paul Beckett et al., *Deutsche Bank, Bankers Trust Near Pact*, WALL ST. J., Nov. 23, 1998, at A2 (describing Deutsche Bank’s cash

transactions are not effected as cash purchases financed by debt, so typical of the acquisitions by the financial buyers of the 1980s.<sup>51</sup> Rather, stock of one of the companies (which may in effect ultimately prove to be more “equal” than the other) is used as merger consideration offered to the shareholders of the partner firm in a reverse triangular merger.<sup>52</sup> As a result of the transaction, shareholders of both firms are combined—none of them is cashed out—and, as the story goes, will benefit from the results of the vision that brought them together in the new mega-firm.

Admittedly, certain advantages of the stock-for-stock exchange structure help explain the prevalence of this kind of merger. In a constantly rising stock market, which characterizes the second half of the 1990s and the beginning years of our new century, stock becomes an available, even inexpensive, acquisition currency.<sup>53</sup> Using stock as merger consideration avoids the significant borrowing costs that accompany a cash acquisition of an enormous firm, for few firms generate enough cash to

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acquisition of Bankers Trust). *But see* Nicole Harris & Steven Lipin, *Vodafone to Buy Air Touch for \$58 Billion*, WALL ST. J., Jan. 18, 1999, at A3 (describing \$58 billion merger of Vodafone (U.K.) with AirTouch (U.S.) as primarily a stock-for-stock exchange).

51. *See* GEORGE P. BAKER & GEORGE DAVID SMITH, *THE NEW FINANCIAL CAPITALISTS: KOHLBERG KRAVIS ROBERTS AND THE CREATION OF CORPORATE VALUE 44-90* (1998) (discussing the use of debt in 1980s acquisitions).

52. In the reverse triangular merger, the acquirer incorporates a special acquisition subsidiary and capitalizes it with acquirer stock. This subsidiary then effects a merger with the target corporation in which the latter is the surviving corporation and in which the target's shareholders receive acquirer shares in exchange for their shares. Although other transaction structures are possible, a reverse triangle merger maintains the separate existence of the target, which generally helps the acquisition to proceed more quickly (e.g., fewer consents are needed from third parties who might be able to object if the target corporation disappeared). *See generally* RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 670-71* (1995).

53. *See* Steven Lipin, *Merger Boom Reverberates Across Century*, WALL ST. J., Dec. 3, 1999, at C1 (“Longtime merger banker Robert F. Greenhill says watch the stock market for whether stock or cash is king. ‘Follow the S&P price-earnings ratio,’ says Mr. Greenhill, chairman of Greenhill & Co., who ran Wall Street’s first merger group at Morgan Stanley. ‘It’s the perfect predictor of whether acquirers will use cash or stock.’ ”); Richard Morgan, *P/E Disparities May Fuel Corporate Buying*, THE DAILY DEAL, at [www.thedailydeal.com/features/insight/A18361-2000Mar10.htm](http://www.thedailydeal.com/features/insight/A18361-2000Mar10.htm) (Mar. 10, 2000) (describing how acquirers have high p/e ratios in relation to targets); *see also* Rau & Vermaelen, *supra* note 20, at 225, 226 (discussing the evidence that the use of stock in acquisitions arises from the fact that it is overvalued).

conduct a mega-acquisition without borrowing. Indeed, the ability to use stock as consideration makes possible mergers in industries, such as financial institutions or electronic commerce, where firms have little debt capacity to fund acquisitions.<sup>54</sup> If, moreover, company management considers that the stock market values highly, and even over-values, its stock, it makes sense for management to use their equity securities in mergers.<sup>55</sup>

The stock-for-stock merger also receives favorable accounting treatment from the perspective of the presentation of a firm's financial results. This transaction can be treated—for now at least—as a “pooling of interests” under U.S. Generally Accepted Accounting Principles (“GAAP”), if it otherwise complies with accounting rules limiting use of this method.<sup>56</sup> In a pooling, the surviving

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54. Financial institutions, such as banks, are by their nature highly-leveraged: they rely upon debt in the form of deposits to fund their investments. Accordingly, it might be difficult for them to raise cash from further debt issuances. Moreover, as regulated institutions they have capital requirements (i.e., that they have a certain amount of equity capital to overall liabilities), which has the effect of discouraging kinds of acquisitions (cash and/or debt financed) that diminish their mandated capital position. *See generally* HERLIHY, *supra* note 7, at 30-31. Similarly, a firm with little cash flow to service the debt, as in a company with good growth prospects but little tangible earnings, might find that stock is the only viable means of effecting an acquisition. *Cf.* Steven Lipin & Stephanie N. Mehta, *Global Crossing to Buy Frontier*, WALL ST. J., Mar. 17, 1999, at A3 (discussing how high technology companies can use their highly-valued stock as acquisition currency); Anthony B. Perkins, *AOL Beat the Odds: Again*, WALL ST. J., Jan. 12, 2000, at A22 (describing ability of AOL to purchase Time-Warner by way of its “overhyped” stock despite the fact that AOL's revenues are less than one-sixth of Time-Warner's).

55. *See* BREALEY & MYERS, *supra* note 1, at 927 (discussing considerations arising in stock financing); *see also* MARK L. SIROWER, *THE SYNERGY TRAP: HOW COMPANIES LOSE THE ACQUISITION GAME* 131-32 (1997). On acquirer and bidder considerations in determining ratios in stock-for-stock mergers, *see infra* notes 282-85 and accompanying text.

56. The rules for eligibility for pooling treatment are technical and are set out in ACCOUNTING PRINCIPLES BOARD, OPINION NO. 16, BUSINESS COMBINATIONS (1970) (setting out twelve requirements for pooling, which are basically designed to ensure that the merger involves a true combination of shareholders of the two constituent corporations and a continuing sharing of risks by each group of shareholders). An important condition for pooling is that voting stock of the acquirer is exchanged for nearly all (at least 90%) of the voting stock of the target. *See* BRUDNEY & BRATTON, *supra* note 37, at A-26 (quoting Olson, *Accounting for Mergers*, 3 Rev. Sec. Reg. 867-871 (1970)). These rules have been further developed by accounting standards associations and the accounting staff of the Securities and Exchange Commission. *See* SEC Staff Accounting Bulletin No. 96, 61 Fed. Reg. 12020 (Mar. 25, 1996) (to be codified at 17 C.F.R. § 211)

firm is permitted to treat the acquisition for financial statement purposes as a combination of firms, rather than as a purchase of the "target."<sup>57</sup> This treatment has a beneficial effect on the acquirer's income statement. First, the companies' income statements are combined from the beginning of the year in which the transaction takes place, which means that the survivor's earnings include the income of the target for the pre-acquisition period.<sup>58</sup> Second and more importantly, the combination of the two firms' balance sheets also favorably affects the income statement. In a typical acquisition (and even in many mega-mergers of equals), an acquirer must pay some premium to the target shareholders to convince them to go along with the merger. If accounting treatment were not accorded to the transaction, and if the "default" purchase method were applied, the purchase price would have to be allotted to the target's assets at their fair market value. The price generally exceeds this fair market value because the firm is worth more than its assets, and the price in excess of this value is placed on the acquirer's balance sheet as an

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(dealing with effect upon pooling of reacquisition of acquirer shares during periods before and after merger); see also JOHNSON & YOKLEY, *supra* note 38, at 1.

57. See FINANCIAL ACCOUNTING STANDARDS BOARD, METHODS OF ACCOUNTING FOR BUSINESS COMBINATIONS: RECOMMENDATIONS OF THE G4+1 FOR ACHIEVING CONVERGENCE 6 (Financial Accounting Series, Dec. 15, 1998) [hereinafter FASB, METHODS OF ACCOUNTING] ("Because no assets are considered to be received (or disbursed) or liabilities incurred (or settled) in the combination transaction and because the entities themselves are not seen as directly involved in the exchange of equity interests, the combined company is viewed as a continuation of its predecessors. Accordingly, no cognizance is given to the values exchanged in the bargained transaction and no new basis of accounting is called for. Instead, since the predecessors are seen as continuing, their recorded assets and liabilities are simply carried forward to the financial statements of the combined company, and no other assets or liabilities are recognized as a result of the combination. Thus, the combination is accounted for as if the only change that occurred was essentially one of legal form rather than economic substance.").

58. See BRUDNEY & BRATTON, *supra* note 37, at A-14. The federal securities laws attempt to address the potential misleading nature of this combination, which could arise if an investor in the combined company did not realize that a significant increase in earnings was simply due to an acquisition, not to enhanced performance by the company. They do this by having the company provide "pro forma" financial statements as if the company had been combined for three years preceding the year of the acquisition. See SEC Form S-4, item 5 (Pro Forma Financial Information), available at <http://www.sec.gov/smbus/forms/s-4htm>.

intangible "goodwill."<sup>59</sup> In the years after the transaction, the income of the acquirer on its income statement is decreased by the portion of the goodwill and the amount of any "step-up" in the value of the tangible assets that are attributable, as expenses, to each future year of their use until the useful life of the asset has ended; in technical terms, goodwill is amortized (over a period not exceeding 40 years) and assets are depreciated in accordance with set periods depending upon the kind of asset.<sup>60</sup> In sum, the purchase method of accounting produces an earnings "penalty" that can reduce a firm's earnings over a number of years following the transaction.<sup>61</sup> Senior managers may take steps to avoid having a merger treated as a purchase if they know that investors in their company focus on earnings—as opposed to its cash results.<sup>62</sup>

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59. BRUDNEY & BRATTON, *supra* note 37, at A-10; see FASB, METHODS OF ACCOUNTING, *supra* note 57, at 6-7 ("The purchase method views a business combination from the perspective of the combining company that is deemed to be the acquirer or purchaser. Because the exchange transaction is assumed to result from arm's-length bargaining between independent parties, the values exchanged are presumed to be equal with the total purchase price establishing the total value of the assets and liabilities obtained. The purchased assets and assumed liabilities are recognized (including those not previously recognized) and measured based on their fair values, and any residual is accounted for as purchased goodwill.").

60. See BRUDNEY & BRATTON, *supra* note 37, at A-14. The 40-year amortization period for goodwill was set forth in ACCOUNTING PRINCIPLES BOARD, OPINION NO. 17 (1970).

61. See also JOHNSON & YOKLEY, *supra* note 38, at 2. See generally Benjamin C. Ayers et al., *The Financial Statement Effects of Eliminating the Pooling-of-Interests Method of Acquisition Accounting*, 14 ACCT. HORIZONS 1, 14 (Mar. 2000) (discussing the massive effects on firms' earnings per share numbers from elimination of pooling method).

62. This leaves the question why this deflated earnings number should be significant for investors because amortization and depreciation are not cash items: they do not reduce the cash position of the acquirer in future years, for the consideration has been paid in the merger year. The reduction in earnings from amortization and depreciation is simply a result of accrual-based accounting that attempts to assign expenses to the year or years in which they occur. In certain industries, market analysts and investors primarily focus on earnings. See generally GILSON & BLACK, *supra* note 52, at 569-78. Yet there seems to be a basis in fact for managers' perception that they would do well to avoid purchase accounting so as not to depress their stock price. See Patrick E. Hopkins et al., *Purchase, Pooling, and Equity Analysts' Valuation Judgments*, Social Science Research Network, at <http://papers.ssrn.com/sol3/results.cfm> (Oct. 27, 1999) (concluding that stock price judgments of buy-side analysts are lower for firms using purchase accounting (where intangibles are not immediately expensed) as opposed to pooling).

Significant tax advantages also accompany a stock-for-stock merger because the transaction is generally tax-free to all parties involved.<sup>63</sup> As these transactions are structured, target shareholders do not realize any taxable gain on the exchange of their shares for shares of the acquirer (except to the extent that they receive any minimal cash in lieu of fractional shares in the transaction),<sup>64</sup> and the tax "basis" of their existing shares carries over to the shares that they receive in the merger.<sup>65</sup> Neither firm, moreover, recognizes any gain in the transaction.<sup>66</sup> Contrast with this the cash merger where the merger is taxable to the target shareholders (and to the target firm, if acquirer wants a stepped-up basis in target's assets).<sup>67</sup> The advantages of the stock-for-stock merger are highly significant if, as is often the case, both the target and its shareholders do not want to incur any tax in the merger.

While the availability of stock as acquisition currency, the favorable pooling accounting treatment, and the tax-free nature of a share exchange help explain why mega-mergers have been structured as stock-for-stock exchanges, they do not alone account for the current prevalence of these transactions. For this explanation, we shall have to turn to business and even to behavioral psychology. But before exploring the foundations of the mega-mergers, it is important first to explain why we are concerned about the

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63. This tax treatment is succinctly described in Bank, *supra* note 6, at 1308-10 and accompanying notes.

64. In a typical stock-for-stock transaction, a target shareholder receives a set ratio (or a ratio determined in accordance with a pre-determined formula) of acquirer shares for his or her target shares. As a result, he or she may receive some fraction of an acquirer share. Merger agreements generally provide that the acquirer will not be obligated to issue any fractional shares, but will give the target shareholder the cash value of any such fractional share.

65. For the statutory support for this proposition, see Bank, *supra* note 6, at 3 and accompanying notes.

66. See generally MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS AND LEVERAGED BUYOUTS: A TRANSACTIONAL ANALYSIS OF THE GOVERNING TAX, LEGAL, AND ACCOUNTING CONSIDERATIONS* ¶ 803 (1991) (describing requirements for tax-free treatment).

67. See GILSON & BLACK, *supra* note 52, at 473-77 (discussing history of tax treatment in taxable acquisitions); see also HOWARD E. ABRAMS & RICHARD L. DOERNBERG, *FEDERAL CORPORATE TAXATION* 191-201 (3d ed. 1995) (discussing ability of acquirer to achieve stepped-up tax basis, but only if target firm realizes corporate level tax). It is possible, then, for an acquirer to receive stepped-up basis for accounting purposes (which reduces earnings), but not for income tax purposes (if stepped-up basis were not elected in the transaction).



transactions.

### B. *Emerging Problems of the Mega-Mergers*

It is disturbing that many mega-mergers are beginning to exhibit different kinds of problems that result in value losses—sometimes startlingly large—for shareholders of the combined firms. The most serious problems involve fraud or significant mismanagement, generally in the target firm, that comes to light only after completion of the merger and that results in a serious decline in the market value of the combined company. A prominent recent case involves Cendant Corporation, which was formed from the merger between CUC International Inc. and the acquisitive HFS Inc. Subsequent to the merger, Cendant disclosed that approximately 60% of CUC's revenue for the three years preceding the merger was fictitious, and Cendant's stock lost one-half its market value.<sup>68</sup> Similarly, McKesson HBOC, a company formed in 1999 by a stock-for-stock mega-merger between McKesson Corp. and HBO & Co., disclosed, several months after completion of the merger, that HBO (the target) had been overstating its revenues, a disclosure that caused the merged firm also to lose one-half its market value.<sup>69</sup> In addition, massive accounting fraud

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68. See Nelson & Maremont, *supra* note 17, at A3; see also Amy Barrett, *Cendant: Who's to Blame?*, BUS. WK., Aug. 17, 1998, at 70 (describing loose accounting system at the former CUC); Emily Nelson & Joann S. Lublin, *Walter Forbes Steps Down At Cendant*, WALL ST. J., July 29, 1998, at A3 (describing resignation of former head of CUC who had become chairman of Cendant); Emily Nelson & Leslie Scism, *Cendant Ends Pact to Buy American Bankers*, WALL ST. J., Oct. 14, 1998, at A4 (describing Cendant's decision to pull out of a merger agreement with American Bankers Insurance Group, given the decline in Cendant's stock price that was to be used as merger consideration); Mitchell Pacelle, *Cendant Ex-Chairman Repays Expense Money*, WALL ST. J., Feb. 23, 2000, at A4 (describing dispute between former chairman of Cendant and current board regarding his severance package and expenses); Mitchell Pacelle & Elizabeth MacDonald, *Ernst & Young Settles One Suit In Cendant Scandal*, WALL ST. J., Dec. 20, 1999, at B9 (discussing record-setting settlement of suits by CUC's auditor and by the firm itself); *In re Cendant Corporation Litigation*, 60 F. Supp. 2d 354 (D.N.J. 1999) (describing legal claims relating to CUC); *In re Cendant Corporation Securities Litigation*, 2000 U.S. Dist. LEXIS 11590 (D.N.J. Aug 14, 2000) (describing Cendant's \$2.8 billion settlement).

69. See Janet Rae-Dupree, *Anatomy of a Shareholder Slaughter*, BUS. WK., May 17, 1999, at 44 (describing accounting fraud and noting that both companies grew tremendously through acquisitions); Ralph T. King Jr., *McKesson Restates 4<sup>th</sup> Period Results*, WALL ST. J., Apr. 29, 1999, at A3 ("The

(again in the target company) surfaced at Waste Management Inc., a company formed by the mega-merger between USA Waste Services Inc. (the acquirer) and Waste Management (the target).<sup>70</sup> And these are only the most publicized examples.<sup>71</sup>

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negative surprise caused McKesson's shares to plummet 48%, wiping out about \$9 billion in the big drug distributor's market value."); Ralph T. King, Jr., *Soft Numbers: McKesson Restates Income Again as Probe of Accounting Widens*, WALL ST. J., July 15, 1999, at A1 (discussing accounting fraud in firm); Ralph T. King, Jr., *McKesson's Chairman, CEO, 5 Others Step Down or Are Fired Amid Scandal*, WALL ST. J., June 22, 1999, at A3 (discussing executive fall-out from scandal); see also *Ash v. McCall*, No. 17132 (Del. Ch., Sept. 15, 2000), slip op. (dismissing claims of lack of due care and waste against McKesson board). But see *Cavaretta v. McKesson HBOC Inc.*, Del. Super. Ct. LEXIS 346 (No. OOC-04-214-WTO, Sept. 7, 2000) (describing securities class action claims against HBOC). The merger was, in fact, never popular with financial analysts, who failed to see any synergies between McKesson's business (drug distribution) and that of HBO & Co. (healthcare software). See Anita Sharpe, *HBO-McKesson Merger Plan Stirs Questions*, WALL ST. J., Oct. 22, 1998, at B16.

70. See Jeff Bailey, *Where it Hurts: An Accounting Scandal Endangers Big Payout For a Retired CEO*, WALL ST. J., May 19, 1999, at A1 (noting that the accounting scandal was known before the merger, but not the depth of the problem, which involved losses of \$3.5 billion in market value of the merged firm); Jeff Bailey, *Ex-Waste Management CEO Buntrock Sues Company and Two of Its Directors*, WALL ST. J., Feb. 23, 2000, at B10 (detailing litigation between current and former management); Jeff Bailey, *Star Rescuers Take On Waste Management-And End Up Tarnished*, WALL ST. J., Feb. 29, 2000, at A1 (discussing continued problems at company despite replacement of management); Jeff Bailey, *Waste Management Names Whitworth Acting Chairman, Issues Revised Outlook*, WALL ST. J., July 14, 1999, at A4 (discussing board shake-up resulting from accounting scandal); Jeff Bailey, *Waste Management Sues on Acquisition*, WALL ST. J., Dec. 31, 1999, at A3 (discussing suit against, among others, former management of Waste Management).

71. See Robert Berner & Mark Maremont, *Lost Heir: As Rite Aid Grew, CEO Seemed Unable To Manage His Empire*, WALL ST. J., Oct. 20, 1999, at A1 (discussing, among other things, accounting problems arising from acquisitions); William C. Symonds et al., *Tyco: Aggressive or Out of Line?*, BUS. WK., Nov. 1, 1999, at 160-65 (describing allegations of questionable accounting at Tyco International, a major acquirer); Heather Timmons, *Creative Accounting at Century?*, BUS. WK., Feb. 21, 2000, at 142 (discussing accounting problems at Century Business Services, a serial acquirer). Indeed, recent reform to board audit committees by industry groups and the SEC partly originated from a concern over improper abuses in financial reporting in connection with acquisitions. See *Audit Committee Disclosure*, Exchange Act Release 42,266, 64 Fed. Reg. 73,389, 73,390 (Dec. 30, 1999) (final rule enhancing audit committee disclosure); *Audit Committee Disclosure*, Exchange Act Release No. 34-41,987, 64 Fed. Reg. 55,648 (proposed Oct. 14, 1999) (proposing new rules and amendments to improve disclosure related to corporate audits); REPORT AND RECOMMENDATIONS OF THE BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES 18 (1999) (discussing various

Other cases involve instances of serious mismanagement, but not fraud, in either merger partner that come to light only after the merger. There is the noteworthy example of BankAmerica, which had massive and unexpected earnings declines due to problems in the target's management of the risks in its loan loss portfolio.<sup>72</sup> Similarly, after engaging in numerous stock-financed acquisitions to become a national firm, crowned by mega-mergers, Bank One has lost momentum—and its CEO lost his job—because of the market perception that the company had expanded too fast and had not adequately addressed management problems in acquired firms.<sup>73</sup>

It could be argued that these problems, while serious, should not be used to indict mega-mergers. Fraud is difficult to detect; mismanagement is a perennial problem whenever, as in all large U.S. corporations, so much control is delegated to professional managers. More importantly, these problems occur equally in companies that have not engaged in mega-mergers. Rather than condemning, and exaggerating the problems with, the transactions, it may make more sense to caution merger participants, such as company executives, investment bankers, accountants and lawyers, to be aware that these difficulties might undermine the benefits of a mega-merger, just as they can destroy a stand-alone company. One solution would be to recommend that deal participants pay more attention to their "due diligence" review of companies involved in a

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financial reporting abuses that trigger the Committee's work); SEC Staff Accounting Bulletin No. 100, 64 Fed. Reg. 67154 (Dec. 1, 1999) (to be codified at 17 C.F.R. § 211) (discussing proper accounting in connection with restructuring).

72. See Rick Brooks & Mitchell Pacelle, *BankAmerica Knew in August of Trading Woes*, WALL ST. J., Oct. 16, 1998, at A3; see also Rick Brooks et al., *Hootie's Blow: Ousting of Coulter Isn't the Only Fracture at New BankAmerica*, WALL ST. J., Oct. 23, 1998, at A1 (discussing additional dissension in the merged company that the decline in revenues only exacerbated); Rappaport & Sirower, *supra* note 8; Dean Foust, *A Megabank in the Making*, BUS. WK., Sept. 13, 1999, at 144 (describing management difficulties with mergers).

73. See, e.g., Joseph Cahill, *Bank One Approves Plan to Rearrange Duties of Top Executives McCoy*, *Istock*, WALL ST. J., Oct. 20, 1999, at B2 (detailing problems of firm formed from mega-merger between Bank One and First Chicago); Joseph Cahill, *Bank One Cuts Forecast a Second Time, Cancels Conference as Stock Falls 9.3%*, WALL ST. J., Nov. 11, 1999, at B6 (questioning management's ability to address problems facing Bank One); Joseph Cahill, *CEO McCoy Quits a Flagging Bank One*, WALL ST. J., Dec. 22, 1999, at A3 (describing early retirement of CEO responsible for creating megabank).

mega-merger and not relax this review on account of the sheer size of the deal and the speed with which it is negotiated and consummated.<sup>74</sup>

Yet what is particularly worrisome about the mega-mergers is that their problems are not limited to those that more due diligence would help parties detect; they undermine the very bases for the combination. A merger is premised on the assumption that the constituent companies can create more value together than separate: this is what is meant by the popular merger term "synergy."<sup>75</sup> This value creation is based upon the ability of the companies to combine effectively for particular value-maximizing strategy or strategies. In other words, synergy may be achieved through a number of well-known strategies, whether through, among other things, lowering costs (which can be achieved in numerous ways), expanding production or distribution into new geographic areas, or markets or making use of complementary technologies or applying one firm's resources to another firm's business.<sup>76</sup> If synergies cannot be achieved, the merger will usually be a failure and even a disaster for shareholders of the combined firm.

The nature of the mega-mergers makes even more difficult the realization of the value-creating synergies than would face participants in a different kind of merger (who nonetheless encounter considerable problems in making the transaction a success). The sheer size of the companies involved in the mega-mergers presents an imposing challenge of uniting disparate and far-flung operations so as to be able to begin realizing the merger synergies. Because, moreover, the mega-mergers of equals involve a sharing of management, operations and culture between the constituent corporations, or at least some power-sharing even if a dominant party exists, one firm does not "swallow," and immediately impose its will on, another, as happens if there were a disparity in firm size and if the

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74. See, e.g., Jennifer Reingold & Amy Barrett, *M&A Frenzy May be Scuttling Due Diligence*, BUS. WK., Aug. 17, 1998, at 72 (pointing out that in a "merger of equals" it may be difficult for each company to do adequate due diligence on the other because no one is in charge of the transaction).

75. See SIROWER, *supra* note 55, at 20 ("*Synergy is the increase in performance of the combined firm over what the two firms are already expected or required to accomplish as independent firm.*") (emphasis in original).

76. See generally *infra* Part III(A).

combination is viewed as a sale of one firm to another. Rather, starting after the merger announcement executives and employees of the combined firm must undertake the difficult task of "meshing" the two firms' operations and themselves into a productive whole. Not surprisingly, in the course of the combination, unless the organization of the new firm is stipulated at the signing of the merger agreement (which is rarely the case), employees *at all levels* from each company struggle to have their strategies, views and especially their jobs prevail in the combined firm because, if they are unsuccessful, they are likely to be looking for work elsewhere.

The current wave of mega-mergers is replete with tales of combination difficulties, which the business media follows much in the way that the society and entertainment pages of newspapers, magazines and Internet sites reveal the couplings and break-ups of the social and entertainment elite (increasingly, one and the same!). And these tales often point to the failure of the merger to realize its promised synergies or, what is similarly disastrous to shareholder value, to delays in this realization. As is typical in the hierarchical world of company life in the United States (despite all the talk of the shift to "flat," nonhierarchical organizations), the media focus has been on the failure of efforts of top executives from the two firms to get along with one another. Generally, a typical mega-merger involves a creation of a unified board of roughly equal membership from the two constituent corporations and the sharing of executive responsibilities by the two CEOs, with or without an understood succession plan.<sup>77</sup> This arrangement has proven to be unstable. The most publicized example of executive combination difficulties (perhaps because it is one of the largest transactions and *the* largest U.S. financial services merger to date) has been in Citigroup, formed from the mega-merger between Travelers and Citibank. The former CEOs of Travelers and Citibank at first co-existed uneasily; the heir apparent to them was abruptly dismissed after the merger; lesser executives struggled for control of different parts of the large company's operations; a former high government official appeared as "peacemaker" to add a third executive to the equation; and finally, Citibank's former chief left the

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77. See HERLIHY, *supra* note 7, at 113.

firm.<sup>78</sup> Unfortunately, Citigroup's problems in combining top management are typical of the mega-mergers.<sup>79</sup>

The difficulty in combining management is itself only the tip of the iceberg, for synergies can be realized only if firms combine at all levels. There have been many reports about how firms formed as a result of recent mega-mergers have not achieved their goals of immediately combining two complex organizations. As middle managers and other employees from the constituent corporations try to work out their differences, costs are added to the firm, rather than synergies being realized, and even value expected to be

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78. See Raghavan & Beckett, *supra* note 19, at A1 (discussing management difficulties resulting in ouster of Jamie Dimon, heir apparent to Co-Chairman Sanford I. Weill from Travelers and John Reed from Citibank); see also Paul Beckett & Patrick McGeehan, *How a New Financial Giant Struggles With Its Message*, WALL ST. J., Nov. 13, 1998, at C1 (observing that Citigroup managers are sending different messages to employees about the firm's strategy); Charles Gasparino & Jathon Sapsford, *Citigroup's Reed to Retire Posts in April*, WALL ST. J., Feb. 29, 2000, at A3 (describing gradual ouster of John Reed); Holman W. Jenkins Jr., *Which Way to Point the Citigroup Firing Squad Next?*, WALL ST. J., Nov. 11, 1998, at A23 (discussing management dissension); Leslie Scism, *Citigroup's Multiple Falls Below the Level of Rivals as Skepticism About Weill Grows*, WALL ST. J., Nov. 18, 1998, at C1 (describing loss of investor confidence in Sanford Weill); Leslie Scism & Patrick McGeehan, *A Resignation at Citigroup Adds to Doubts*, WALL ST. J., Nov. 3, 1998, at C1 (discussing loss of market value in Citigroup stock due to the firm's management difficulties); Gary Silverman et al., *Is This Marriage Working?*, BUS. WK., June 7, 1999, at 127 (discussing management tension at Citigroup). And yet the business media continues to celebrate the acquisition acumen of Sandy Weill! See, e.g., Matt Murray & Paul Beckett, *Recipe for a Deal: Do It Fast*, WALL ST. J., Aug. 10, 1999, at B1.

79. See, e.g., Joann S. Lublin, *At Global Crossing, Not Lonely at the Top*, WALL ST. J., Mar. 23, 1999, at B1 (describing complex management structure at Global Crossing, a telecommunications firm created by numerous mergers); Marks, *supra* note 10; Stephanie N. Mehta & Rebecca Blumenstein, *US West Chairman Trujillo Rejects Merger Role*, WALL ST. J., Mar. 1, 2000, at B6 (citing dissension among top management of merging Qwest and US West); Timothy D. Schellhardt, *A Marriage of Unequals*, WALL ST. J., Apr. 8, 1999, at R8 (describing problems among senior management in combined companies when the compensation of executives in one firm is greater than that in the other firm); Susan Warren, *Hercules's Cook Resigns, Ending Co-CEO Accord*, WALL ST. J., Dec. 1, 1998, at B14 (discussing dissension between co-CEOs of Hercules Inc., formed from the merger between Hercules and BetzDearborn Inc., that led to resignation of one of the CEOs). See generally Jordan D. Lewis, *One Head Is Better Than Two*, DAILY DEAL, at [www.thedailydeal.com/features/judgment/A17773-2000Mar3.html](http://www.thedailydeal.com/features/judgment/A17773-2000Mar3.html) (Mar. 3, 2000). But see *Post Mortem*, THE DAILY DEAL, at [www.thedailydeal.com/features/postmortem](http://www.thedailydeal.com/features/postmortem) (Mar. 1, 2000) (describing management harmony between former CEOs of AIG and SunAmerica).

generated by each constituent firm pre-merger is lost.<sup>80</sup> Amid such dissension, or even to head it off, it is not surprising to see examples of one company ultimately deciding to impose its "will" on its strategic partner, if only to break out of the morass of indecision and mounting costs.<sup>81</sup> These kinds of combination problems, moreover, sometimes surface even after a merger's announcement and before the closing. This event does not necessarily allow shareholders to avoid value losses, even if it results in the merger's being called off. The stock market may penalize firms for having made bad judgments in selecting their potential mega-merger partner, despite the avoidance of the value losses that would have flowed from the merger had it been consummated.<sup>82</sup>

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80. See, e.g., Brooks, *supra* note 72, at A1 (describing strife between former employees of BankAmerica and NationsBank); Peter Elstrom, *AT&T: The Problems Keep On Coming*, BUS. WK., Oct. 18, 1999, at 41 (discussing management issues at AT&T as a result of its mega-acquisitions in cable); Matt Murray, *Missed Opening: KeyCorp Fails to Prove It Can Unlock Promise Of a Merger of Equals*, WALL ST. J., Aug. 25, 1998, at A1 (discussing merger of equals that has failed to live up to its promise because of integration problems). *But see* Scott Thurm, *Joining the Fold: Under Cisco's System, Mergers Usually Work; That Defies the Odds*, WALL ST. J., Mar. 1, 2000, at A1 (explaining great efforts taken by Cisco, when it engages in acquisitions, to harmonize the combined firm at all levels). The companies most likely to face difficulties in "meshing" their cultures are those formed as a result of mergers between firms from different countries. See, e.g., Jeffrey Ball & Scott Miller, *Full Speed Ahead: Stuttgart's Control Grows With Shakeup At DaimlerChrysler*, WALL ST. J., Sept. 24, 1999, at A1 (noting problems of combining systems and cultures of auto companies from the United States and German); Jeffrey Ball, *Eaton Retires As Co-Leader Of Daimler*, WALL ST. J., Jan. 27, 2000 at A3 (describing how the merger of equals between U.S. Chrysler and German Daimler has turned into a dominance by the German firm); Christopher Rhoads, *Deutsche Bank to Give BT "No Autonomy"*, WALL ST. J., Dec. 1, 1998, at A3 (reporting that German bank will control firm resulting from merger with U.S. bank).

81. See Robert Frank & Steve Liesman, *While BP Prepares New U.S. Acquisition, Amoco Counts Scars*, WALL ST. J., Mar. 31, 1999, at A1 (describing the imposition of British Petroleum's culture on the firm resulting from the merger between BP and Amoco); Nicole Harris, *Sprint CEO Loses Clout, But Not His Ardor for MCI Deal*, WALL ST. J., Feb. 3, 2000, at B6 (describing MCI WorldCom's increasing dominance of Sprint in their merger—a transaction later abandoned); Allanna Sullivan, *Exxon and Mobil Are Already Devising Their New Blend*, WALL ST. J., Apr. 6, 1999, at B4 (discussing Exxon's control of Mobil in their merger of equals).

82. See, e.g., Thomas M. Burton & Elyse Tanouye, *Clash of Cultures Kills Monsanto, AHP Marriage*, WALL ST. J., Oct. 14, 1998, at B1 (attributing failed merger between American Home Products and Monsanto to problems with combining different corporate cultures).

The above reports about problems in recent mega-mergers all point to a basic concern of this Article, the loss of value to shareholders of the firms involved because of these transactions. Yet it should be remembered that, if a firm suffers because a merger is unsuccessful or takes too long to succeed, others “stakeholders” in the firm could be hurt as well, even more than harms to them contemplated by the original justification for the merger: the employees and communities where firms are located, to name those primarily, although not exclusively, affected.<sup>83</sup> When a new mega-firm loses the high stakes gamble of doing a successful mega-merger, it suffers in its product markets, which means the steady or sudden demise of the firm itself. Because there is so little margin for error in these transactions, even mega-mergers that are not *initially* justified on the basis of synergies resulting from cost-cutting often end up engaging in significant cost-cutting in order to make up for the unachieved synergies based on other combination strategies and the mounting costs resulting from the merger itself. This cost-cutting, as was so typical of the restructuring of the 1980s, produces significant employee lay-offs and closing of facilities and headquarters.<sup>84</sup> Employees have to find other positions (or to relocate to do so), and local communities lose sources of jobs and tax revenue.<sup>85</sup> These consequences have flowed from the mega-mergers and will likely increase in the next years as the merged companies—often out of desperation—try to improve their performance in order to realize the promise of the mega-merger.<sup>86</sup>

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83. See Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 253 n.16 (1999).

84. See, e.g., Paul Beckett, *Citigroup to Cut 6% of Its Work Force, Take a \$900 Million Charge After Tax*, WALL ST. J., Dec. 16, 1998, at A8 (discussing elimination of 10,400 jobs in Citicorp's merger with Travelers); Emily R. Sandler, *SPX Plans to Trim Sites, Jobs in Restructuring*, WALL ST. J., Dec. 29, 1998, at A4 (describing job elimination and plant closings following merger between SPX Corp. and General Signal Corp.); Thomas E. Weber, *On Jarring Note, AOL to Cut 350-500 of Staff*, WALL ST. J., Mar. 25, 1999, at B4 (describing job cuts from America Online's merger with Netscape); see *supra* note 15 and *infra* note 171.

85. See, e.g., John Hechinger, *Fleet Touts Benefits of BankBoston Deal*, WALL ST. J., Mar. 16, 1999, at A3 (describing concern by Boston civic leaders that the city could lose a major employer and their relief when two Boston banks merged).

86. Compare FISCHER, *supra* note 16, at 33 (explaining how restructuring in



### C. *Systematic Evidence About Past Merger Waves and Current Mega-Mergers*

A final judgment on the mega-merger must await future empirical studies.<sup>87</sup> The systematic empirical evidence on past mergers and the available data on the mega-mergers, however, *now* supports the conclusion that a large majority of these transactions destroy shareholder value. It is a commonplace in financial circles<sup>88</sup> (as recognized occasionally even by the business press)<sup>89</sup> that mega-mergers are generally value-decreasing transactions for shareholders. Evidence from past merger waves shows that public companies engaging in mergers underperform their peer companies that have not followed similar acquisition strategies.<sup>90</sup> Indeed, the worst performers are

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effect produced more jobs and more competitive firms in the long run), with Mark J. Roe, *Backlash*, 98 COLUMBIA L. REV. 217, 236-37 (1998) [hereinafter Roe, *Backlash*] (justifying political control of restructuring as a "second best" solution that avoids political upheaval)

87. For example, the "final judgment" on hostile takeovers has come only in the past few years with empirical studies measuring the performance of firms subsequent to a takeover. See, e.g., James F. Cotter et al., *Do independent directors enhance target shareholder wealth during tender offers?*, 43 J. FIN. ECON. 195 (1997) (discussing the issue on a database involving takeovers in the period 1989-1992).

88. See Robert G. Eccles et al., *Are You Paying Too Much for That Acquisition?*, HARV. BUS. REV. 136, 136 (July-August 1999) ("Despite 30 years of evidence demonstrating that most acquisitions don't create value for the acquiring company's shareholders, executives continue to make more deals, and bigger deals."); Jeffrey L. Hiday, *Most Mergers Fail To Add Value, Consultants Find*, WALL ST. J., Oct. 12, 1998, at B9I ("Most mergers don't work. Hard as that may be to imagine in this bigger-is-better age, it is accepted wisdom in investment-banking circles."); SIROWER, *supra* note 55, at 19 ("So many mergers fail to deliver what they promise that there should be a presumption of failure. The burden of proof should be on showing that anything really good is likely to come out of one.") (quoting Warren Hellman, former head of Lehman Brothers) (footnote omitted).

89. See *supra* note 10. See also Phillip L. Zweig, *The Case Against Mergers*, BUS. WK., Oct. 30, 1995 at 122-30 (special report on the problems associated with mergers).

90. See SIROWER, *supra* note 55, at 145-66 (reviewing, as of 1997, management and finance literature on the negative consequences of mergers); Loughran & Vijh, *supra* note 20, at 1767; Rau & Vermaelen, *supra* note 20, at 235-39 (discussing underperformance of acquiring companies). See also Anup Agrawal & Jeffrey F. Jaffe, *The Post-merger Performance Puzzle*, 7-9, 11-39, Social Science Research Network, at <http://papers.ssrn.com/sol3/cfm> (Jan. 5, 1999) (summarizing numerous studies by financial economists and concluding that there is "strong evidence of abnormal under-performance following

companies engaging in stock-for-stock mergers with comparably-sized firms—the very focus of this Article.<sup>91</sup>

Certainly, the evidence on past transactions is subject to qualifications and refinements, as financial economists attempt to identify the characteristics that make for a *value-enhancing* merger. For example, nonconglomerate mergers (i.e., meaning those involving merger partners in related industries that can take advantage of economies of scale or scope) tend to increase shareholder value, at least in comparison to conglomerate or diversifying mergers.<sup>92</sup> Where one firm can apply certain knowledge-based skills to another's business and improve the performance of the target firm enhances the possibility that the merger will create value.<sup>93</sup> Some evidence suggests that even stock-for-

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mergers"); Mark L. Sirower & Stephen F. O'Byrne, *The Measurement of Post-Acquisition Performance: Toward A Value-Based Benchmarking Methodology*, 11 J. CORP. FIN. 1, 1 (Summer 1998).

91. See, e.g., Carlos P. Maquieira et al., *Wealth creation versus wealth redistributions in pure stock-for-stock mergers*, 48 J. FIN. ECON. 3, 8 (1998) ("Second, research indicates that stock-for-stock mergers have systematically lower offer premiums for target firm stockholders, significantly negative abnormal returns for acquiring firm stockholders, and lower net synergistic gains created.") (footnote omitted); Rappaport & Sirower, *supra* note 8, at 148 ("In studies covering more than 1200 major deals, researchers have consistently found that, at the time of announcement, shareholders of acquiring companies fare worse in stock transactions than they do in cash transactions. What's more, the findings show that early performance differences between cash and stock transactions become greater—much greater—over time.")

92. See Maquieira, *supra* note 91, at 16 ("The first significant result is that the common stockholders in nonconglomerate mergers experience average VPEs [excessive value] that are economically and statistically significantly higher (8.58% versus 3.28%) than do shareholders in conglomerate mergers."); *id.* at 30 ("Target firm shareholders always experience net wealth gains, as do bidding firm stockholders in nonconglomerate mergers, clearly suggesting that, on average, acquiring firm managers who execute nonconglomerate mergers are acting in their shareholders' best interests, while those who launch conglomerate mergers most definitely are not."); see also Lance A. Nail et al., *How Stock-Swap Mergers Affect Shareholder (and Bondholder) Wealth: More Evidence of the Value of Corporate "Focus,"* 11 J. CORP. FIN. 95 (Summer 1998).

93. See, e.g., Randall Morck & Bernard Yeung, *Why Firms Diversify: Internalization vs. Agency Behavior*, 3, 22 (Oct. 15, 1998), available at [www.ssrn.com](http://www.ssrn.com) (explaining that the effort to expand the use of "knowledge-based assets," or to have them used more efficiently, explains the value-increasing aspects of mergers in the 1979-85 period); see also Zsuzsanna Fluck & Anthony W. Lynch, *Why Do Firms Merge and Then Diversify? A Theory of Financial Synergy*, 72 J. BUS. 319 (1999) (explaining value of diversifying mergers as financing marginally profitable projects); Hubbard & Palia, *supra* note 1, at 1149 (explaining diversifying mergers as efforts by firms to remedy information

stock mergers may increase overall value when conducted by firms that are not market favorites, that is, not the so-called "glamour" firms (i.e., those highly valued by the market in relation to their book value).<sup>94</sup> On the whole, the evidence on past transactions suggests that, for a given mega-merger to escape falling into the usual pattern of value destruction, the participants in it must walk a careful, fine line.

More importantly, evidence on current mega-mergers shows that they, too, decrease value for their shareholders.<sup>95</sup> This result is not surprising, because these transactions often exhibit the attributes that, according to financial economists on the basis of their studies, lead to value-decreasing transactions. Many recent mega-mergers, for example, are being initiated by "glamour" acquirers whose stock is trading at high levels over book value.<sup>96</sup> In the ongoing merger wave, as in past mergers,<sup>97</sup> companies grow ever larger by serial acquisitions and their CEOs receive increasingly laudatory attention from financial professionals, investors and the business media for their successful acquisition "track record" until their ultimate

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defects in capital markets).

94. See Rau & Vermaelen, *supra* note 20, at 239 (discussing better performance by acquirers in mergers that are "value" firms (i.e., those with high ratios of book to market value)); see also SIROWER, *supra* note 55, at 88-135 (discussing general attributes suggestive of optimal, or at least less negative, transactions, such as size of transaction, nature of consideration, relatedness of merger partners).

95. See, e.g., Eccles, *supra* note 88, at 136 ("Recent research shows that acquisitions in the 1990s have just as poor a record as they did in the 1970s."); *id.* at 139 (finding that, on the basis of a sample of 131 acquisitions from 1994 to 1997, current mergers demonstrate the historical result: "that well over half of mergers and acquisitions failed to create their expected value."); Albert Viscio et al., *What Makes Mergers Work? It May Not be What You Think*, M&A LAW., Oct. 1999, at 18 ("Additionally, half of all mergers [of 117 most significant deals closed between January 1, 1994 and July 30, 1996] failed to deliver excess returns: 51.3% under performed industry peers.") (detailing results measuring performance vs. industry peers two years post-closing); KPMG, UNLOCKING SHAREHOLDER VALUE: THE KEYS TO SUCCESS 5, 7-8 (1998) (taking a sample from the "top 700 cross border deals by value between 1996 and 1998" and concluding that, on the basis of shareholder value "one year after completion of the deal" 83% of the mergers "failed to unlock value," with 53% destroying value and 30% producing "no discernible difference" as to value).

96. Cf. Steven Lipin & Paul M. Sherer, *Boom Is Back: Merger Deals Charge Ahead*, WALL ST. J., Nov. 24, 1998, at C1 (describing rise in stock prices as an incentive for firms to continue in the merger wave); see also *supra* note 53.

97. See Rau & Vermaelen, *supra* note 20, at 225.

failure to realize synergies in a mega-merger finally catches up to them.<sup>98</sup>

In light of the above data, it is important to emphasize how value is destroyed when a merger does not achieve the promised synergies and why, in financial terms, it is so difficult for a merger to succeed. Because a firm's value is based upon expectations of its future value (e.g., its growth and prospects), its stock price reflects this value.<sup>99</sup> In essence, a merger promises to add value *beyond* that already incorporated in the stock prices of the two merging firms. For a mega-merger to succeed, therefore, not only must the combined firm achieve the expected performance of each constituent firm (itself quite a challenge, given the size of each of the firms and the highly competitive markets in which they operate), but it must also attain the additional value—the synergies—arising from the transaction.<sup>100</sup>

This high performance level of the mega-firm must occur in difficult circumstances that heavily weigh against its success. Chief among them is the premium that the shareholders of the target firm may expect and that their management and board demand. A premium simply represents that part of the value to be realized from the promised synergies that is allotted to the target shareholders.<sup>101</sup> In a mega-merger of equals, one could argue that target shareholders should receive an amount of acquirer stock essentially based upon the approximate value of their shares before consummation of the merger

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98. See, e.g., Nelson & Maremont, *supra* note 17, at A3 (observing how Henry Silverman, CEO of Cendant, was known as a “merger-savvy executive” who had built up the “one-time Wall Street darling that grew rapidly through numerous acquisitions” until the CUC disaster); Scism, *supra* note 78, at C1 (“Mr. Weill’s reputation as one of Wall Street’s savviest deal makers is losing some of its crispness as investors struggle with bad news stemming from his two latest and biggest acquisitions—last year’s \$9 billion purchase of Salomon Brothers and the \$50 billion merger five weeks ago of Travelers Group with Citicorp, forming *Citigroup*.”) (emphasis in original); Symonds, *supra* note 71, at 162-65 (describing Tyco’s CEO’s strategy of constant acquisitions); David Weidner, *Pluck of the Irish*, THE DAILY DEAL, at [www.thedailydeal.com/features/postmortemA18737-2000Mar15.html](http://www.thedailydeal.com/features/postmortemA18737-2000Mar15.html) (Mar. 15, 2000) (describing potential problems arising from serial acquisitions of FleetBoston’s CEO, Terrance Murray).

99. See BREALEY & MYERS, *supra* note 1, at 57-79.

100. See generally *id.* at 914-16.

101. See Rappaport & Sirower, *supra* note 8, at 148.

because the acquirer shares they receive will in time reflect their proportionate value of the synergies (keyed to their percentage ownership of the combined firm).<sup>102</sup> Yet even in this kind of transaction shareholders of the target firm may still negotiate for some premium, if only to compensate themselves for the real risk that the merger will not achieve its synergies and may even destroy some of the value that the market had previously accorded to their firm.<sup>103</sup> The new firm must thus outperform the expected value of the two separate firms *and* the premium given to the target shareholders for the acquirer's shareholders to be better off as a result of the merger.<sup>104</sup> The target shareholders have the cushion of the premium, but even it may not be enough to keep the transaction from destroying value for them, if the merger either fails to achieve its synergies and/or causes each constituent firm not to realize its pre-merger future value. The high performance bar for the merged firm, moreover, must be achieved amid the difficult circumstances, mentioned above, of integrating two enormous firms, which distract the firm from achieving the synergies or even the expectations of each constituent firm, and of responding to competitors who attack the distracted firm.<sup>105</sup>

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102. That is, if one takes a simple example, assume two firms, one (Firm A) with a market value of \$200 and ten shareholders and another (Firm B) with a market value of \$100 with ten shareholders. If the managers of both firms agree that synergies of \$100 can be realized by a combination of the two firms, it could be argued that, in a stock-for-stock exchange, Firm B shareholders should receive .5 shares of Firm A for each Firm B share, which would represent their justifiable proportionate ownership of the combined firm and entitlement to the realization of synergies. If Firm B's shareholders are paid any premium in the transaction (in the form of a greater exchange ratio), then they capture more of the synergies, to the detriment of Firm A's shareholders. *See id.* at 149. Of course, if one could identify what part of the synergies will be contributed by the target firm, the shareholders should also receive payment for that value as well.

103. *See id.* at 149-51. Indeed, because a merger in which stock is offered as consideration conveys negative signals about the acquirer's confidence relating to the transaction (if the synergies are likely to materialize, why give so much of their value to the target shareholders?) and about the value of the shares offered (the acquirer believes them to be overvalued, for why else use them as acquisition currency?), the target company's management has a rational incentive to demand as much of the alleged synergies as possible. *See id.* at 154.

104. *See* SIROWER, *supra* note 55, at 21 ("So achieving synergy—improvements above what is already expected or required—is like starting a new business venture.")

105. *See id.* at 24-26, 39-42.

## III. THE MOMENTUM OF THE MEGA-MERGERS

A. *Executive Decision-Making Under Uncertainty*

A major cause of the value destruction of the mega-mergers is that CEOs are making flawed decisions in proposing them and pushing boards to approve them. Yet this poor decision-making is more than another example of the common agency problem in large U.S. corporations, where executives exert so much power and control, in comparison to the weak position of shareholders, and can thus disastrously mismanage a firm.<sup>106</sup> There are powerful business and economic reasons for executives at least to consider a mega-merger: in the 1990s firms in a bewildering number of industries are in the middle of a rapid restructuring caused by many changes, most particularly by massive technological advances in communication. Making decisions in these circumstances, however, is extraordinarily difficult. This difficulty, coupled with the decision-making flaws exhibited by most people and exacerbated by the hubris and overconfidence to which CEOs are particularly prone, has contributed to the mega-merger phenomenon.<sup>107</sup>

It is clearly difficult for CEOs to make major decisions in current business circumstances. This is a time of great economic transformation and uncertainty as technological advances, particularly in communications, make possible

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106. This issue refers to the fact that, in large U.S. public corporations, shareholders have been dispersed and unorganized and thus in a position where it is difficult for them to control managers of the corporation, who can operate the firm with little check by these owners, often for their own benefit to the shareholders' detriment. *See generally* ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 78-82 (Transaction Publishers, reprinted 1991); MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* 3-8 (1994). *See also* MICHAEL C. JENSEN, *FOUNDATIONS OF ORGANIZATIONAL STRATEGY* 53-55 (1998). The effort to address this agency problem inspires much legal and financial scholarship (and shareholder activism) regarding the public corporation. *See* Blair & Stout, *supra* note 83, at 248 n.1 (citing the literature).

107. *See* ANJU SETH ET AL., *SYNERGY, MANAGERIALISM OR HUBRIS? AN EMPIRICAL EXAMINATION OF MOTIVES FOR FOREIGN ACQUISITIONS OF U.S. FIRMS* 8-11 (Univ. of Illinois, College of Commerce and Business Administration, Office of Research Working Paper No. 98-0122, Nov. 1998) (describing literature on managerial motivations for mergers). *See also* Loughran & Vjih, *supra* note 20, at 1775; David J. Denis et al., *Agency Problems, Equity Ownership, and Corporate Diversification*, 52 *J. FIN.* 135, 136 (1997).

startling changes in business structure.<sup>108</sup> These advances are reshaping the production and distribution processes (to name only a few business attributes) in many industries and firms, are making some industries and firms obsolete and are establishing connections between others that were previously unseen (and thus are creating new firms). The period has witnessed great “shocks” to firms and business, which typically lead to much restructuring and thus merger activity.<sup>109</sup>

In the middle of this transformation, CEOs must make sense of the possible changing nature of their firm and industry and decide how to allocate resources to particular businesses and technology, while abandoning or selling others.<sup>110</sup> They also have to take into account other firm- and industry-specific factors, which may or may not be due to technological change and which add more decision-making complexity. This is the classic kind of decision-making that all executives face: e.g., to consider whether they can enhance the competitive position of their firm by expanding its scale or scope. Recent mega-mergers, for example, have been in diverse industries—financial services, pharmaceuticals, telecommunications and commodities (such as oil and copper)<sup>111</sup>—each with its own industry-specific justifications.<sup>112</sup>

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108. See Jensen, *supra* note 25, at 841-42.

109. See Gregor Andrade & Erik Stafford, *Investigating the Economic Role of Mergers* 16, Social Science Research Network, at <http://papers.ssrn.com/sol3/results.cfm> (Jan. 12, 1998) (concluding that merger activity reflects “shocks” to an industry and often an effort to eliminate excess capacity, although observing that the evidence about mergers in the 1990s points to an expansionary, rather than, contracting role for mergers); Jensen, *supra* note 25, at 851-52; Moon H. Song & Ralph A. Walking, *Abnormal returns to rivals of acquisition targets: A test of the “acquisition probability hypothesis”*, 55 J. FIN. ECON. 143, 145 (2000) (discussing “shock” hypothesis for mergers).

110. See generally Timothy A. Luehrman, *What's It Worth? A General Manager's Guide to Valuation*, HARV. BUS. REV., May-June 1997, at 132 (discussing basic strategy for resource allocation decisions).

111. See Thompson Financial Securities Data, *supra* note 2, at 2 (observing that top industries for 1998 mergers were financial services, telecommunications and oil and gas); *id.* (observing that telecommunications, financial services and radio and television and broadcasting were the main industries of 1999 merger activity).

112. Financial institution mergers, for example, owe much to a consolidation (which has technological causes) among financial services companies as banks, securities houses, and insurance firms increasingly offer similar products and to legal changes permitting bank geographic expansion and bank development of

Executives, moreover, are not acting in a vacuum, for they make their decisions in reaction to, and within the constraints imposed by, their competitors' strategies.<sup>113</sup> Competition has become even more acute for the kinds of mega-firms that are involved in the mega-mergers. Given the decline of trade barriers, a typical U.S. mega-firm now faces both domestic and foreign competitors because the product and services markets for the firms are global.<sup>114</sup> If, for example, one firm, through an acquisition or otherwise, captures more market share by entering a new geographic or product market or by producing goods or services at lower costs, the competitive landscape can be entirely changed. The existence of a massive merger in the same or related industries puts considerable pressure upon a CEO to react, often by a similar mega-merger strategy.<sup>115</sup>

Executives have numerous strategic options to respond to the macro-economic and business- and industry-specific changes, including internal growth, alliance with other firms, a mega-merger and even an exit from one or more businesses (with the most radical approach being a sale of the firm). A mega-merger (like any merger) can permit a firm to attain an immediate position in a market, product or form of technology or to rationalize its present production or distribution of services.<sup>116</sup> This tactical selection,

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nonbanking products. See generally Allen N. Berger et al., *The consolidation of the financial services industry: Causes, consequences, and implications for the future*, 23 J. BANK. & FIN. 135, 144-51 (1999). See also Marcia Vickers & Peter Coy, *A New Net Equation*, BUS. WK., Jan. 31, 2000, at 138-40 (describing competitive necessity of combining internet and offline companies); *Commodities get big*, ECONOMIST, Aug. 28, 1999, at 47-48 (discussing explanations for current mega-mergers among commodities firms).

113. See generally Oz SHY, INDUSTRIAL ORGANIZATION: THEORY AND APPLICATIONS 59 (1995) (describing items affecting firm behavior to include "[f]irms' expectation about the actions available to competing firms, and how the competing firms will respond to each firm's action").

114. See Jensen, *supra* note 25, at 843-47.

115. Indeed, following the announcement of a significant mega-merger appear articles speculating about the likely merger strategy of the remaining mega-firms. See, e.g., *How the Merger Will Affect Other Big Web and Media Players*, WALL ST. J., Jan. 11, 2000, at B12 (speculating about strategies of firms following announcement of the AOL-Time Warner merger).

116. See generally Alfred Rappaport, *Calculating The Value-Creation Potential of a Deal*, 33 MERGERS & ACQUISITIONS 33 (July/August 1998) (stating that "[t]he basic objective of making acquisitions is identical to any other investment associated with a company's overall strategy, namely, to add value").



however, comes with its own internal set of problems and concerns, chief of which (as mentioned above) is consolidating the operations of two large firms. The concerns, moreover, take on a different shape and importance depending upon the business and industry in question. In the high technology area, for example, which is so dependent upon human capital and in which so many recent mega-mergers have occurred, it is important to plan and conduct a merger in such a way so as not to alienate and thus lose the key creative employees of both firms.<sup>117</sup>

Even in the best of times, it is difficult for a CEO to propose a large “bet the company” kind of merger, with all of the uncertainty and risks surrounding it. In current circumstances, with the rapid technological changes and actions and reactions from competitors, the difficulties, uncertainties and pressures are enormously magnified. This situation has led executives to enter into mega-mergers on the basis of the kind of decision-making biases<sup>118</sup> that, according to behavioral and psychological research, are typical of human beings reacting in the face of complexity and uncertainty.<sup>119</sup> People often make decisions from little data, or from data that is exemplary, in the foreground or available, but that is not statistically

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117. See Saikat Chaudhuri & Behnam Tabrizi, *Capturing the Real Value in High-Tech Acquisitions*, HARV. BUS. REV., Sept.-Oct. 1999, at 128-30 (pointing out how the key to success in acquisitions involving high technology companies involves successfully integrating the employees of both firms). See generally Towers Perrin, *Mergers and Acquisitions Foster “Cool Hand Luke” Syndrome; “What We Have Here Is Failure To Communicate”*, at [www.towers.com/towers/news/pr991020.html](http://www.towers.com/towers/news/pr991020.html) (Jan. 5, 2000) (management consulting firm reports that lack of communication with employees is a central failure for companies involved in mergers).

118. See, e.g., SIROWER, *supra* note 55, at 164.

119. Work discussing the influences of psychological and behavioral biases on economic decision-making is voluminous and has spawned a branch of behavioral law and economics. See generally BEHAVIORAL LAW & ECONOMICS Cass R. Sunstein ed., 2000); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1477-78 (1998) (reviewing data calling into question rationality of economic actors); Cass R. Sunstein, *Behavioral Law and Economics: A Progress Report*, 1 AM. L. & ECON. REV. 115 (1999) (discussing current state of research); Cass R. Sunstein, *The Future of Law and Economics: Looking Forward: Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1182-84 (1997) (outlining psychological behavior that undermines rationality); Symposium: *The Legal Implications of Psychology: Human Behavior, Behavioral Economics, and the Law*, 51 VAND. L. REV. 1495-1788 (1998) (featuring representative legal scholarly work inspired by behavioral law and economics).

representative.<sup>120</sup> With respect to mega-mergers, for example, this means that a chief executive proposes a transaction on the basis of the apparent success of a past merger (which might not be of the same order of magnitude) or of a recent mega-merger of significant competitors, without considering the difference between the past and the proposed transactions or between the competitors and one's own firm, and importantly without focusing on the likely negative results from a large sample of mega-mergers.

Related to this point is the evidence from behavioral studies that people (particularly men) are prone to excessive optimism and attached to points of view that they have adopted and thus fail to consider realistically the probability of the negative outcomes of their decisions and the reasonableness of viewpoints or perspectives different from their own.<sup>121</sup> If anything, a CEO of an enormous firm, at the pinnacle of an elaborate hierarchy and in possession of so much power, is particularly prone to these common decisional problems, which would be exacerbated when he proposes a mega-merger.<sup>122</sup> For it takes a very optimistic and/or behaviorally "blind" CEO to believe that his or her

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120. See, e.g., Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1504 (1998) ("People often find causal patterns and relationships in matters that are the product of random chance. Statistical base rates are ignored in favor of highly salient or available, but less predictive, information."); CASS R. SUNSTEIN, COGNITION AND COST-BENEFIT ANALYSIS 9-10 (Univ. of Chicago John M. Olin Law & Economics Working Paper No. 85 (2d Series), Oct. 1999) (describing the "availability heuristic" pursuant to which "people tend to think that events are more probable if they can recall an incident of its [sic] occurrence") (footnote omitted).

121. See, e.g., HERSH M. SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 18-20 (2000); Jennifer Arlen, Comment, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1773 (1998); see also Terrance Odean, *Volume, Volatility, Price, and Profit When All Traders Are Above Average*, 53 J. FIN. 1887 (1998) (discussing empirical data on investor reactions based on overconfidence). It may be somewhat unfair to focus on the unreasonable behavior of male CEOs. Psychological evidence also shows that firstborns tend jealously to guard their position and views and to brook no opposition. See FRANK J. SULLOWAY, BORN TO REBEL: BIRTH ORDER, FAMILY DYNAMICS, AND CREATIVE LIVES 79 (1996).

122. See, e.g., Eccles, *supra* note 88, at 144. "A lot of deals happen because managers fall in love with the idea of the deal. Successful executives, after all, are competitive people who hate to lose, and nothing brings out the competitive juices like going after another company, particularly when one's rivals are in hot pursuit." *Id.*

merger could overcome the high probability that the transaction will fail, and this kind of person, having committed to a course of action, will become attached to the strategy and ignore its real negative consequences (and hostile to those mentioning them). Again, this perspective on problems in executive decision-making is completely compatible with, and indeed supported by, the classic view of the dominant role of the CEO in large firms and studies of his or her hubris and overconfidence.<sup>123</sup>

The effects of competitor strategies on executive decision-making must be understood in this behavioral focus. It is well-established that, in the midst of uncertainty, human beings are inclined to imitate strategies that they perceive to be successful.<sup>124</sup> The rapid imitation of transactions in industries, which so characterizes mega-mergers, is not so much the outcome of an elaborate chess game of visionary business thinkers as it is a sometimes desperate imitation of another's strategy by a CEO, egged on by investment bankers eager to promote transactions.<sup>125</sup> And this desire to imitate draws support from yet other decision-making biases: the "alarmist" focus upon the new risk posed by competitors' mega-merger<sup>126</sup> and the concern over the loss that it threatens to the present

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123. See generally Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 623-28 (1989) (reviewing the literature).

124. See Robert Sugden, *Spontaneous Order*, 3 J. ECON. PERSP. 85, 94 (Fall 1989).

125. Cf. P. Raghavendra Rau, *Investment Bank Market Share, Contingent Fee Payments, and the Performance of Acquiring Firms*, 56 J. FIN. ECON. 293, 314-16 (May 2000) (finding, on the basis of data relating to mergers occurring between 1980 and 1994, that more reputable investment banks (determined on the basis of their market share), as opposed to lesser tier banks, do not produce "superior" transactions that they advise on and that there is no relation between long-term performance of a firm engaged in a merger and the contingent fee charged by an investment bank; rather, evidence suggests that the market share of investment banks in this area is "positively related to their ability to complete the deal"). Moreover, bankers add to the value-destruction of deals by foregrounding data about comparable prices paid in similar transactions, which may have little to do with the reasonableness of a particular acquisition decision; see also Jayant R. Kale et al., *On the Participation and Reputation of Financial Advisors in Corporate Acquisitions*, Social Science Resource Network, at <http://papers.ssrn.com/sol3/results.cfm> (Aug. 11, 1998) (finding that there is no relation between bidder wealth effects and bidder advisor's reputation in mergers, but that such relation exists in tender offers). Cf. Rappaport & Sirower, *supra* note 8, at 149.

126. See SUNSTEIN, *supra* note 120, at 15-17 (discussing "alarmist bias" and the role of emotions in decision-making).

market position of the executive's firm.<sup>127</sup> Motivated by competitors' actions, CEOs thus rush into transactions, which in turn produce a cascade of additional deals until the movement exhausts itself.

My point here is not to suggest that *all* decisions by executives proposing a mega-merger are flawed because of behavioral biases or that there is an available comprehensive rationality that CEOs should employ when considering a mega-merger. We are, after all, all creatures of "bounded rationality," unable to detect, foresee and comprehend all necessary factors in any given decision,<sup>128</sup> and our behavioral shortcuts are often adaptive mechanisms that help us survive in the world.<sup>129</sup> The message here is simply that CEOs of the large U.S. firms are not free of the biases that we all share and may even be *more* prone to them because of the complexity of mega-merger decision-making in this period coupled with the hubris that their position often leads to; the history of bad executive decisions in mega-mergers suggests that this is indeed the case. As do ordinary people, CEOs can resist, overcome or at least minimize these biases in their mega-merger decision-making if they become aware of the existence of biases, and especially receive help from people who critically evaluate the decision. But this leads us to other reasons for the mega-mergers.

## B. *Failure of Boards and the Financial Community to Restrain CEOs in Mega-Mergers*

1. *Board Failure.* Another reason for the mega-mergers is that the CEOs' behavior is unchecked by the two groups associated with a firm that should be most interested in eliminating value-decreasing behavior: boards of directors of companies involved in the mergers and investors

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127. See *id.* at 13 (discussing "loss aversion").

128. See generally OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* 6 (1996) ("The cognitive and self-interestedness assumptions from which transaction cost economics works are bounded rationality, defined as behavior that is *intendedly* rational, but only *limitedly* so" ([Herbert] Simon, [Administrative Behavior] [2d ed.] 1961, p. xxiv, emphasis in original) . . .").

129. See Hersh M. Shefrin & Richard H. Thaler, *The Behavioral Life-Cycle Hypothesis*, in *QUASI-RATIONAL ECONOMICS* 91, 97 (1991) (describing habitual rules that enable individuals to resist impulses, such as the impulse to consume rather than to save).

themselves. And the failure of these two groups to restrain executives owes much to the same behavioral problems that influence the managers, although with differences associated with their respective positions in firms. The board's usual inability to veto a mega-merger is particularly troubling because the board is the foundation of the intricate legal and normative support and regulation of companies that characterize U.S. corporate governance.<sup>130</sup>

Board members of the enormous companies engaging in the mega-mergers, who are themselves often executives of similarly large companies or service providers (investment bankers, lawyers) to these companies, suffer from many of the same behavioral limitations as characterize CEOs: they, too, can be very optimistic and are pressured to react quickly in a highly competitive, rapidly changing situation.<sup>131</sup> Yet another problem, not of their own creation, enhances these limitations and thus hinders them from fulfilling their role of dispassionate, critical evaluators of

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130. See, e.g., Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997) (characterizing the U.S. system of corporate governance as one characterized by the rule of law); Raphael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (contrasting the rule of law in the United States and other Anglo-Saxon countries with that in countries of the German and French tradition); Rafael La Porta et al., *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (pointing out that strong legal protection in countries, such as the United States, produces large capital markets). Consensual or normative structure would add weight to the law. See generally Richard H. McAdams, *The Origin, Development and Regulation of Norms*, 96 MICH. L. REV. 338, 343-50 (1997). In the United States, examples of non-legal efforts to address problems in corporate governance and financing abound. See generally THE BUSINESS ROUNDTABLE, STATEMENT ON CORPORATE GOVERNANCE (1997).

131. Indeed, a telling sign of this overoptimism is that decision-makers in mergers believe that *their* mergers are successful, despite the existence of objective evidence of value destruction resulting from these transactions. See, e.g., KPMG, UNLOCKING SHAREHOLDER VALUE, *supra* note 95, at 7. Organizations often suffer from problems in highlighting negative information about themselves or their projects for the behavioral reasons noted above. See generally Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 133-48 (1997) (discussing the tendency to construe facts in terms of one's initial views, overoptimism (despite indications to the contrary), commitment to a decided-upon strategy despite its evident failure, holding beliefs that magnify one's own position and importance). The discussion below assumes that the board members are independent of management and are thus "outside" directors. If they are management, i.e., "inside" directors, their views on and behavior regarding the mega-merger are likely to reflect those of the CEO.

CEOs' mega-merger proposals. Behavioral studies have shown that the outcome of a decision is highly susceptible to how choices are portrayed or "framed."<sup>132</sup> It is a well known that, in public corporations, CEOs and their assistants, including outside counsel and investment bankers, control the presentation and flow of information to the board.<sup>133</sup> They can thus present a proposed mega-merger in a way so as to avoid or undermine any board critical evaluation of it. For example, an unremittingly positive presentation of a mega-merger (with no mention of the large body of negative evidence of the results of this kind of transaction) influences board members to overlook the potentially negative aspects of the transaction and adds to the "cascade" of information supporting it.<sup>134</sup> Similarly, when executives present a mega-merger as necessary to avert a loss of a competitive position or to respond to another mega-merger threatening such loss, they tap into the "loss aversion" that so motivates human decision-making.<sup>135</sup>

It is also difficult for boards to take a critical position regarding CEO mega-merger proposals because these projects do not trigger established concerns on management oversight that, on account of legal developments and custom, board members are trained to look for. The purpose of the board is to address the U.S. form of the "classical" agency problem:<sup>136</sup> to ensure that executives do not operate companies for their own interests at shareholders' expense, as well as to deal with perennial problems of executive

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132. See Langevoort, *supra* note 120, at 1504.

133. Indeed, it is well-accepted in corporate law that directors are legally entitled to rely upon information provided to them by corporate officers. See generally 1 AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 188-96 (1994).

134. See SUNSTEIN, *supra* note 120, at 12-13 (discussing the importance of foregrounding information in the results of decisions). Moreover, once the board decides upon a merger, the firms' publicity departments swing into action with unremitting positive presentations of the transaction; Cf. 'Cool Hand Luke' Syndrome, *supra* note 117, at 3 (referring to the "rah-rah" role of firms' formal communication media, which is not even credible to firms' employees). On the "cascade" effect (i.e., positive views producing more positive views, or negative views more negative views), see CASS R. SUNSTEIN, THE LAW OF GROUP POLARIZATION 7-9 (Univ. of Chicago John M. Olin Law & Economics Working Paper No. 91 (2d series), Dec. 7, 1999) [hereinafter SUNSTEIN, GROUP POLARIZATION].

135. See SUNSTEIN, *supra* note 120, at 13.

136. See *supra* note 106.

financial fraud.<sup>137</sup> In proposing the mega-mergers, CEOs are not displaying obvious signs of management self-interested behavior and advocating a course of action that would suggest an entrenchment motive. That is, the mega-merger strategies do not resemble the empire building of the 1970s or indicate the opportunism found when management alters financial results or pushes for excessive compensation packages. Rather, the mega-merger is presented and justified as necessary to *maintain* shareholder value in a highly competitive environment, where like companies are engaging in similar transactions. More importantly, the executive who proposes the mega-merger is usually a CEO who has delivered shareholder value, has a good track record on previous mergers and acquisitions and has increased firm size through mergers and who thus has considerable credibility with the board.<sup>138</sup>

In sum, when other boards are approving mega-mergers amid a rapidly changing industry or industries and amid often hysterical celebration from the business media concerning the transactions, it is difficult for board members to resist these trends and the weight of opinion. In this situation of uncertainty and celebration, a board member's understandable inclination is to defer to a successful CEO rather than to resist a merger that is presented as potentially "making or breaking" the company, particularly since he or she generally has less familiarity with the firm's business than do the executives. Board members invariably accede to the CEO's request that a mega-merger proceed and often approve them in a short time (although after the requisite meetings and following the appropriate procedures to satisfy the requirements of the legal duty of care).

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137. See *supra* note 71 (discussing improvements to board audit committees to prevent significant, often fraudulent, accounting practices in companies generally arising from management's inclination to meet earnings expectations at all costs).

138. See, e.g., *supra* note 98. Evidence suggests that, if board members disagree with a CEO's strategy, they are likely either to go along with it or to resign from the board—not to oppose it. See William O. Brown & Michael T. Maloney, *Exit, Voice, and the Role of Corporate Directors: Evidence From Acquisition Performance*, 4-5, 20-21, Social Science Research Network, at <http://papers.ssrn.com/sol3/results.cfm> (Aug. 25, 1999) (referring to the literature supporting this proposition and finding that their empirical evidence dealing with board member behavior in firms making acquisitions supports this point).

2. *Failures of Investors and the General Financial Community.* In a market system, like our own, the conclusion that managers and board members are proposing and approving value-decreasing mega-mergers, while disturbing, should not be greeted with concern. In highly competitive industries, where competition is increasingly global, the “market” in all its complexity should eventually identify and punish CEOs, boards and firms that engage in value-decreasing mega-mergers. From a product market perspective, any combination that does not make business sense will place the new mega-firm at a competitive disadvantage as more nimble competitors outflank it to gain market share at its expense; from a capital market viewpoint, the firm must pay a higher return to obtain capital as investors penalize its managers and board for having made a bad decision.<sup>139</sup> In a world of “second-best” and multiple solutions to economic and business problems, which is the one we inhabit,<sup>140</sup> market competition, together with the existing normative and legal structures that have been developed to support it and correct its obvious failings, will ultimately address the abuses of the mega-mergers most efficiently (i.e., with the least cost) in our circumstances, although it may not do so immediately. Just as institutional investors, financial professionals and others who make up the financial community eventually corrected the excesses of the conglomerate mergers in the 1970s and 1980s, they will eventually turn their attention to, and remedy the abuses of, the mega-mergers.

It is not, however, a satisfactory answer to the problems of the mega-mergers to observe that, as in the case of conglomerate mergers, it is best to wait another “break-up” or “spin-off” movement that will take care of these

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139. See Jensen, *supra* note 25, at 850-52.

140. See Roe, *Backlash*, *supra* note 86, at 239-41 (arguing that what appear to be economic inefficiencies may be an effort to prevent political turmoil and suggesting that different country situations call for different, second-best economic and business compromises); see also Mark Roe, *Political Preconditions to Separating Ownership from Control: The Incompatibility of the American Public Firm with Social Democracy*, Social Science Research Network, at <http://papers.ssrn.com/sol3/results.cfm> (Aug. 25, 1999) [hereinafter Roe, *Political Preconditions*] (arguing that, for political reasons, most Continental countries could not have a U.S.-style capitalism and corporate ownership structure).



transactions. This argument has the important force of the status quo,<sup>141</sup> but also its negative consequences, for it is a thinly veiled apologetics for the numerous parties—the CEOs, the board members, the investment bankers and financial professionals, the M&A lawyers and their advocates in the legal academy—who benefit from present circumstances.<sup>142</sup> Even market proponents, moreover, point out that its strongest component, the discipline of the product market, often arrives late and is ill-adjusted to dealing with problem firms without engendering a considerable amount of waste and destruction.<sup>143</sup> And if, as the evidence clearly shows, so many mergers decrease value either immediately or over time, sometimes disastrously, the market can hardly be said to have produced an optimal mechanism to police mergers.

The lack of adequate disciplining of those proposing and approving the mega-mergers by the most immediate of market solutions, the capital market, owes much to the cognitive biases previously discussed. Because investors and the numerous financial professionals who guide them and/or manage their funds—all of whom make up the capital market—appreciate the difficulty of strategic decision-making in economic circumstances characterized by rapid technological change and uncertainty, they, too, are inclined not to judge too harshly the CEOs and boards who must make the strategic decisions. Yet the heightened uncertainty has caused these investors and professionals to exhibit the psychological and behavioral problems that undermine their own rational evaluation of the mega-mergers. In recent years, a growing body of evidence, which financial economists use to explain the persistence of irrational market behavior, shows that even sophisticated investors exhibit cognitive biases, such as overoptimism,

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141. The status quo argument would be as follows: if a situation, such as the present U.S. approach to mergers, has endured, there is a presumption that it may be the best available solution in our circumstances. In a political and cultural situation where strong financial institutional monitors of management never developed, it is no surprise that managers may periodically build inefficient empires through mergers (only to be just as periodically disciplined). See generally ROE, STRONG MANAGERS, *supra* note 106, at 28-42.

142. See *infra* note 170. The very dynamic of capitalism, which involves a creative entrepreneurialism, and thus change, should make one careful about status quo arguments. Cf. FRIEDRICH A. HAYEK, INDIVIDUALISM AND ECONOMIC ORDER 92-106 (1948).

143. See Jensen, *supra* note 25, at 854.

failure to accept statistical probabilities, inability easily to move away from a given investment strategy and imitation of competitor strategies (to name just a few).<sup>144</sup> It is not surprising, therefore, that investors and financial professionals do not provide any brake on mega-mergers, because these transactions appeal (and are even designed to appeal) to many of the cognitive biases that afflict them.<sup>145</sup> In a situation of industrial uncertainty, firms engaged in the mega-mergers announce the transactions with great fanfare and optimism, which create a momentum and approval cascade among investors, particularly among the retail investors who are increasingly entering the securities markets through online trading and have little understanding of business combinations,<sup>146</sup> who may believe the often told tale of merger synergies and who add to the momentum by bidding up the stock prices of the acquirer.<sup>147</sup> It is important to emphasize that this process does not necessarily involve duplicity: CEOs and board members are not “manipulating” the financial community but only trying

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144. The literature on market irrationality is truly voluminous. See generally SHEFRIN, *supra* note 121, at 1-12 (discussing origins of behavioral finance); ROBERT J. SHILLER, MARKET VOLATILITY 7-48 (1989); see also Kent Daniel et al., *Investor Psychology and Security Market Under- and Overreactions*, 53 J. FIN. 1839, 1839-44 (1998); Terrance Odean, *Are Investors Reluctant to Realize Their Losses?*, 53 J. FIN. 1775, 1776-78 (1998); Richard H. Thaler & Hersh M. Shefrin, *An Economic Theory of Self-Control*, in QUASIRATIONAL ECONOMICS 77, 79 (1991).

145. Of course, financial professionals, like investment bankers who are often their colleagues, may have an interest in promoting transactions for no other reason than because it increases their own business.

146. See Fanto, *supra* note 27, at 121.

147. On investor hysteria, see CHARLES P. KINDLEBERGER, MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES (3d ed. 1996). Although securities markets appear to be informationally efficient, particularly regarding historical and current public information about companies, see BREALEY & MYERS, *supra* note 1, at 323-36, the market of course consists of its participants. If these participants have no memory of past problems with mergers, or decline to unearth information that would point to these problems, it is questionable whether, either in the short or long term, the market is operating efficiently in its evaluation of present mergers. Under the most extreme version of this argument, experienced investors leave the market or transfer their money to an index fund. See BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 421-32 (1996). New investors, unfamiliar with the problems, provide capital for a new wave of problematic mergers because of their having been harmed by these transactions in the past. Cf. Lynn Stout, *Are Stock Markets Costly Casinos? Disagreement, Market Failure, and Securities Regulation*, 81 VA. L. REV. 611, 666 (1995) (discussing how new investors have no “market memory”).

to bring investors and financial professionals within their optimistic vision of the transaction, and, for the most part, they have succeeded.

In effect, the situation is even more complicated. Caught up in the exuberance of an ever-rising stock market, impatient investors and their financial advisors are putting pressure on CEOs and boards to produce constantly improving financial results, which justify a higher stock price. A momentary stumble of a firm or even an announcement of less than stellar financial results or a perception of a lack of a bold strategy (a situation made worse by the announcement of a mega-merger by a competitor) means that investors, including the "activist" investors beloved by corporate law scholars, support the immediate replacement of the management team and board members.<sup>148</sup> Investors thus *expect* CEOs to come up with ambitious growth strategies, with the mega-merger being a necessarily move; it is not too strong an expression to say that investors have become addicted to these transactions. It is no wonder that the CEOs who rise and succeed in these circumstances are those who exhibit similar unbounded optimism and who can satisfy this investor appetite for bold schemes.<sup>149</sup>

### *C. Media and Political Reasons for the Celebration of Mega-Mergers*

CEOs and board members can be made more cautious in their mega-merger decisions when they feel that the business media is critically scrutinizing their decisions, which scrutiny, in turn, may inspire government officials and politicians to turn their attention to, and even to hinder or prohibit, the transactions. Yet, with rare exceptions, this critical scrutiny has not occurred regarding mega-mergers. Rather, the media has celebrated the transactions and lionized the CEOs proposing them and, if anything, has contributed to investor exuberance for this merger wave.

The lack of critical press scrutiny first owes much to

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148. Again, the examples here are legion. Indeed, the rapid demise of John McCoy, CEO of Bank One, could be seen either to exemplify market discipline of a "serial acquirer" and market impatience once such a person fails to deliver on expectations. *See supra* note 73.

149. *See, e.g., A Theory of the Case*, ECONOMIST, Jan. 15, 2000, at 24 (discussing "unshakeable conviction and iron nerve" of AOL CEO Steve Case).

politics in the media itself, both in a broad and narrow sense. That this is the case is clear when the present press treatment of the mega-mergers is contrasted with the widespread media condemnation of the "bust-up" mergers of the 1980s. In a well-known, but largely inaccurate, tale, the 1980s were characterized as the "decade of greed," with unscrupulous and immoral financiers destroying corporate America as they engaged in highly-leveraged acquisitions of conglomerates effected through tender offers followed by mergers and as they then broke up the companies.<sup>150</sup> The press largely condemned those mergers as symptomatic of and favored by a "*laissez-faire*" Republican administration given to the ostentatious displays of wealth of its high-income and high-net worth supporters.<sup>151</sup> The media political message was that the Republican Party championed a capitalism destructive of U.S. industry and society. Galvanized by, and making political use of, a popular opinion stirred up by the media, politicians and government officials did their best to put an end to this corporate restructuring, whether by passing corporate laws facilitating management resistance to tender offers,<sup>152</sup> aggressively pursuing financial promoters of these transactions for securities law violations,<sup>153</sup> or generally making the transactions more costly.<sup>154</sup>

The current media treatment of the mega-mergers, which has been generally adulatory rather than critical, is partly due to the media's reluctance to undermine a Democratic administration (the administration of William Jefferson Clinton), indeed the first such administration

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150. See, e.g., CONNIE BRUCK, *THE PREDATORS' BALL: THE JUNK BOND RAIDERS AND THE MAN WHO STAKED THEM* (1988); see also TOM WOLFE, *THE BONFIRE OF THE VANITIES* (1988) (for a fictional account of the years). The leveraged buyout of the 1980s was simply a variation on an earlier practice whereby most of the equity in a firm was bought out (for a premium) and put in the hands of a few financial buyers and management with the goal of improving the return on the firm's assets. See BAKER & SMITH, *supra* note 51, at 50-58. The 1980s' variation was simply to apply the technique to large firms.

151. See FISCHER, *supra* note 16, at 4.

152. See generally Mark J. Roe, *Takeover Politics*, in *THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE* 321, 330-53 (Margaret M. Blair ed., 1993) (discussing the influence of politics in corporate governance).

153. See FISCHER, *supra* note 16, at 128-89.

154. See BRUDNEY & BRATTON, *supra* note 37, at 676 (describing changes in tax laws that made leveraged acquisitions more costly).

after twelve years of Republican executive rule.<sup>155</sup> With few exceptions, the media has thus not condemned the excesses in the mega-mergers that have so dominated business and finance, because, from a simple political perspective, these excesses are not supposed to occur during this kind of administration.<sup>156</sup> In today's circumstances, the media presents much of business and finance, including the mega-mergers, as background phenomena that contribute to the good economic times benefitting most people (which further redounds to the stewardship of the most recent Administration), rather than as leading to social dislocation and wealth disparities and thus becoming targets of harsh press and then political criticism.

Naturally, the explanation is more complex than a general media preference for a Democratic administration.<sup>157</sup> The hostility to the 1980s' LBOs owed much to a longstanding U.S. populism that manifests itself in a fear of and opposition to financiers and concentrated financial power and that surfaces in and out of *both* established political parties.<sup>158</sup> Managers of "Main Street" businesses, the target of the leveraged buyout financiers and in alliance with politicians of all stripes and parties, tapped this populism, which the media fanned, to resist the aggression of financial buyers.<sup>159</sup> The mega-mergers have raised—so far<sup>160</sup>—no obvious populist issue, because, as

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155. On the general permissive, progressive orientation of the media, see references in GERTRUDE HIMMELFARB, *ONE NATION, TWO CULTURES* 119 (1999).

156. The Democratic Party, at least that of the twentieth and twenty-first centuries, is understood not to be under the control of business people and financiers. See, e.g., ROBERTA S. KARMEL, *REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA* 23 (1982). "I considered myself a liberal Democrat. Accordingly, I was anti-business, pro-labor and in favor of government intervention in the economy, if not outright nationalization of essential industries for the public good." *Id.*

157. One nuance is the following: as this Article has shown, there are media stories critical of mergers. They are simply not as numerous, nor do they receive the kind of display, as do the reports extolling the mergers.

158. See ROE, *supra* note 106, at 28-29.

159. See *id.* at 151-68.

160. An interesting question is whether mega-mergers can continue to remain free of populist animus in light of their growing size. Indeed, recent actions by AOL and Time Warner suggest that they are not only attempting to defuse antitrust scrutiny regarding their merger, but also any populist attack on their control of media. See Kathy Chen & Nick Wingfield, *Time Warner, AOL Vow to Give Rivals Access*, WALL ST. J., Mar. 1, 2000, at B8 (describing appearance of company executives before the Senate Judiciary Committee

commentators point out, they often involve strategic transactions designed and executed by the "Main Street" businesses themselves, not Wall Street financiers and their legal assistants.<sup>161</sup> Big business, moreover, has not received a "free ride" during this Administration. Populist suspicion has traditionally focused on a U.S. business perceived as growing too large and on foreign businesses acquiring excessive control of U.S. firms.<sup>162</sup> The government's initially successful antitrust suit against Microsoft, as well as the media "demonization" of that company,<sup>163</sup> and the intermittently expressed concern about foreign acquisitions of U.S. firms and globalization in general, which violently surfaced in Seattle, reveal a populist based-hostility to business that the media echoes and that animates politicians and government officials of both mainstream political parties.

The explanation for the media portrayal of the mega-mergers is even more complicated than this rough macro-political and populist account. Wall Street professionals actively participate, and may even stimulate, many transactions, as investment bankers push CEOs to respond to mega-mergers with similar mergers.<sup>164</sup> Yet, for several reasons, Wall Street is no longer a simple Democratic and populist target. First, Wall Street and the financial world it symbolizes are simply not the bastion of Republicans hostile to Democratic administrations that typified the New Deal period.<sup>165</sup> Rather, close links have been forged between Wall

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vowing to open their media delivery services to rival content providers).

161. See *How to Make Mergers Work*, *supra* note 10, at 15 (observing that current mergers may have better chances of success than former ones because of their industrial logic).

162. See ROE, *supra* note 106, at 28.

163. See John R. Wilke & Keith Perine, *U.S. Says Microsoft Had 'Enemies List' of Rivals*, WALL ST. J., June 17, 1999, at A3 (discussing Microsoft's "enemies list" of small software makers and Bill Gates's role in it); see also *United States v. Microsoft*, No. 98-1232 (D.D.C. Apr. 3, 2000) (finding Microsoft to have violated the federal antitrust laws).

164. See, e.g., Steve Lipin & Nikhil Deogun, *Anything Goes! After AOL Time Warner, Who's Next?*, WALL ST. J., Jan. 11, 2000, at C1 (reacting to the announcement of the AOL Time Warner merger, Gary Kominsky, a managing director at money manager Neuberger Berman, states "It's like Christmas again for the investment bankers").

165. See generally JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 19-38* (1982) (discussing politics around the time of advent of federal securities laws).

Street and Democratic elites, particularly in the recent Administration, and even the most partisan of Democratic politicians and government officials move easily between these worlds, as do Republican and politically independent elites.<sup>166</sup> Second, investing has become so much a part of ordinary life for a majority of Americans that it is not seen or felt as being the province of some well-to-do, generally Republican, upper middle class (which, in any event, no longer exists).<sup>167</sup> For pure business survival reasons, the media must respond to the popular investor interest in the mega-mergers and it no doubt fears the bottom-line result of simply condemning the transactions (i.e., people will turn to competitors for financial news). Third and significantly, it should be remembered that much of the media originates from the very media and entertainment companies that are involved in some of the largest mega-mergers and that receive much advertising from securities professionals.<sup>168</sup> These facts not only raise questions about media independence and objectivity regarding the transactions, but also explain why the media coverage of them, with the tales of mega-merger personalities and intrigues, have become increasingly indistinguishable from entertainment itself.

What is particularly ironic about this media treatment of mega-mergers is that the media ignores the same excesses that it and politicians condemned so vigorously in the 1980s. Recent years have seen growing wealth disparities in the United States, starker than those in the 1980s, that the mergers have helped foster, as mega-firms justify larger executive compensation packages.<sup>169</sup> The huge

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166. See Steven Lipin, *Deals & Deal Makers: Lazard Names Vernon Jordan As Rainmaker*, WALL ST. J., Dec. 1, 1999, at C24 (discussing appointment of President Clinton's notorious confidant, Vernon Jordan, as a managing director of investment bank, Lazard Freres). This movement between the recent administration and investment banks has taken a humorous turn. See, e.g., Michael Lewis, *The Artist in Gray Flannel Pajamas*, N.Y. TIMES, Mar. 5, 2000, Sec. 6, at 45 (referring to rumor that President Clinton will become an investment banker upon leaving office).

167. See Fanto, *supra* note 27, at 112-26 (describing growth of attraction for Wall Street by ordinary Americans).

168. See Marcia Vickers & Gary Weiss, *Wall Street's Hype Machine*, BUS. WK., Apr. 3, 2000, at 113 (describing media and brokerage industry connections encouraging ordinary people to trade securities).

169. See, e.g., John Hechinger, *BankBoston's CEO Got Safeguards In Fleet Buyout*, WALL ST. J., Mar. 17, 1999, at A13 (describing lucrative severance

wealth gains have not been restricted to CEOs, for the mega-mergers have created a bonanza for financial services professionals (again, a group so condemned during the 1980s)—Wall Street bankers and lawyers, consultants and accountants—whose profits dwarf those made during the earlier period.<sup>170</sup> Accompanying many of the combinations are massive layoffs and the social dislocations that occur when an enormous company must cut costs on a titanic scale and move its headquarters and operations out of a community.<sup>171</sup> Indeed, the very size of the companies involved in these transactions magnifies the social effects.

My point here is not that the media *must* criticize the mega-mergers and stir up a populist animus against them (which would spur political action), for, as in the past, populism and populist politicians could well condemn economically sensible transactions with the bad. Nor is the point to highlight the hypocrisy of the media, which stirs up

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package offered to a target firm's CEO); Debra Sparks, *The Mother of All Stock Option Plans*, BUS. WK., Nov. 23, 1998, at 158 (describing stock option plans for executives of Conseco, a company formed by serial acquisitions); Reingold, *supra* note 15, at 41; *see also supra* note 14 (discussing executive compensation). *See generally* Ajay Khorana & Marc Zenner, *Executive compensation of large acquirors in the 1980s*, 4 J. CORP. FIN. 209, 233 (1998) ("This result has two important implications: (i) for acquirors, there is an *ex ante* managerial expectation that a larger firm size will result in correspondingly larger managerial remuneration, and (ii) the relative size/compensation sensitivity of an executive compensation contract can be an important determinant in a firm's decision to undertake a large acquisition."). On general income and net worth disparities, *see* Arthur B. Kennickell et al., *Recent Changes in U.S. Family Finances: Results from the 1998 Survey of Consumer Finances*, 86 FED. RES. BULL. 1, 6 (2000), stating that from 1995-98, the "median net worth rose most markedly for families headed by someone with at least some college education, while it fell for families headed by those with less than a high school diploma; indeed, for the latter group, the median has fallen over the period of the four surveys."

170. *See* Thompson Financial Securities Data, *supra* note 2, at 4-5 (discussing involvement of financial advisors and securities law firms in 1998 mergers); Thomson Financial Securities Data, *supra* note 2, at 5 (same for 1999 deals); *Cf.* Rau, *supra* note 125, at 6-7 (describing investment banking fee structure in mergers and tender offers).

171. *See generally* Joan Harrison, *M&A Is a Key Source Of Corporate Layoffs*, MERGERS & ACQUISITIONS, Jan./Feb. 1999, at 7 (observing that mergers and acquisitions account for at least 10% of the job losses, and probably more since layoffs often occur gradually after mergers); KPMG, UNLOCKING SHAREHOLDER VALUE, *supra* note 95, at 12 (observing that, of the survey's sample, "headcount reduction is the area where most companies have achieved benefits [in terms of merger synergies]"); *see also supra* note 15 (exploring negative situations resulting from mergers).



anti-business sentiment at politically convenient times. Rather, it is simply that, for politically and socially complex reasons, the press and the politicians who are motivated by it have not placed upon CEOs and particularly board members what can at times be a salutary pressure to justify to themselves and to the public the increasingly enormous mega-mergers, but have encouraged and celebrated the transactions, making the “cascade” of favorable information about them complete.<sup>172</sup> When this media treatment is coupled with the complexity of the industrial situation facing most firms, the behavioral biases that executives, directors, finance professionals and investors are prone to, it is no surprise that there has been little to check the value destruction produced by the mega-mergers.

#### IV. THE FAILURE OF LAW TO CONSTRAIN MEGA-MERGERS

##### A. *The Law Governing Consensual Mergers*

Law has done little to brake the momentum of the mega-mergers promoted by CEOs, accepted by boards, and embraced and encouraged by investors and the press. This outcome is not surprising, because corporate and securities laws provide a very limited process for outsider (that is, court or agency) review and criticism of a friendly merger, no matter how great its size. Two assumptions generally support this result. The first assumption is related to the standard deference courts give to business decisions: as articulated in the well-known case, *Dodge v. Ford Motors*, “judges are not business experts.”<sup>173</sup> Judges are in a much worse position than executives and board members to decide upon and review *any* merger. Related to the first is the assumption that the “invisible hand” of the market is the most economical means of evaluating mergers and punishing those who make poor merger decisions.<sup>174</sup> In more

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172. There are occasional voices in the wilderness. See, e.g., Jeffrey E. Garten, *Megamergers Are A Clear and Present Danger*, BUS. WK., Jan. 25, 1999, at 28 (expressing concern that, as a result of mergers, private power is growing too big in this country while government is shrinking); see also Jaret Selberg, *Anti-M&A Initiatives Grow in D.C.*, THE DAILY DEAL, at [www.thedailydeal.com/topstories/A20411-2000Apr3.html](http://www.thedailydeal.com/topstories/A20411-2000Apr3.html) (Apr. 3, 2000) (discussing the hostility of various politicians to large mergers).

173. See *Dodge v. Ford Motor Co.*, 204 Mich. 459, 508 (1919).

174. See, e.g., COX, *supra* note 34, at 607 (“When the parties are dealing at

prosaic terms, but significant for doctrinal purposes, the law limits court intervention in mergers because the market judgment operates through the vote of each combining firm's owners (the shareholders) to approve or disapprove the merger.

Although the law declines to intervene in the *substance* of the merger decision, as every student of corporate law knows it surrounds the merger decision *process* with considerable formality and procedural safeguards, which emphasizes the importance of this transaction for the firm.<sup>175</sup> The rationale is that, if the process is adequate, then the best board and shareholder decision under the circumstances has been made. Corporate law establishes that each board of directors of a constituent firm must agree upon the terms of the transaction with the other board and recommend the merger to their shareholders for approval.<sup>176</sup> In most cases (and in nearly all mega-mergers), shareholders of each firm must approve the merger, generally by a majority vote of outstanding shares.<sup>177</sup> Once shareholders have made the merger decision, certain formalities ensure that the corporate existence of one firm ends and the other survives as the combined entity (or, in some cases, both firms disappear into a new firm).<sup>178</sup>

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arm's length, there is little justification for judicial scrutiny, any more than for the business decisions of the board of directors or officers generally. This is not to suggest that mistakes, errors in judgment, or bad results do not flow from acquisitions; they most certainly do. The law's caution here [is] that capitalism works best when it is Adam Smith's invisible hand, not causes of action, that is the preeminent force in placing resources to their highest use.").

175. The law governing the affairs of a corporation is the law of the State in which it is incorporated. See COX, *supra* note 34, at 45. Accordingly, corporate law on mergers involves the law of the fifty States. As mentioned above, for purposes of this Article, I concentrate on the General Corporation Law of Delaware (the State with the largest number of public corporations), the law governing nearly all of the mega-mergers.

176. See, e.g., DEL. CODE ANN. tit. 8, § 251(b) (1999); MODEL BUS. CORP. ACT § 11.01(a) (1998) [hereinafter MODEL ACT].

177. The special shareholder voting requirement is that some absolute number of votes (generally a majority) of *all* outstanding shares must be cast in favor of the merger (not a majority of a quorum). See, e.g., DEL. CODE § 251(c); MODEL ACT § 11.03(e). In some States, the statutory minimum number of shareholder votes is higher than a majority, see COX, *supra* note 34, at 586 (citing jurisdictions with a higher than majority vote required), and a corporation may always require a supermajority vote (as stipulated in its certificate of incorporation).

178. See, e.g., DEL. CODE ANN. tit. 8, § 251(c).

Depending upon the jurisdiction, there may be a statutory right of exit for shareholders of the disappearing firm who oppose the transaction and wish to be "cashed out" of their shares prior to the combination (this is the appraisal or "dissenters'" remedy).<sup>179</sup>

Corporate law, moreover, strengthens the decision-making of the board by imposing fiduciary duties upon the directors.<sup>180</sup> A director has duties to supervise the affairs of the corporation, on behalf of the corporation and its shareholders, as an ordinarily prudent person would in like circumstances and not to allow his or her own interests to interfere with those of the corporation and its owners.<sup>181</sup> The duty of supervision, known as the duty of care, is more relevant than a duty to avoid conflicts of interest (the duty of loyalty) in a mega-merger where two unrelated firms are combining. In essence, the duty of care dictates that directors must inform themselves about the merger and make a rational business decision that, if they recommend it, the transaction benefits the corporation and its shareholders.<sup>182</sup> If a court finds that they have adequately conducted the process of merger decision-making, it will defer to their business decision—that is, accord them the deference of the "business judgment rule"—on the transaction.<sup>183</sup> A further jurisprudential development based on this duty of care is a "duty of disclosure," which generally arises when a board requests a shareholder vote on an issue, as in a merger.<sup>184</sup> This latter duty requires that

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179. See, e.g., *id.*, § 262(a); MODEL ACT § 13.02(a)(1). For recent writings on this remedy, see Peter V. Letsou, *The Role of Appraisal in Corporate Law*, 39 B.C.L. REV. 1121 (1998), for a proposal offering a theory to explain the use of appraisal, and Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613 (1998), for an argument supporting a reformation and extension of the appraisal remedy.

180. Fiduciary duty does not literally apply to a company's disclosure under the federal securities laws. Yet, as explained below, since it governs the behavior of board members in all actions affecting the corporation and since they must approve such disclosure, it indirectly affects their obligations under the federal securities laws.

181. See 1 BLOCK, *supra* note 22, at 1.

182. See, e.g., GILSON & BLACK, *supra* note 52, at 1024-25; see also PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 133, at 389-98 (discussing the board of directors' role in control transactions).

183. See PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 133, at 139, 172-85.

184. See *Malone v. Brincat*, 722 A.2d 5, 14 (Del. 1998).

The duty of disclosure is, and always has been, a special application of

directors provide shareholders with the requisite "material" information so that the latter can competently make their important decision.<sup>185</sup>

As is typical of their overall relationship with corporate law, federal securities laws support the corporate law emphasis upon adequate decision-making in mergers, at least for those transactions involving "public" companies that fall within the jurisdiction of these laws (which include firms involved in mega-mergers).<sup>186</sup> Federal proxy rules dictate the procedures that public companies must follow in soliciting shareholder votes in a merger and the information that they must provide to shareholders. Under these rules, shareholders receive considerable disclosure about the transaction, the parties involved, the reasons for it, its risks and the merger consideration, as well as have time to evaluate the information and to decide whether to cast their vote in support of the merger.<sup>187</sup> If, as in the mega-mergers, the merger consideration consists of securities, the firm offering the securities must register them under the Securities Act of 1933, a process that provides shareholders with information on that firm's business, management and financial results, as stipulated on the Form S-4 used to register securities offerings in business combinations.<sup>188</sup>

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the general fiduciary duty owed by directors. The duty of disclosure obligates directors to provide the stockholders with accurate and complete information material to a transaction or other corporate event that is being presented to them for action.

*Id.* See generally 1 BLOCK, *supra* note 22, at 499-508.

185. See *Malone*, 722 A.2d. at 9-11.

186. Companies that have securities registered on a national securities exchange (or traded on a national securities association), that have done a public offering or that have a class of equity securities held by 500 or more holders and have more than ten million dollars in total assets must register their securities under the Securities Act of 1934 and are subject to the jurisdiction of this Act. See 15 U.S.C.A. § 78l(a)-(g), 78o(d) (West Supp. 2000).

187. See 15 U.S.C. § 78n(a) (1988); 17 C.F.R. § 240.14a-1 to 14b-2 (1999).

188. See 17 C.F.R. § 230.145 (requiring that securities offered in a merger be registered under the Securities Act of 1933). There is a special form that an issuer must follow in registering its securities in a business combination. See *id.* § 239.25 (requiring, among other things, detailed information on risk factors, terms of the transaction, pro forma financial information of the "combined" company). Companies involved in a strategic merger often file a "joint proxy statement/prospectus" that both registers the securities offered to the "target" company and follows the mandated procedure for seeking a vote from shareholders. See *id.*

Again, it must be emphasized that shareholders of companies involved in mega-mergers receive almost no direct *substantive* protection and rights, apart from the right to vote.<sup>189</sup> If the mega-merger is undertaken under Delaware law, shareholders of both merger partners have no statutory appraisal right, given that publicly-traded stock is the merger consideration.<sup>190</sup> As for their process rights, there is no debate in the proxy statements or other disclosure documents on the merits of the proposed merger, for executives of the companies involved and their counsel prepare them. While the disclosure documents must present the shareholders with considerable information about the combination, including the risks associated with it, in accordance with SEC guidelines and often as a result of specific comments on disclosure documents by the SEC staff, the disclosure is geared to protect the companies against future (or ongoing) shareholder lawsuits, not to stimulate among shareholders a debate on the merits of the merger.<sup>191</sup> Recent changes in SEC rules governing business combinations, moreover, allow combining firms in stock-for-stock transactions greater freedom to promote, and thus to increase the momentum for, the transaction outside the mandated disclosure documents and to complete it more quickly than in the past.<sup>192</sup> The only legally mandated "debate" about a merger occurs if a third party seeks to

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189. A corporation conducting an acquisition can avoid the requirement of shareholder approval of a merger by conducting the transaction through a special acquisition subsidiary established for this purpose (the well-known "triangular" merger structure). See *supra* note 52; see also COX, *supra* note 34, at 590. In the triangular merger, an acquiring corporation may have to seek shareholder approval if the number of shares needed for the acquisition exceeds the number authorized in the certificate of incorporation (thus requiring an amendment to this certificate and a shareholder vote) and/or if the corporation is listed on the New York Stock Exchange and issues a number of shares amounting to 20% of the corporation's equity capital. See NYSE LISTED COMPANY MANUAL § 312.03(c) (1999). Most mega-mergers need the approval of the shareholders of the acquiring company.

190. See DEL. CODE ANN. tit. 8, § 262(b) (1999); Wertheimer, *supra* note 179, at 620, 632-35.

191. See 17 C.F.R. § 229.503 (providing that a company must provide a discussion of the most significant factors that make the offering speculative or risky).

192. See generally Regulation of Takeovers and Security Holder Communications, Securities Act Release No. 7760, 64 Fed. Reg. 61,408 (Nov. 10, 1999) (final release); Securities Act Release No. 7607, 63 Fed. Reg. 67,331 (Nov. 3, 1998) (proposing release). See also *infra* notes 335-37.

break up the transaction and files its own disclosure documents, which generate a required response from the combining companies.<sup>193</sup>

Even the *process* protection to shareholders in the mega-mergers derived from fiduciary duties imposed upon board members should not be exaggerated. The plain fact is that a court rarely finds fault with a board's decision to enter into a friendly mega-merger conducted in stock-for-stock form.<sup>194</sup> Admittedly, the boards' duties are situational: the behavior that the duties demand of a director varies in accordance with the context.<sup>195</sup> From the fiduciary duty perspective, directors of enormous public companies should have considerably more responsibility when deciding upon a mega-merger, particularly if the directors themselves have business experience.<sup>196</sup> Yet the fiduciary standards of conduct, combined with the "business judgment" court deference, are not onerous. Provided that there is no controlling shareholder nor any director interested in the transaction (which is generally the case in the recent mega-mergers), court evaluation of the decision is focused upon process, although courts tend to give additional deference to boards composed primarily of "outside" directors.<sup>197</sup> In

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193. See 17 C.F.R. §§ 240.14d-9, 240.14e-2.

194. The well-known case, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), where board members were held liable for a violation of their duty of care in approving a merger decision, is not to the contrary, insofar as it involved a situation in which a company agreed to be the target of a cash-out merger, there were suggestions of self-interest and the board had not adequately sought "outside" advice concerning the merger. See generally GILSON & BLACK, *supra* note 52, at 1054-57. It should be added that the consequences of the violation of the duty of care are not significant, because the law generally allows corporations to exempt directors from liability for good faith violations of the duty of care. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7); see also GILSON & BLACK, *supra* note 52, at 1057 (observing that forty-one states have such protection in their corporate statutes). Board members also receive protection through indemnification and directors' and officers' insurance for such violations. See generally COX, *supra* note 34, at 449-55. The failure of directors to comply with their fiduciary duty of care does not make the merger invalid, for such a duty arises not from the statutory law, but from equity. See *Arnold v. Soc'y for Sav. Bancorp Inc.*, 678 A.2d 533, 537 (Del. 1996).

195. See, e.g., *Francis v. United Jersey Bank*, 432 A.2d 814, 821 (N.J. 1981) ("[D]irectors must discharge their duties in good faith and act as ordinarily prudent persons would under similar circumstances in like positions.").

196. See PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 133, at 178-79.

197. Courts ask whether directors adequately informed themselves before agreeing upon a transaction and whether the decision can be seen as rational. See *id.* at 177-81.

arriving at their decision, moreover, the board is expected, and legally encouraged, to rely upon "experts," such as investment bankers and outside counsel, and even executives—that is, the very parties who are advocating the transaction, for courts do not impose upon the board the duty of independently seeking information.<sup>198</sup> At most, courts impose a slightly higher process burden on the target firm in an acquisition, but this remark properly leads to the discussion in the next section.

### *B. Impact of Hostile Takeover Law on the Law of Mega-Mergers*

The deferential business judgment approach to mergers, which applies to the mega-mergers, places no brake on the momentum of these transactions. Corporate law also gives substantial legal encouragement to this kind of transaction and thus adds to the momentum of the current merger wave. This jurisprudential outcome occurred, somewhat unintentionally, as a result of the judicial reaction to the hostile takeover. In the 1980s, the courts (primarily the Delaware state courts) had to address standards governing board behavior in a hostile takeover. As a by-product of their decisions regarding hostile takeovers, courts implicitly, and in some cases explicitly, approved the strategic merger of equals, conducted as stock-for-stock transactions, which had none of the transaction attributes or Wall Street personalities that the courts often found distasteful and which became the model for the mega-merger of the 1990s.<sup>199</sup> The clear message from the courts was that these mergers, rather than the "bust-up" LBOs, would receive favorable judicial review.<sup>200</sup> This

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198. See DEL. CODE ANN. tit. 8, § 141(e) (2000); see also *Ash v. McCall*, No. 17132, slip op., at 27 (Del. Ch. Sept. 15, 2000) ("What would plaintiffs have the McKesson board do in the course of making an acquisition other than hire a national accounting firm and investment bank to examine the books and records of the target company?").

199. For a number of reasons, judges did not look favorably upon hostile transactions: selected from the bar of local communities, they had more affinity with managers of firms that were the targets of takeover activity than with the aggressive financial entrepreneurs undertaking these transactions, and they would also likely be influenced by the anti-Wall Street populism of their fellow citizens. See generally *Roe*, *supra* note 152, at 341 (noting that the Delaware judiciary became only gradually anti-takeover).

200. The result of this jurisprudence was to allow boards to resist the value-

judicial signal was not lost on corporate and securities lawyers, who further developed the contracts locking parties into the mega-mergers, once hostile offers became less frequent at the end of the 1980s.

1. *Judicial Support for the Mega-Merger.* My goal here is not to re-examine exhaustively the takeover jurisprudence of the 1980s and the related academic literature.<sup>201</sup> Rather, it is simply to highlight how, while developing the law on board fiduciary duties in reaction to this financial phenomenon, courts promoted the mega-merger as *the* favorable transaction structure, which it became in the 1990s. The following discussion refers almost exclusively to the most important corporate case law on hostile transactions, that of Delaware.<sup>202</sup>

The well-known *Paramount Communications, Inc. v. Time, Inc.*,<sup>203</sup> which has appropriately been referred to as a “watershed” case in Delaware corporate law jurisprudence,<sup>204</sup> best exemplifies how judicial promotion of the mega-merger emerged from the development of jurisprudence on hostile transactions. The case is about a paradigm mega-merger. In a combination of media content

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creating hostile acquirer, even though the overwhelming economic evidence suggests that these parties add value. *See, e.g.,* Loughran & Vjih, *supra* note 20, at 1767 (“We find that postacquisition returns of acquirer’s stock are related to both the mode of acquisition and form of payment. In the overall sample of 947 cases, acquirers that make merger bids earn, on average, 15.9% less than matching firms whereas acquirers that make tender offers earn 43.0% more than matching firms during a five-year period after acquisition. Similarly, stock acquirers earn 24.2% less than matching firms whereas cash acquirers earn 18.5% more than matching firms.”).

201. The literature, whether legal or financial, on the takeover and its jurisprudence is voluminous and continues to grow. *See generally* THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE, *supra* note 152 (collection of essays from financial economists and legal scholars). *See also* BRUDNEY & BRATTON, *supra* note 37, at 936-1163 (reviewing cases, policy discussion and finance literature on takeovers); GILSON & BLACK, *supra* note 52, at 730-1008 (same).

202. Because other jurisdictions were more unfavorable to the hostile offer than Delaware courts (and had few opportunities to consider it), their jurisprudence was even more supportive of the strategic merger. *See* Roe, *Takeover Politics*, *supra* note 152, at 338-40.

203. 571 A.2d 1140 (Del. 1989).

204. *See* COX, *supra* note 34, at 620 (“Thus *Paramount* reaffirms the board of directors as a presumptively infallible decision-maker regarding the long-term benefits of an incumbent board’s strategic plan.”).



and distribution that is a precursor to present day Internet-related mergers (even to one involving Time Warner itself with AOL!), Time located a strategic partner in Warner with the idea of creating a publishing and film media firm with numerous delivery options (particularly cable). As is typical in a merger of equals between two enormous firms, Time and Warner's executives negotiated over management of the combined firm, management succession and board structure and initially structured the deal as a stock-for-stock transaction, whereby Warner shareholders would receive Time stock and shareholders of both firms would share in the fortunes of the combined firm.<sup>205</sup> In accordance with a standard procedure for mergers during hostile times, which became further developed in the 1990s, the two firms guarded their transaction by "deal protection" mechanisms, such as a mutual share exchange and no-shop clause.<sup>206</sup> Significantly for the outcome of the case, Time and Warner publicly contrasted their proposed strategic merger with the typical hostile takeovers then prevalent.<sup>207</sup>

Like a story in the classic literary form of the comedy, where the hero and heroine come together only after incurring and surmounting danger, the blissful marriage of Time and Warner took a turn for the worse when Paramount launched a surprise all-cash hostile offer for all Time shares. Fearing that the delay necessary under corporate law and the federal proxy rules to solicit the approval of Time and Warner shareholders for the merger would play into Paramount's hands (i.e., Time shareholders would sell their shares at a discount to the Paramount tender price to arbitrageurs, who would then have an economic interest in Time's accepting Paramount's cash

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205. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d at 1146 ("The resulting company would have a 24-member board, with 12 members representing each corporation. The company would have co-CEO's, at first Ross and Munro, then Ross and Nicholas, and finally, after Ross' retirement... Nicholas alone. The board would create an editorial committee with a majority of members representing Time. A similar entertainment committee would be controlled by Warner board members. A two-thirds supermajority vote was required to alter CEO successions but an earlier proposal to have supermajority protection for the editorial committee was abandoned.").

206. See *id.* at 1146-47. For more discussion of these mechanisms, see *infra* Part IV(B)2.

207. See *Paramount Communications v. Time*, 571 A.2d at 1147 ("Time representatives lauded the lack of debt to the United States Senate and to the President of the United States.").

offer),<sup>208</sup> Time changed its transaction form to a two-step tender offer for Warner, with cash for 51% of the shares in the “front end” and a mixture of cash and securities in the back end.<sup>209</sup> This change resulted in the transaction’s looking a lot like the leveraged acquisitions that Time and Warner had implicitly criticized and in the debt-laden Time-Warner becoming unattractive to Paramount.

In its decision approving the action of Time’s board, the Delaware Supreme Court gave a significant impetus to the mega-merger as the favored (i.e., insulated from most corporate legal problems) transaction for a major restructuring. As is well known, the critical question in takeover jurisprudence that the Court had to answer in response to challenges to the transaction that were brought by the suitor Paramount and disgruntled Time shareholders was the following: Under which standard should the Court evaluate the behavior of Time’s board—its primary standard regarding board behavior, as articulated in *Unocal Corp. v. Mesa Petroleum Co.*,<sup>210</sup> that was favorable to target company management or the variation set forth in *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*<sup>211</sup> that was more protective of shareholder interests. In an outcome critical for planning of mega-mergers, the Court decided that Time’s decision to enter into its strategic “merger of equals” with Warner did not trigger the board’s *Revlon* duties to maximize shareholder value, so long as the combined company would remain in the hands of a “fluid group of undifferentiated stockholders.”<sup>212</sup> Once the Court

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208. That is, Time would have to file a joint proxy/prospectus for the shareholder meetings of Time and Warner and for the registration of the Time shares offered to Warner shareholders. This involved a process made lengthy by the necessary SEC review of the proxy/prospectus and the notice provisions for calling shareholder meetings. A shareholder who wanted to take advantage of the Paramount cash offer could sell his or her shares to an arbitrageur, who would buy them at a discount to Paramount’s offer price (a discount calibrated to the risk that the offer would be successful). The arbitrageur’s profits would depend upon the success of this offer. See generally Francesca Cornelli & David Li, *Risk Arbitrage in Takeovers*, DISCUSSION PAPER NO. 2026 (Centre for Economic Policy Research 1998) (“[T]he arbitrage community has often come to control, in total, 30 to 40% of the stock and therefore they have become the single most important element in making many deals happening [sic].”).

209. See *Paramount Communications v. Time*, 571 A.2d at 1148.

210. 493 A.2d 946 (Del. 1985).

211. 506 A.2d 173 (Del. 1985).

212. See *Paramount Communications v. Time*, 571 A.2d at 1150. The Court observed that “without excluding other possibilities” the two circumstances for

adopted a *Unocal* analysis as an appropriate standard of review, the result was foregone that Time would prevail against legal challenges to the merger given the relatively deferential character of the *Unocal* test.<sup>213</sup> From a legal perspective, it mattered little that Time had to change the transaction from a stock-for-stock merger to its leveraged acquisition of Warner, for this response was an acceptable defensive response by Time to Paramount's bid. What mattered, rather, was that, so long as structured as a mega-merger, a corporation could enter into a transaction that would massively change its character and business, but that would not trigger the significant enhanced judicial scrutiny that would apply to a potential major restructuring from a hostile offer.

The next major case in the takeover area, *Paramount Communications Inc. v. QVC Network*<sup>214</sup> confirms, albeit

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the application of *Revlon* were (i) an auction and (ii) abandonment of a long-term strategy in favor of a breakup of the company. When *Revlon* is triggered, directors must maximize the price for the stockholders. *See id.* at 1150.

213. In considering whether Time satisfied the first *Unocal* prong ("reasonable grounds for believing that a danger to corporate policy and effectiveness existed," *id.* at 1152), the Court adopted a business judgment-like approach by according much deference to the board's definition of a "threat." It suggested that it was not a court's place to assess what *was* the threat posed by a hostile offer but simply to ask whether the threat seen by the board was a *reasonable* one. *See id.* at 1153 ("Indeed, in our view, precepts underlying the business judgment rule mitigate 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."). Similarly, under the second *Unocal* prong ("that the defensive measure adopted was reasonable in relation to the threat posed," *id.* at 1152), the Court gave the board considerable scope in resisting a threat that it had identified, provided that the resistance did not constitute an absolute "show stopper." In other words, defensive measures, including the restructuring of the transaction, were reasonably justifiable as the board's resistance to Paramount's threat to its long-term policy of a strategic combination with Warner. *See id.* at 1154 ("Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.") (citation omitted). Given the heavy "business judgment" implications of this decision, it is not surprising that commentators have concluded that *Unocal* analysis is reducible to the business judgment rule of court deference to board consensual merger decisions. *See GILSON & BLACK, supra* note 52, at 894 ("The Supreme Court's opinion reduces to a business judgment inquiry judicial review of the target board's determination that an offer presents a threat to the company's business plans. If a poison pill is always a reasonable response to such a threat, then the *Unocal* intermediate standard has become just another incantation of the business judgment rule.") (footnote omitted).

214. 637 A.2d 34 (Del. 1994).

indirectly, that structuring a transaction as a strategic merger of equals will enhance judicial deference regarding the transaction, regardless of whether the company that is the object of the legal challenge is the acquirer or the target of the transaction.<sup>215</sup> In *Time*, Time was the initiator of the combination with Warner. In *Paramount*, Paramount, the unwanted suitor in *Time*, agreed to a "strategic merger" with Viacom Inc. in another media mega-merger, but here Paramount was the target with its shareholders receiving voting and nonvoting stock of Viacom, as well as cash. As in *Time*, an interloper, QVC, appeared following announcement of the transaction, proposing that Paramount combine with it. In response to the threat to their merger, Viacom and Paramount restructured the transaction so that Viacom would take control of Paramount by a cash tender offer for 51% of Paramount's shares followed by a back-end merger for a combination of voting and nonvoting shares and convertible securities. A bidding war then ensued with Paramount favoring Viacom despite consecutively higher QVC offers.

When QVC sought an injunction against Viacom and Paramount's proceeding with their merger, the Court declined to accept their argument that the Paramount board's decision to engage in a strategic merger with Viacom was entitled to the relatively deferential *Unocal* scrutiny. It based this decision not on Paramount's status as a "target" rather than as the acquirer of the Viacom/Paramount merger. In a merger of equals, the respective role had little jurisprudential significance. Rather, the Court observed that the transaction was simply

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215. There is no question that, even in a strategic transaction, a board of the company that is the "less equal" in the merger of equals is always under a legal obligation to obtain some premium for its stockholders. In *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), decided in the same year as *Unocal*, the Delaware Supreme Court found that a board of a target company in a leveraged buyout violated its duty of care by agreeing to a consensual merger without adequate investigation about the value of the company, even though the board had obtained a substantial premium for the shareholders. However, the issue of obtaining an adequate premium to satisfy business judgment analysis is different from that of obtaining the *highest* premium that might emerge out of an auction. And, in any event, *Van Gorkom* did not involve a consensual stock-for-stock merger, but a cash-out merger that was essentially a takeover of the target and that might well have triggered *Revlon* duties on the target's board, had *Revlon* been decided at that time. See GILSON & BLACK, *supra* note 52, at 1054-57.

not a merger of equals: Viacom had a controlling shareholder, Sumner Redstone, who would dominate the combined company following the merger. In these circumstances, as in a breakup or auction, it made no sense to talk about a strategic combination of firms in which management and shareholders would be united. Instead, the public shareholders of Paramount would be losing their voice in their firm (the Viacom shareholders other than Redstone had no such control to begin with), and in this case the Paramount board had a legal obligation to obtain the "best value" for its shareholders—*Revlon* duties applied.<sup>216</sup> The clear implication is that, in the absence of a shift of control (or the other circumstances triggering *Revlon*), courts should defer to a target board's decision to engage in a mega-merger, just as to a similar decision by an acquirer's board.<sup>217</sup>

Delaware cases after *QVC* make it clear that the board of each company involved in a mega-merger, whether it be the "acquiring" or "acquired," is under no greater burden to maximize shareholder value in the transaction than what the standard duty of care analysis provides, unless the special circumstances of *Revlon* exist.<sup>218</sup> Indeed, so protected

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216. See *Paramount Communications, Inc. v. QVC Network*, 637 A.2d at 44-45 ("While the assessment of these factors may be complex, the board's goal is straightforward: Having informed themselves of all material information reasonably available, the directors must decide which alternative is most likely to offer the best value reasonably available to the stockholders.").

217. Moreover, the Court even implied considerable deference in the *Revlon* analysis. It observed that it had no expertise in determining the best value of a corporation and simply expected to find that a board had made a reasonable decision after adequately informing itself about alternatives:

There are many business and financial considerations implicated in investigating and selecting the best value reasonably available. The board of directors is the corporate decision-making body best equipped to make these judgments. Accordingly, a court applying enhanced judicial scrutiny should be deciding whether the directors made a *reasonable* decision, not a *perfect* decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.

*Id.* at 36 (emphasis in original) (citations omitted).

218. In *In re Santa Fe Pacific Corp. Shareholder Litigation*, Santa Fe Pacific Corporation was the target of a consensual, stock-for-stock merger with Burlington Northern, Inc. when Union Pacific Corporation, rebuffed by Santa

from strict scrutiny are board decisions in consensual mergers (in the absence of a shift in control) that the recent focus of Delaware case law regarding these transactions has been almost exclusively on whether various board defensive measures satisfy the two-pronged *Unocal* test, not on whether *Revlon* analysis invalidates these actions.<sup>219</sup> Courts evaluate the merger decision and the merger protective devices (see below), if challenged, in the same way that they analyze a board's resistance to an unwanted suitor when no friendly partner is on the horizon. Just as a board has the right "just to say no" to an unsolicited bid and to proceed in life without a combination, it can select its desired partner, again assuming no change in control. In either case, by means of *Unocal* or related doctrines in the case law,<sup>220</sup>

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Fe's board, launched a hostile offer for Santa Fe. Although the Santa Fe board felt pressure to—and did in fact—maximize the value to its shareholders from the friendly transaction because of a hostile offer, the Court evaluated the board's decision to proceed with the Burlington merger and erect defenses to Union Pacific's offer under *Unocal*, not the scrutiny of *Revlon*. Without any shift in control, auction or break-up, the Santa Fe board was entitled to proceed with its strategic transaction, provided that its defensive measures passed *Unocal* analysis. In re Santa Fe Pacific Corp. Shareholder Litigation, 669 A.2d 59 (Del. 1995). See *id.* at 71 ("While the [Santa Fe] Board properly encouraged Union Pacific to improve its offer and may have used the results as leverage against Burlington, the Plaintiffs do not allege that the Board at any point decided to pursue a transaction which would result in a sale of control of Santa Fe to Burlington. Rather, the complaint portrays the Board as firmly committed to a stock-for-stock merger with Burlington."). Recent cases follow this deferential approach to strategic mergers. See also *Wells Fargo & Co. v. First Interstate Bancorp*, 1996 Del. Ch. LEXIS 5502, \*1 (Del. Ch. 1996) (rejecting contention that *Revlon* scrutiny should apply to board decision to proceed with a stock-for-stock merger with one company to the exclusion of another interested suitor).

219. See *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995) (upholding Unitrin board's defensive repurchase of shares under *Unocal* analysis); *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998) (challenging "dead hand" poison pill—i.e., in which newly appointed directors cannot remove rights plan—as disproportionate defensive measure under *Unocal*); see also *Quickturn Design Sys. v. Shapiro*, 721 A.2d 1281 (Del. 1998) (invalidating "no hands" rights plan—which can be removed by the board only six months after the board's membership changes—as unduly restricting the board's exercise of its fiduciary duties). In other cases, parties understand that *Revlon* analysis applies, but they dispute whether the board adequately fulfilled its *Revlon* duties. See, e.g., *Matador Capital Mgmt. v. BRC Holdings, Inc.*, 729 A.2d 280 (Del. Ch. 1998); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997).

220. The primary related doctrine, which arguably has independent validity, is that articulated in *Stroud v. Grace*, 606 A.2d 75 (Del. 1992) and *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), which invalidates

courts basically concentrate on whether, in proceeding upon its chosen strategic path, the board of either company prevents shareholders from ultimately disagreeing with and rejecting its merger proposal.<sup>221</sup>

In one sense, the jurisprudential outcome of the case law on hostile offers was a judicial reaffirmation of the deference that courts traditionally accorded to boards of companies engaging in friendly mergers. Indeed, if no third party bidder for either company emerged, even the relatively benign *Unocal* standard would not be triggered if a shareholder challenged the transaction, for the appropriate standard of review was the "business judgment" rule. If management of merging firms anticipated a third-party challenge to their transaction, they had only to emphasize the transaction's "strategic" nature to put themselves in a particularly favorable legal position.<sup>222</sup> The judicial "message" of deference to boards in mergers was thus reinforced in the crucible of the 1980s' case law. Although the jurisprudence did not itself determine the mega-mergers of the 1990s, there is no question that it gave an impetus to these transactions, rather than impeding them.

2. *Practical Consequences of the Legal Impetus to the Mega-Merger.* The case law favoring the strategic mega-merger gives further impetus to these transactions through its effects on merger law practice. In corporate law, as in other legal areas, the force of the law also arises from legal practice, when, seeking to give legal certainty to clients' transactions, practicing lawyers translate the dictates of the law into contracts and other means of private ordering.<sup>223</sup> Guided by case law favoring strategic mega-

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defensive measures that "purposefully disenfranchise" shareholders. *Stroud*, 606 A.2d at 92 n.3; see, e.g., *Carmody*, 723 A.2d at 1193-94 (invalidating "dead hand" rights plan on *Blasius* grounds). For a recent case in which the Delaware Chancery Court explained the limited scope of *Blasius*, see *Chesapeake Corp. v. Shore*, 2000 Del. Ch. LEXIS 20 (Del. Ch. 2000).

221. See Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. IOWA CORP. L. 583, 606 (1994) (arguing that the Court's jurisprudence can be seen as consistent on this point).

222. Naturally, if merger consideration is all cash, the board of the acquired firm will have to admit that it is selling the company and that *Revlon* duties arise. The acquiring company in such a transaction can maintain the strategic transaction position.

223. See generally Marcel Kahan & Michael Klausner, *Standardization and*

mergers, merger lawyers devised or reinforced numerous contractual provisions that, *on their own*, contributed to the occurrence of the transactions. This legal practice shaped the structure and many features of the mergers and made (and makes) it difficult and expensive for boards to rethink and pull back from a merger decision once they have made it. When considering challenges to these devices from a *Unocal* or other case law perspective, courts have generally upheld their legality, adding yet another layer of case law support for the mega-merger. It should be noted, however, that, in some recent cases, courts are expressing uneasiness with the extent to which the contractual provisions “lock in” boards once they have made the merger decision.

These “lock up” provisions that, once a merger is agreed to, keep the merger partners focused on, and committed to do everything possible to effect, the transaction and that discourage and penalize them for looking for and deciding upon another deal, have been the subject of considerable scholarly and practice analysis.<sup>224</sup> They have generally been justified as the rational response of parties to consensual mergers in a financial climate that permits hostile interruptions to announced transactions by third parties and in highly competitive, rapidly changing industries where firms fear being left behind during a merger wave.<sup>225</sup> A firm simply does not want to waste its time, energy, and money on a transaction, only to see a third party snatch it away and to find itself without a valued and potentially important merger partner in a consolidating industry. My immediate point here is not to add to this literature or to challenge the economic rationality of the contractual provisions, as it is to emphasize the impetus that they give

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*Innovation in Corporate Contracting (or “The Economics of Boilerplate”),* 83 VA. L. REV. 713, 720-21 (1997).

224. See generally GILSON & BLACK, *supra* note 52, at 1009-10, 1020-23 and accompanying notes; Coates & Subramanian, *supra* note 6, at 4-5 and accompanying notes; Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L. J. 1739 (1994). For a practitioner’s detailed review of all of these devices, see 1 BLOCK, *supra* note 22, at 908-1003.

225. See GILSON & BLACK, *supra* note 52, at 1020 (“Competitive bidding adds a new risk: that the investment in making a bid will be lost because a competitive bid will be successful. The planning problem is then how to encourage a favored acquirer to go forward by reducing that risk. Note that the problem is not simply assuring the favored acquirer that it will win. Rather, the favored acquirer must be assured that its investment in bidding will have a positive net present value even if it loses the competition.”).



to mega-mergers, so many of which turn out badly.<sup>226</sup>

The contractual provisions in a typical merger agreement designed to ensure that a merger in fact occurs are familiar to anyone engaged in merger practice and are the object of often complex drafting.<sup>227</sup> The entire detailed agreement, of course, accomplishes the goal of a successful transaction by committing both parties to do the necessary tasks: the representations reflect the parties' understanding of each other; the covenants set forth the specific actions they must undertake to bring the merger to fulfillment; and at least some of the conditions to the merger ensure that there is no closing unless the transaction satisfies each party's goals.<sup>228</sup> More specifically, the "target" company's board covenants to recommend the transaction to its shareholders (under corporate law, it must make a recommendation to them in a merger)<sup>229</sup> and to

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226. See Kahan & Klausner, *supra* note 223, at 729-36 (discussing the potential for suboptimal contracting as a result of standardization).

227. Gilson and Black summarize them. See GILSON & BLACK, *supra* note 52, at 1020-23; see also Coates & Subramanian, *supra* note 6, at 6 and accompanying notes. To get a sense of these provisions, one has only to look at the proxy/registration statement addressed to the "target" company shareholders in any typical strategic merger, which both summarizes the major provisions of the merger agreement and includes as a central exhibit to the registration statement this agreement. See 17 C.F.R. § 229.601(b)(2) (requiring inclusion of the "plan of acquisition" as an exhibit in the Form S-4, the Securities Act form for the registration of securities used in a business combination); Form S-4, Item 4 (a)(1), available at <http://www.sec.gov/smbus/forms/s-4.htm> (requiring in the Form S-4 prospectus "[a] brief summary of the terms of the acquisition agreement"). For a typical Form S-4 with an attached merger agreement, see Exxon/Mobil Joint Proxy Statement/Prospectus, SEC File No. 333-75659 (Apr. 5, 1999) [hereinafter Exxon/Mobil Prospectus].

228. Such commitments, as one might expect, generally occur in the covenants of an agreement, which has separate covenant sections for the acquirer and target as well as joint covenants. These covenants can be tailored to the nature of the acquisition and businesses involved, although there are certain standard ones: for the target, that it will not change its business; for the acquirer, that it will provide indemnification and insurance to the target's officers and directors for suits arising post-merger, as well as maintain certain employee benefits; and for both parties, that they will cooperate with each other to see the transaction through, make the requisite legal filings, will give each other access to information and notices about certain events, and will make joint public announcements. See, e.g., Exxon/Mobil Prospectus, *supra* note 227, at A-21 to A-30 (Articles V-VII). For an excellent discussion of the rationale behind provisions of a merger agreement, see JAMES C. FREUND, ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS (1975).

229. See DEL. CODE ANN. tit. 8, § 251(b) (2000).

do what is legally necessary to ensure that a shareholder vote occurs (i.e., call a meeting and prepare and file the proxy statement that satisfies federal proxy rules).<sup>230</sup> Similarly, the acquirer covenants to do the same and even more: to offer the target's shareholders its shares as merger consideration, which means preparing and filing an SEC registration statement on Form S-4, and to prepare its own proxy to obtain approval from its shareholders for amending its certificate of incorporation in order to authorize the shares needed for the transaction.<sup>231</sup>

More importantly for binding parties to the merger is the classic "no shop" provision. To address specifically third party intercession in the transaction, each party in a merger of equals insists that the other agree to cease any ongoing negotiations with any third parties, not to engage in any discussions with, to solicit interest in an alternate transaction with or to provide information to a potential alternative merger party, and to report any third party advances to each other.<sup>232</sup> There is a well-established

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230. See, e.g., Exxon/Mobil Prospectus, *supra* note 227, at A-23 (§ 5.02), providing that:

[T]he Company shall cause a meeting of its stockholders . . . to be duly called and held as soon as reasonably practicable, on a date reasonably acceptable to Acquiror, for the purpose of voting on the approval and adoption of this Agreement and the Merger . . . . [T]he Board of Directors of the Company shall recommend approval and adoption of this Agreement by the Company's stockholders. . . . In connection with the Company Stockholder Meeting, the Company (x) will promptly prepare and file with the SEC, will use its reasonable best efforts to have cleared by the SEC and will thereafter mail to its shareholders as promptly as practicable the Company Proxy Statement and all other proxy materials for the Company Stockholder Meeting, (y) will use its reasonable best efforts, subject to the immediately preceding sentence, to obtain the Company Stockholder Approval and (z) will otherwise comply with all legal requirements applicable to the Company Stockholder Meeting.

231. See, e.g., *id.* at A-26 (§ 6.04) (providing that Exxon covenants to call a shareholders' meeting to submit proposals for amending its certificate of incorporation and to prepare the registration statement on Form S-4 and expedite its effectiveness with the SEC). Exxon and Mobil, as is often typical, filed a joint proxy statement/registration statement addressed to both shareholder groups.

232. See *id.* at A-23 (§ 5.03), which provides that:

The Company and its Subsidiaries will not, and the Company will use its reasonable best efforts to cause the officers, directors, employees, investment bankers, consultants and other agents of the Company and its Subsidiaries not to, directly or indirectly, take any action to solicit,

exception to this “no shop” clause, the “fiduciary out.” In its current form, the exception provides that the board of either company may enter into discussions with, and provide information to, a third party and change its recommendation regarding the merger if this party makes an unsolicited offer and if the board determines that it must take these actions in order to comply with its fiduciary duties.<sup>233</sup> The jurisprudential support for this “out” comes from the case law on hostile offers: if, as a result of the announced merger, a bidder for either merger partner enters the arena and if, because of a particular bid, one of the merger partner’s board begins to change its intentions regarding its firm’s future (i.e., it begins to enter the *Revlon* “mode”), it needs to be able contractually to withdraw from the merger. Indeed, in these circumstances, a court would read this exception into the agreement, even if the exception were not contractually provided for, because, under *Revlon*, a court would invalidate as unlawful a “no shop” clause that had no “fiduciary out.”<sup>234</sup> The art of

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initiate, encourage or facilitate the making of any Acquisition Proposal (including without limitation by amending, or granting any waiver under, the Company Rights Agreement) or any inquiry with respect thereto or engage in discussions or negotiations with any Person with respect thereto, or disclose any non-public information relating to the Company or any Subsidiary of the Company or afford access to the properties, books or records of the Company or any Subsidiary of the Company to, any Person that has made, or to the Company’s knowledge, is considering making, any Acquisition Proposal . . . . The Company and its Subsidiaries will, and the Company will use its reasonable best efforts to cause the officers, directors, employees, investment bankers, consultants and other agents of the Company and its Subsidiaries to, immediately cease and cause to be terminated all discussions and negotiations, if any, that have taken place prior to the date hereof with any parties with respect to any Acquisition Proposal.

On “no-shop” provisions, see generally William T. Allen, *Understanding Fiduciary Outs: The What and the Why of an Anomalous Concept*, 55 BUS. LAW. 653, 653-54 (2000).

233. See generally 1 BLOCK, *supra* note 22, at 935-57 (characterizing this exception, at 942-45, as a “window shop” exception); see also Allen, *supra* note 232, at 654.

234. In *Revlon*, the court specifically invalidated the “no-shop” provision in *Revlon*’s merger agreement with Forstmann stating that “[t]he no-shop provision, like the lock-up option, while not *per se* illegal, is impermissible under the *Unocal* standards when a board’s primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder.” *Revlon, Inc. v. Mac Andrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1985). The implication is that, when *Revlon* duties are not triggered, which is the typical

drafting this provision focuses on (because of some legal uncertainty to be discussed further below) how strictly to make the exception: for example, should the exception language provide that the third party offer has to be written and/or to be a superior offer to the existing transaction on the basis of the opinion of a valuation expert? Must outside counsel to the board opine that the board has legally to invoke the exception when the third party bid surfaces in order for the use of the exception to be justified under the contract?<sup>235</sup>

Penalty provisions in the merger agreement are designed to ensure that the "fiduciary out" is rarely used in a mega-merger.<sup>236</sup> Because a merger partner does not want to be a "stalking horse" (i.e., to invest significant amounts of time and money, only to see another reap the benefits of the transaction, and to lose the opportunity of competing transactions), it will generally demand a termination fee plus expense reimbursement if the other firm invokes the "fiduciary out."<sup>237</sup> Indeed, the provisions governing these fees (commonly known as "break-up" fees) are drafted broadly enough to be triggered not only where one partner's

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situation of a strategic merger, the no-shop provision is perfectly legal. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1151 n.15 (Del. 1989). The reason that the exception is now standard is that, without it, counsel cannot opine that the merger agreement is legal. See generally Allen, *supra* note 232, at 656, 659.

235. See, e.g., Exxon/Mobil Prospectus, *supra* note 227, at A-23 to A-24 (§ 5.03). It may not matter how strictly the proviso is drafted so long as the exception depends upon the board's exercise of its fiduciary duties. Under *Time*, unless the board has decided upon a sale of the company, it need not obtain the best price for its shareholders in a merger. However, if an unwanted third party's bid is clearly superior to the merger premium, the board may feel both pressure from its shareholders to entertain that bid and fear that a court will find its insistence upon the initial merger somewhat irrational. Accordingly, in any negotiation, lawyers for the target board may try to draft the exception as broadly as possible (while bidder's counsel will insist that it be triggered only if the third party offer is clearly superior to the bidder's proposal).

236. "Rarely" does not mean never. In a friendly merger, one merger partner may concede defeat and leave the transaction to a third party, taking with it the termination fee and any other negotiated benefit. See, e.g., Leslie Cauley & Rebecca Blumenstein, *Comcast, in AT&T Accord, Abandons MediaOne Bid*, WALL ST. J., May 5, 1999, at A3 (describing how AT&T broke up the Comcast Corp. merger with MediaOne, but that, in the settlement, Comcast left with, among other things, the \$1.5 billion termination fee).

237. See 1 BLOCK, *supra* note 22, at 957-58 (noting that the termination fees, exclusive of expense reimbursement, often amount to 1 to 3% of the transaction value).

board decides to pursue an alternative transaction, but also where the board changes its recommendation to the shareholders regarding the merger without any third party on the horizon, where the board fails to do the necessary to effect the deal, where a firm's shareholders vote the transaction down (with or without an existing third party offer) and even where a third party simply appears and the merger partner decides to abandon the field to it.<sup>238</sup> In addition, generally in an ancillary agreement to the merger agreement each merger partner may give the other the right to purchase a significant portion of its shares at the current market price (the stock "lockup") or the right to purchase certain valuable assets at a favorable price (the "crown jewels" lockup).<sup>239</sup> The no-solicitation clause together with the break-up fees and lockup makes a competing transaction oftentimes prohibitively expensive, although not impossible.<sup>240</sup>

Delaware case law has reinforced this contractual

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238. See, e.g., Exxon/Mobil Prospectus, *supra* note 227, at I-60 (explaining that the termination fee is triggered if Mobil's board enters into an alternative transaction, if Mobil's board, among other things, withdraws its recommendation or if Mobil's shareholders vote down the transaction during the pendency of a third party offer and Mobil later does a transaction with such third party). Again, the amount of the termination fee and the expansiveness of the conditions triggering it depend upon the respective bargaining power of the parties.

239. See 1 BLOCK, *supra* note 22, at 909-34 (describing "lockup" stock and asset options and describing "lockup" stock options as those that simply give a merger partner a certain percentage (between 10% and 20%) of the other's share capital); see also Coates & Subramanian, *supra* note 6, at 6-10 (describing empirical evidence on use of lockups); see, e.g., Exxon/Mobil Prospectus, *supra* note 227, at B-1 to B-9 (establishing a stock option "lockup" of approximately 15% of Mobil stock).

240. Of course, the most well-known of the stock lockups was that invalidated in *Paramount Communications v. QVC*, where Paramount granted Viacom the option to purchase 19.9% of its stock at the market price (or, at Viacom's option, to pay Viacom the difference between such market price and the stock price when the option was exercised). See *Paramount Communications, Inc. v. QVC Network*, 637 A.2d 34, 39 (Del. 1994). The asset lockup is exemplified in *Revlon* where Forstmann demanded and received an option to purchase two Revlon divisions at a below market value price. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 (Del. 1985). One way that a stock lockup discourages alternative transactions is that it makes "pooling" accounting treatment difficult, if not impossible, for one condition to pooling is that there be no significant share issuance or repurchase at a time around the transaction. See ACCOUNTING PRINCIPLES BOARD, OPINION NO. 16, *supra* note 56; see also Coates & Subramanian, *supra* note 6, at 11 n.28.

structure to keep transactions "on track." Courts have generally upheld the validity of the no-solicitation clause as well as the termination fees and lockup penalties discouraging use of the "fiduciary out." Although the judicial treatment of termination fees and lockups is not identical,<sup>241</sup> courts have declared these provisions invalid when they interfere with a board's fulfillment of its fiduciary duties: that is, when a firm has entered into a *Revlon* mode and the board properly elects to use the fiduciary out, the penalty provisions cannot prevent the board's action.<sup>242</sup> Yet this jurisprudence is not necessarily relevant where a board has no fiduciary duty to entertain competing offers to the mega-merger: enhanced fiduciary duties do not arise, because no shift in control is occurring. If a third party surfaces, a court would review the contractual deal-protection provisions only under *Unocal*.<sup>243</sup> Guided by the Delaware Supreme Court's objection in *Paramount* to a stock lockup that would have imposed no "cap" on the benefit that a merger partner would receive from it and by the general *Unocal* prohibition on defensive measures that preclude shareholder choice among competing bidders, practicing lawyers limit the total benefit that any disgruntled merger partner can receive from both termination fees and stock lockups to a set percentage of the transaction.<sup>244</sup>

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241. See 1 BLOCK, *supra* note 22, at 908-1002 (summarizing the case law permutations on various defensive measures).

242. Again, the classic statement of this position is in *Paramount*, 637 A.2d at 48-51, where the Court found that the numerous defensive devices in the contract (no-shop, stock lockup and termination fee) impeded the *Paramount* board from exercising its fiduciary duties.

243. There may or may not be a theoretical problem with an absolute "no shop" clause without a "fiduciary out." See generally A. Gilchrist Sparks III, *Merger Agreements Under Delaware Law: When Can Directors Change Their Minds*, 51 U. MIAMI L. REV. 815 (1997). Yet it is customary in current merger practice for companies to insist on an out.

244. That is, a termination fee or benefits from a lockup could be so high as to preclude an alternative transaction and violate *Unocal's* proportionality prong as well as push against the outer bounds of the business judgment rule. In addition, the language of the court condemning the size of the stock lockup in *Paramount Communications v. QVC* was broad and could apply outside the *Revlon* context. See *Paramount Communications v. QVC*, 637 A.2d at 55. Accordingly, it is customary for the termination fee and stock lockup to be interrelated; in essence, the merger partner gets a set amount approximately in the amount of the termination fee or somewhat higher, and can take it either through the stock lockup or termination fee arrangement. See, e.g., Exxon/Mobil

Even more significantly, the Delaware Supreme Court rejected a predictable shareholder (as opposed to a third party bidder) challenge to these penalty provisions. The shareholder vote in a merger is a key justification for subjecting board merger decisions (in the absence of competing bidders) to the business judgment rule<sup>245</sup> as well as for that aspect of the *Unocal* analysis investigating whether a defensive tactic unduly interferes with the shareholder franchise.<sup>246</sup> In *Brazen v. Bell Atlantic Corp.*,<sup>247</sup> a Bell Atlantic shareholder, Brazen, opposing the stock-for-stock mega-merger between Bell Atlantic and Nynex argued that the termination fee in the merger agreement both impaired the Bell Atlantic board's exercise of its fiduciary duty and "coerced" Bell Atlantic shareholders into voting for the transaction, thus adversely affecting their franchise.<sup>248</sup> Brazen argued that, since the fees were so high, he was compelled not to vote against the transaction (which he opposed), because a shareholder rejection would damage Bell Atlantic by forcing it to pay the enormous breakup fees.<sup>249</sup>

The Delaware Supreme Court first agreed with Bell Atlantic that the fees should be characterized as liquidated damages<sup>250</sup> and that they satisfied the liquidated damages standard because they were reasonable in a situation where damages to the aggrieved party were uncertain.<sup>251</sup> The Court accepted the justifications for the breakup fees (i.e.,

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Prospectus, *supra* note 227, at B-8 (essentially capping Exxon's benefits from a break-up at \$2 billion, where the contractual termination fee is \$1.5 billion).

245. See COX, *supra* note 34, at 607.

246. See *Carmody*, 723 A.2d at 1195 (finding adequacy in claim that a "dead hand" poison pill affects shareholder franchise (and could be disproportionate under *Unocal*) by figuratively forcing shareholders to vote constantly for directors who instituted the pill).

247. 695 A.2d 43 (Del. 1997).

248. See *id.* at 46-47.

249. The fees potentially amounted to \$550 million (approximately 2% of Bell Atlantic's market value) and were payable in two tranches, depending upon whether Bell Atlantic entered into a transaction with a third party that triggered the merger's termination. See *id.* at 45-46 (describing the provisions of the merger agreement that required payment of \$200 million upon termination and \$350 million if a competing transaction were completed within eighteen months of termination of the agreement).

250. See *id.* at 48.

251. In a situation where the amount of loss is difficult to calculate and there is great uncertainty surrounding a transaction, courts give considerable deference to the rationality of a fee amount.

compensating the acquirer for its expenses and the opportunity costs of foregoing other transactions in a competitive acquisitions environment, the reasonableness of these fees in relationship to those in similar transactions).<sup>252</sup> It observed in passing that, if the fees had not been characterized as liquidated damages, it would have applied the even more deferential business judgment review.<sup>253</sup> The Court then summarily dismissed the coercion argument, observing that the fees were not “egregiously large” and that coercion did not arise, simply because shareholders knew that their rejection of the merger would trigger payment of the fee or because not every termination event gave rise to the fee (which, as Brazen argued, was additional evidence that the fees were intended to coerce shareholders).<sup>254</sup> Relying upon *Williams v. Geier*,<sup>255</sup> the Court observed that an action coercive of shareholders must be designed to obtain a shareholder approval of a transaction that is not based on the transaction’s merits. The Court appeared to conclude that the fees were not coercive from this perspective, because they were integral to the transaction (i.e., the deal would not occur without deal protection provisions), customary in merger agreements and thus not provisions specially designed to have coercive effect.<sup>256</sup>

The Delaware Chancery Courts are, however, beginning to object to some of the deal protection provisions that lock boards into stock-for-stock mega-mergers and that contribute to the momentum of these transactions. Yet the objections often arise from their concern that shareholders of one firm involved in a merger should have the possibility

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252. *See id.* at 48-49.

253. *See id.* at 49.

254. *Id.* at 50.

255. 671 A.2d 1368 (Del. 1996). *Williams* involved a situation where a company was recapitalized by its giving each shareholder a share with ten votes. However, if a shareholder sold the share, the share had only one vote until the new shareholder had held it for three years. *Id.*

256. *See Brazen v. Bell Atlantic Corp.*, 695 A.2d 43, 50 (“To the contrary, it appears that the reciprocal termination fee provisions, drafted to protect both Bell Atlantic and NYNEX in the event the merger was not consummated, were an integral part of the merits of the transaction. Thus, we agree with the finding of the Court of Chancery that, although the termination fee provision may have influenced the stockholder vote, there were ‘no structurally or situationally coercive factors’ that made an otherwise valid fee provision impermissibly coercive in this setting.”) (footnote omitted).



of electing to go with another bidder, rather than with the merger partner chosen by the board, and *not* from any uneasiness with the mega-mergers themselves. This is apparent in *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,<sup>257</sup> where Phelps Dodge (which desired to merge with Cyprus) sought a preliminary injunction to prevent Cyprus and Asarco from consummating their pending stock-for-stock mega-merger. It argued that several deal protection provisions were invalid: (i) a provision in the “no solicitation” section that prevented Cyprus from having discussions with a competing bidder (a “no talk”) and (ii) the amount of the termination fees (6.3% of the value of the target).<sup>258</sup> Chancellor Chandler rejected Cyprus and Asarco’s argument, based on *Time*, that each firm had no duty to talk to a competing bidder, because they were engaged in a strategic merger not involving a sale of either company. He reasoned that, while a board of a firm agreeing to a merger has no duty to negotiate with a third party bidder, it must make an *informed* decision not to negotiate. A “no talk” provision prevents the board from exercising its fiduciary duty of becoming informed: he called it the “legal equivalent of willful blindness.”<sup>259</sup> Despite his dissatisfaction with the “no-talk” clause and with the amount of the fee (“I think 6.3 percent certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond the breaking point.”), however, he declined to grant the temporary injunction because the shareholders of Cyprus/Asarco were about to vote on their merger and because Phelps had already adequately publicized its alternative to them.<sup>260</sup>

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257. 1999 Del. Ch. LEXIS 202, \*2 (Del. Ch. 1999).

258. *See id.* at \*4-\*5.

259. *See id.* at 4 (“No-talk provisions, thus, in my view, are troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party.”); *id.* (“Now, this should not be understood to suggest that Cyprus or Asarco were legally required to or even should have negotiated, privately or otherwise, with Phelps Dodge. It is to say, rather, that they simply should not have completely foreclosed the opportunity to do so, as this is the legal equivalent of willful blindness, a blindness that may constitute a breach of a board’s duty of care; that is, the duty to take care to be informed of all material information reasonably available.”).

260. *Id.* at \*6 (“I also need not rescue the shareholders from losing out on a premium bid, as they can simply vote down the Cyprus/Asarco transaction which is scheduled to be voted on this Thursday. When such self-help measures

In a more factually complex case that also involved a third party attempting to break up a strategic stock-for-stock merger, a different Chancery Court judge cast further doubt on the "no talk" clause common in a "no solicitation" covenant. In *ACE Ltd. v. Capital Re Corp.*,<sup>261</sup> Capital Re agreed to a merger with ACE and, in the merger agreement, to a standard "no solicitation" provision with a "fiduciary out" that, as was customary, required Capital Re's board to receive "written advice of its outside legal counsel" before exercising the "out." If the merger agreement were not terminated in accordance with its terms, ACE was essentially guaranteed a successful Capital Re shareholder vote: it already held 12.3% of Capital Re stock and had obtained shareholder agreements from other Capital Re shareholders holding 33.5% of the stock to vote to approve the merger, which agreements were terminable only if the merger agreement itself were properly terminated. When the value of ACE stock fell prior to the merger's closing and when another bidder emerged, offering more per Capital Re share than ACE's consideration, the Capital Re board exercised its fiduciary out, held discussions with the other bidder, XL Capital, and terminated the merger agreement. A bidding war between ACE and XL Capital ensued, with ACE finally asking the Chancery Court to enjoin Capital Re from terminating the merger agreement because the Capital Re board had failed to receive written advice from counsel before exercising the fiduciary out (as required by the "no solicitation" covenant). One of ACE's arguments was that no counsel would give this opinion unless Capital Re had entered an auction or *Revlon* mode (which arguably was not the case here).

From one perspective, the *ACE* court, in denying the preliminary injunction, was consistent with established Delaware law, particularly with *Revlon* and *Unocal*. Indeed,

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are clearly available and when the arsenals of both parties have been unleashed so as to fully and completely educate the shareholders of their choices, it is not for this Court to ride to their rescue."). The Court also suggested that Phelps could purchase the combined Cyprus/Asarco—a *Time* reasoning. Following the decision, the Cyprus/Asarco merger was terminated, and Phelps Dodge acquired Cyprus and Grupo Industrial Minera Mexico SA (a Mexican company) purchased Asarco. See Elisabeth Malkin, *A Copper King in Mexico*, BUS. WK., Nov. 8, 1999, at 124E10; Carlos Tejada & Nikhil Deogun, *Phelps Dodge to Acquire Cyprus Amax*, WALL ST. J., Oct. 1, 1999, at A3.

261. 747 A.2d 95 (Del. Ch. 1999).

Capital Re argued that granting ACE's requested relief would "chill an ongoing auction and potentially deprive Capital Re stockholders of the opportunity to take advantage of an offer significantly more valuable than the merger," contending that its board had entered a *Revlon* mode. Capital Re's desire to promote the auction required it to exercise the "out" for, without a proper termination of the merger agreement, it would be forced to merge with ACE, not necessarily the bidder providing the highest value to Capital Re's shareholders. The court, however, did not rest its decision simply upon Capital Re's *Revlon* argument. Rather, it suggested that any clause in a merger agreement that would lock the shareholders into the transaction or, put another way, would prevent the Capital Re board from terminating the transaction so as to give shareholders the choice to accept or reject the deal was an act improperly preclusive of shareholder choice under *Unocal*.<sup>262</sup>

From a broader perspective, Chancellor Strine echoed a disapproval of certain aspects of deal protection clauses that Chancellor Chandler had expressed in *Phelps Dodge* and that was not necessarily limited to either a *Revlon* situation or one suggesting *Unocal* preclusiveness.<sup>263</sup> Indeed, drawing inspiration from a recent law review

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262. See *id.* at 106 ("It is quite another thing for a board of directors to enter into a merger agreement that precludes the board from considering any other offers unless a lawyer is willing to sign an opinion indicating that his client board is 'required' to consider that offer in the less than precise corporate law context of a merger agreement that does not implicate *Revlon* but may preclude other transactions in manner that raises eyebrows under *Unocal*." (footnotes omitted)); *id.* at 107 ("More fundamentally, one would think that there would be limited circumstances in which a board could prudently place itself in the position of not being able to entertain and consider a superior proposal to a transaction dependent on a stockholder vote. The circumstances in this case would not seem to be of that nature, because the board's inability to consider another offer in effect precludes the stockholders (including the 33.5% holders) from accepting another offer."); *id.* at 108 ("Absent an escape clause, the Merger Agreement guarantees the success of the merger vote and precludes any other alternative, no matter how much more lucrative to the Capital Re stockholders and no matter whether the Capital Re board itself prefers the other alternative. As a practical matter, it might therefore be possible to construct a *plausible* argument that a no-escape Merger Agreement that locks up the necessary votes constitutes an unreasonable preclusive and coercive defensive obstacle within the meaning of *Unocal*." (footnotes omitted).

263. Indeed, Chancellor Strine cited with approval Chancellor Chandler's opinion in *Phelps Dodge*. See *Phelps Dodge*, 1999 Del. Ch. Lexis 202, at \*31 n.46.

article offering courts guidance on when to invalidate contracts (albeit an article focusing on a *Revlon* situation)<sup>264</sup> he suggested that, while a board can contractually agree not to solicit other bidders (“It is one thing for a board of directors to agree not to play footsie with other potential bidders or to stir up an auction. That type of restriction is perfectly understandable, if not necessary, if good faith business transactions are to be encouraged.”), it cannot make the exercise of its fiduciary duties dependent upon a third party’s (here a lawyer’s) approval.<sup>265</sup> The Chancellor observed that a “fiduciary out” dependent for its application by the board upon a non-board member’s opinion amounted to the board’s abdication of its responsibilities.<sup>266</sup> Even more broadly, he stated that a board would violate its duty of care by not leaving itself with a broad “out” in a merger agreement to consider more favorable offers.<sup>267</sup>

It is open to question whether, and to what extent, these cases announce a new line of Delaware jurisprudence regarding deal protection provisions.<sup>268</sup> The language of *Phelps Dodge* and *ACE* disapproving the provisions was broad, but the result in the first was consistent with *Time* and in the second with *Revlon* and *Unocal*, and both involved a competitive bidding situation. Several days following *ACE*, moreover, Chancellor Steele observed in

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264. See generally Paul R. Regan, *Great Expectations? A Contract Law Analysis For Preclusive Corporate Lock-Ups*, 21 CARDOZO L. REV. 1 (1999).

265. *Ace Ltd.*, 747 A.2d at 106 (“But in another sense, the provision is much more pernicious in that it involves an abdication by the board of its duty to determine what its own fiduciary obligations require at precisely that time in the life of the company in which the board’s own judgment is most important.”).

266. See *id.* at 107 n.37 (citing *Quickturn Graphics Design System v. Shapiro*, 721 A.2d 1281 (Del. Ch. 1998)).

267. See *id.* at 31 (“In this context where the board is making a critical decision affecting stockholder ownership and voting rights, it is especially important that it negotiate with care and retain sufficient flexibility to ensure that the stockholders are not unfairly coerced into accepting a less than optimal exchange for their shares.”); see also *id.* at 33-34 (“These fiduciary responsibilities are of special importance in situations where a board is entering into a transaction as significant as a merger affecting stockholder ownership rights. For that (sometimes unspoken) reason, our law has subordinated the contract rights of third party suitors to stockholders’ interests in not being improperly subjected to a fundamental corporate transaction as a result of a fiduciary breach by the board.”) (footnote omitted).

268. See, e.g., Stephen A. Radin, *Talking About Talk: No Talk And Fiduciary Out Provisions in Delaware After Phelps Dodge, Capital Re And IXC*, 11 BUS. & SEC. LIT. 1 (2000).

another case that “no talk” provisions “are common in merger agreements and do not imply some automatic breach of fiduciary duty,” although his decision is arguably consistent with *ACE* and *Phelps Dodge* on its facts.<sup>269</sup> At the very least, the cases indicate judicial uneasiness with, and the likelihood of more judicial scrutiny of, the provisions, albeit in a context where the provisions might prevent shareholders of a merger partner from considering other offers.

Although experienced M&A lawyers and investment bankers do not decide upon the mega-mergers, they are repeat players who often have much more familiarity with this kind of transaction than do the boards of the merger partners and who, on account of their experience and reputation, guide the boards as to market practice in the deal.<sup>270</sup> This practice and contract drafting, which are based upon the case law on hostile and consensual mergers, have added to the momentum of the mega-mergers by “locking in” boards, who are already inclined to follow the lead of a “visionary” CEO, to these transactions. Merger partners

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269. See *In re IXC Communications, Inc. Shareholder Litigation*, 1999 Del. Ch. LEXIS 210, at \*14 (Del. Ch. 1999). In this case, shareholders of IXC challenged its consensual merger with CBI (with no third party bidder on the horizon) on the grounds that the board of IXC had violated its fiduciary duties by agreeing to the merger. With respect to the “no talk” provision, Chancellor Steele observed that, while IXC did not conduct an auction, it clearly spoke with numerous potential merger partners before going with CBI, and, further, that it adopted the “no talk” provision late in the process and in fact retracted the provision (a retraction that generated no other offers).

270. The foremost example of this legal influence in the M&A area is the law firm, Wachtell, Lipton, Rosen & Katz, which specializes in this practice, and Martin Lipton, perhaps the most preeminent M&A lawyer and one of the champions of the strategic merger. Not only do Lipton and his colleagues regularly explain the structure and drafting devices of strategic mergers, see LIPTON, *supra* note 49, but he regularly provides to his clients his views on current M&A activity and developments. See, e.g., Letter of M. Lipton to author (May 17, 1999) (on file with the Buffalo Law Review) (explaining that the following “merger technology” helps boards to accomplish a strategic merger without a third party breaking it up: “(1) speed and secrecy in the negotiation stage, (2) avoiding leaks, (3) a well structured [sic] announcement and rollout designed to have the analysts and investors recognize the advantages of the merger, (4) structuring the exchange ratio to avoid or minimize arbitrage pressure, (5) a merger agreement that prevents an interloper from pooling and makes it difficult for an interloper to compete without paying a significantly higher price, (6) compensation, incentive and severance arrangements that deter an interloper and (7) a structure that gives consummation of the original deal a significant time advantage over an interloper”).

can, and do, legally walk away from mega-mergers, sometimes even without triggering any contractual penalties,<sup>271</sup> but this seldom occurs.<sup>272</sup> Although Delaware Chancery Courts are beginning to express some concern about the effects of the deal protection provisions on the exercise of fiduciary duties by board members, their focus has been not on ensuring that a board has the freedom to resist the momentum of a merger decision itself and even to rethink it, as it is to allow the board and the shareholders to consider (or to generate) other merger bids. Accordingly, the law through both its jurisprudence and practice adds further impetus to the mega-mergers.

#### V. HOW CAN THE MOMENTUM OF MEGA-MERGERS BE RESISTED?

It is tempting to conclude that nothing short of a financial or political cataclysm can slow down the momentum of mega-mergers. Powerful circumstances overdetermine these transactions: massive, and at times frenzied, restructuring triggered by a revolution in information technology, the ever-present management agency problems in large public corporations, behavioral problems afflicting in varying degrees executives, board members and investors that encourage them to enter into or to review these transactions with excessive optimism and confidence, a media and political climate that has not placed much critical attention on the transactions, and a corporate law jurisprudence and practice that have promoted and reinforced them. With all of these forces arrayed in support of the mega-merger and with many individuals benefitting from them, it is not realistic to think that one action or reform could address all the problems associated with them. Yet it is important to emphasize that the goal here is not to eliminate the strategic stock-for-stock mega-mergers, some of which are without doubt economically necessary and value enhancing, but simply to

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271. Every merger agreement includes a provision for a mutual termination, which does not trigger any penalties. *See, e.g.,* Exxon/Mobil Prospectus, *supra* note 227, at A-33.

272. Companies are concerned about wasted expenses and efforts and the adverse publicity that comes from a reconsidered decision. *See* Burton & Tanouye, *supra* note 82, at B1 (describing the fallout from the mutual termination of the Monsanto/American Home Products merger).

counteract the powerful momentum in favor of these generally value-destroying transactions by introducing more rationality into the decision-making process of boards of merging firms.

In this Part, I first propose, and argue for, a reform of the corporate law governing board decision-making in the transactions. Law reform is necessary because, as shown in Part IV, existing law inadequately addresses the problems arising from, and has actually added to, the momentum of the mega-mergers. Moreover, this reform is required because it is a useful way of introducing rationality into a process distorted by behavioral problems. I thus propose that courts adopt a new standard for defining the fiduciary duties of board members of companies engaging in a mega-merger and offer jurisprudential support for this standard. I then contend that the legal reform has a better chance of succeeding if it is combined with the following reforms, both non-legal and legal. Shareholder activists need to add the problem with mega-mergers to their list of corporate actions demanding more board oversight. Accounting standard setters should continue with their plans to eliminate an accounting treatment that favors the stock-for-stock merger. And the SEC should enhance its current review of disclosure on board decision-making that is represented in the companies' proxies seeking shareholder approval for the mega-mergers.

#### *A. Reform of the Law Governing Board Decision-Making in a Mega-Merger*

I first propose to enhance the standard governing the duty of board members in a mega-merger, whether they are on the board of the company that is the ostensible acquirer or target of the transaction. I define mega-merger to mean any merger between two publicly-traded companies where the size of one merger partner is at least 30%, in terms of market capitalization, of the other and where the transaction is conducted primarily as a stock-for-stock exchange. The proposed standard is the following: when deciding whether to participate in a mega-merger, a board would have the burden of establishing that it has reasonable grounds, supported by particular findings, for believing that (1) the transaction maximizes shareholder value and (2) is the best alternative among those currently

available to the company, particularly the alternative of *not* engaging in the mega-merger and remaining independent. A board would also improve its chances of satisfying this standard if a majority of its independent directors approved the transaction.

The standard should apply only to the kind of transactions between publicly-traded firms that, according to the economic evidence, are the most damaging to each of the merging companies: those involving "bet the company" combinations with a firm of comparable size done primarily as stock-for-stock exchanges. As a way of defining comparable size (and of limiting application of the proposed standard), the standard considers a mega-merger to exist where one public firm (whether the acquirer or target) has 30% of the market capitalization of the other.<sup>273</sup> The reasoning here is that, if one merger partner is considerably smaller than the other, the transaction will more likely be a "sale" than a "partnership" and will have less chance of resulting in the kind of value losses associated with a mega-merger.<sup>274</sup> In a true sale, for example, an acquirer may increase the likelihood of realizing synergies simply because it dominates from the outset the combined firm and a target board has little choice but to negotiate for the highest value for its shareholders.<sup>275</sup> The standard would also be applied

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273. A higher figure could be used. See Coates & Subramanian, *supra* note 6, at 12 n.37 (focusing on a higher figure for mergers of equals), but the 30% figure is nothing more than an approximation of comparable size and would constitute a presumptive mega-merger. A party challenging a merger with a lesser figure (say 25%) would have the burden of showing that the merger in question effects a major change of the firm's business. As formulated, the standard makes no reference to size of the companies involved in a merger, other than to limit its application to public companies. Although the Article has focused on mega-mergers involving enormous companies, the problems discussed above could apply to any merger transforming the nature of the two companies. The public company limitation would establish a baseline size limitation on companies affected by the new standard, and, I suspect, the standard will *in practice* be applied generally in mega-transactions, which stir up shareholder opposition and pose the most potential for value loss.

274. This is not to say that a merger between a large and small company (relative to each other) cannot lead to significant value losses for the same reasons discussed earlier. It is simply that the problems producing these losses (generally, the non-realization of synergies) are exacerbated in the mega-merger context.

275. That is, the "target" board recognizes that, with a dominant acquirer, it is selling the firm; no argument about a strategic combination makes much sense. It thus has a legal obligation under *Revlon* to negotiate for the highest



only to stock-for-stock mergers, or those that primarily involve a stock exchange,<sup>276</sup> because the behavior-distorting momentum is most present in these transactions. Cash transactions are more indicative of a "sale" and, in them, both boards focus more closely on shareholder value than in a stock transaction.<sup>277</sup>

The first prong is intended to make the board of each firm specifically articulate how the proposed transaction increases shareholder value. The *Unocal* standard has clearly inspired this prong: under *Unocal*, a board needs to specify the threat a hostile offer poses to corporate policy;<sup>278</sup> here the board must articulate how the merger generates value. Yet the standard here emphasizes even more than *Unocal* the particular basis for the board's decision because of the overwhelming pressure, both within and outside a firm, on a board to accede to a mega-merger. The emphasis on specificity and particularity is to discourage the board from adopting wholesale the generalized conclusions about "synergies" offered by management and the investment bankers selected by management.<sup>279</sup> The prong does not mean that the board need engage in independent fact-finding and cannot rely upon information concerning and justifications for the merger presented by management and others.<sup>280</sup> Rather, the standard seeks to encourage the board

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premium. Similarly, because of the target's insistence on this premium, the acquirer board will likely take a more critical view of the transaction.

276. This formulation is necessary so that parties do not try to avoid the transaction by introducing some cash or non-equity securities into the merger consideration in order to avoid the application of the new standard. Parties can do this without losing all the tax advantages of a stock-for-stock merger.

277. See, e.g., Loughran & Vjih, *supra* note 20, at 1767. Again, the target board agreeing to a cash merger could hardly make the argument that its shareholders will continue to participate in the combination (they are being cashed out!).

278. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

279. Indeed, emphasis on the creation of shareholder value through a merger is necessary because boards often fail to focus on this paramount issue in approving mergers. See KPMG, UNLOCKING SHAREHOLDER VALUE, *supra* note 95, at 8 (observing that in its survey only 20% of the respondents cited "maximizing shareholder value" as the purpose of the transaction).

280. To suggest otherwise would upset the well-established roles of directors and executives under corporate law, under which directors may rely upon information presented by management and others. See DEL. CODE ANN. tit. 8, § 141 (1974). The reliance, however, must be reasonable and, if circumstances so demand (as in the case of a mega-merger), board members may well have a duty to conduct some independent information gathering, or—what is more likely—

to demand from management, and to test critically for *reliability*, concrete data and indicia of value production resulting from the mega-merger. For example, when deciding upon a merger, a board should require management to present specific forecasts of synergies, whether in cost savings or expansion in economies of scope or scale, and should then demand that all assumptions underlying the forecast synergies be exposed and critically tested for reasonableness and reliability.<sup>281</sup> Similarly, the board should question whether management and its assistants have adequately and reasonably identified to the best of their abilities all risks arising from the transaction, particularly risks associated with harmonizing management and with not achieving the pre-merger goals of each company. A court would likely find that a board had satisfied this standard if there were repeated meetings in which the board debated the merits of the merger and that, as a result of meetings, management needed to return to the board with revised presentations and new information or projections demanded by the board.

A particularly salient example of the kind of particularized findings that the board of each company in a mega-merger should make involves the merger consideration, which is fraught with risks for both parties. It is common in a "merger of equals" to structure the transaction as one in which one firm (the ostensible acquirer) gives the other (the target) a fixed ratio of its

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to direct managers to produce information for them. Admittedly, this standard suggests that Delaware courts should be harder on directors in interpreting their reliance upon management and management's experts than is currently the trend in Delaware case law. *See, e.g., Brehm v. Eisner*, 746 A.2d 244, 249 (Del. 2000) (while disallowing challenge to reliance of Disney board on management expert regarding executive compensation, suggesting that "the processes of the boards of directors in dealing with [compensation arrangement] were casual, if not sloppy and perfunctory").

281. Under this standard, the board members must base their decisions only on specifics of value creation that have been tested by critical questioning about their methodology. This testing recognizes that management proponents of the merger are only too ready to put forward numbers, which, given the rapidity of their preparation and their origin, need to be scrutinized. *See Eccles et al., supra* note 88, at 143 ("Most calculations of synergy value occur under horrendous conditions: time pressure is intense, information is limited, and confidentiality must be maintained. Since conditions are so far from ideal, the managers and board members responsible for the final decision should always scrutinize the assumptions underlying the numbers.").

shares in exchange for a share of the target.<sup>282</sup> A basic justification for this consideration structure is that, since the transaction is a partnership, both parties should share in its upside and downside and take the percentage of shares in the combined firm reflecting their respective pre-ownership value, as well as their likely contribution to post-merger synergies. But, under finance theory, the acquirer would rationally use stock as merger consideration only when its management believes that its shares are overvalued or when it has doubts about achieving the synergies of the future partnership.<sup>283</sup> Giving shares (instead of cash) to target shareholders can actually capture for the acquirer's shareholders some of the target value (i.e., target value is transferred for overinflated acquirer stock) and/or shift to target shareholders a disproportionate share of the risk that merger synergies will not be achieved. If, however, an acquirer's management and board, swept up in the momentum of the transaction, do not act rationally despite their belief that its shares are *undervalued*, they may give the target's shareholders some of the acquirer's shareholders' value, as well as a disproportionate amount of the value to be created from the synergies, in order to accomplish the transaction.

The board of the target, by contrast, must similarly evaluate the transaction, although the benefits and harms received by its shareholders are the opposite of those of the acquirer's shareholders.<sup>284</sup> This board, moreover, might well consider negotiating for the various kinds of contractual mechanisms that can protect its shareholders in the pre-closing period, which might be particularly useful if it fears that the acquirer's shares are overvalued or that market doubts may surface about the expected merger synergies. For example, it may negotiate that its shareholders receive a minimum fixed value of consideration if the price of acquirer's stock drops below a certain threshold.<sup>285</sup> Here,

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282. See ESCHERICH, *supra* note 9, at 15.

283. See Rappaport & Sirower, *supra* note 8, at 154.

284. See *id.* at 156.

285. In merger parlance, this is the "collar" mechanism, which guarantees a value for the target's shareholders. In cases where a collar is used, the acquirer often insists on its own protections: if its stock price rises too much, it can "cap" the value that the target shareholders receive in the exchange so that they do not receive a disproportionate amount of the perceived merger synergies. See *id.* at 154-55. Similarly, an acquirer may agree to provide enough of its shares to

however, the danger exists that target's management and board (influenced by their own role in the future combined enterprise) may accept, or help design, the deal's synergy story and agree that their shareholders receive an amount of acquirer stock that does not adequately compensate the shareholders for the risks of the transaction and target's contribution to the merger synergies.

Obviously, both acquirer and target boards, with the help of investment bankers, review these considerations now.<sup>286</sup> Yet the proliferation of fixed exchange transactions, as opposed to other consideration structures, and the infrequency of contractual provisions designed to address pre-closing risks, such as exchange ratio "collars,"<sup>287</sup> in mega-mergers suggest that the board analysis of these risks and justification of the agreed-upon consideration are

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guarantee a fixed value, but only if it does not have to issue too many shares (i.e., the buyer allows itself to "walk away" from the transaction if its share price declines so precipitously that it must issue so many shares to guarantee the fixed value). See ESCHERICH, *supra* note 9, at 18. In the mega-mergers, these collar mechanisms are rare when firms are of relatively equal size because the argument prevails that they should share equally in the risk. See *id.* at 17.

Another alternative for the target is to negotiate from the outset that its shareholders take acquirer shares, at whatever amount is necessary at closing to guarantee a fixed value. See Rappaport & Sirower, *supra* note 12, at 152. The approach is akin to a cash deal in the pre-closing period (where target shareholders are guaranteed their value), but not in the post-closing period (where their value depends upon the fortunes of the firm). Yet this structure is uncommon in the mega-mergers and is used more often when a target firm is clearly selling itself to the acquirer. See ESCHERICH, *supra* note 9, at 15.

286. The merger consideration structure is always discussed in the merger proxy statements, but generally not in a way in which the selected structure is justified over others. See, e.g., Exxon-Mobil Prospectus, *supra* note 227, at I-24 (discussing factors considered by Mobil board, one of which relates to merger consideration: "(4) the value of the exchange ratio provided for in the merger agreement relative to the then-current market prices and historical trading prices of Mobil and Exxon shares over the past year and relative to the stock price premiums paid in mergers of comparable size as discussed in Goldman Sachs' selected transaction analysis, that the premium offered in the merger was within the range of premiums paid in comparable transactions, and that Mobil's shareholders would hold approximately 30% of the outstanding stock of the combined company after the merger.").

287. For example, a collar mechanism in a fixed exchange transaction would provide that, if the value of acquirer's shares fell below some agreed-upon threshold, target shareholders would receive a "fixed value" amount or "floor," i.e., a number of acquirer shares equal to a dollar figure (it could also "cap" the value an acquirer gives to the target if the acquirer's share price rises too high after announcement of the transaction and before closing). See ESCHERICH, *supra* note 9, at 16.

inadequate. Under the proposed standard, the board of each company would have the burden of showing with particularized findings that the structure of merger consideration, together with its reliance on management on this issue, was justified in relation to other consideration structures.

This first prong represents a significant, although not revolutionary, change to current law.<sup>288</sup> Under the application of the duty of care (and business judgment review by the courts) in the acquisition context, boards should base their merger decision upon a showing that the merger increases shareholder value. This is, after all, the teaching of *Smith v. Van Gorkom*, where the Delaware Supreme Court concluded that the board of Trans Union (the merger target) violated its duty of care because its members "were uninformed as to the intrinsic value of the Company."<sup>289</sup> As a result of this decision, it is now standard for both firms in a mega-merger to obtain fairness opinions from their respective investment banker about the fairness of the transaction to their shareholders and about its potential for value creation.<sup>290</sup> Yet this jurisprudential emphasis on a showing of value creation from the transaction generally applies to the target firm, not the acquirer, in the merger and loses considerable force in the "merger of equals" typical of mega-mergers where no sale

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288. As noted earlier, Professor Sirower would prefer that board members demand from management a realistic showing that present value of the merger benefits exceed its costs, *i.e.*, that the transaction makes sense in net present value terms. See Rappaport & Sirower, *supra* note 8, at 152. Despite the arguments of many legal scholars, courts are unwilling to believe (and usually reject out of hand) that a board's decision can be reduced to a mathematical calculation. See, *e.g.*, *Paskill Corp. v. Alcoma Corp.*, 1999 Del. Ch. LEXIS 129 (Del. Ch. 1999) (reaffirming that, in an appraisal proceeding, that there is no set method of determining fair value of a corporation). Accordingly, it makes more sense in corporate law jurisprudence to encourage a board to focus on value creation, rather than to require the adoption of a set procedure, no matter how much the latter is favored by financial economists.

289. *Smith v. Van Gorkum*, 488 A.2d 858, 874 (Del. 1985).

290. See, *e.g.*, *Exxon/Mobil Prospectus*, *supra* note 227, at I-39 to I-49. Under the federal securities laws, merger parties must not only describe these opinions, but also specify the reasons for the transaction (and not use "boilerplate" reasons), which adds an incentive for boards to conclude that value arises from the transaction. See SEC Form S-4, item 4, available at <http://www.sec.gov/smbus/forms/s-4.htm>; see also *id.*, item 3 (cross-referencing to 17 C.F.R. § 229.503 (1999), which requires presentation of a summary in "plain English").

occurs. Given the prevalence of these transactions, more emphasis on the particularity of the board's own findings on this issue, even if based only on a critical assessment of information provided by management and investment bankers, is needed to strengthen the board's ability to resist the momentum of the transaction by examining critically all justifications for it.

The second prong would compel the board to justify the mega-merger against competing strategic alternatives, particularly the alternative of remaining independent. Under this prong, the board should articulate why the transaction is necessary at this time and has the best chances of success out of these available alternatives.<sup>291</sup> The point here is not to make the absurd suggestion that boards of firms engaging in mega-mergers do not give these issues consideration in their merger decisions, even though a board may not always have several transactions to select from.<sup>292</sup> Rather, the prong is designed to give more weight to the *status quo* of *not* engaging in the mega-merger precisely at the moment when management is encouraging the board to abandon these circumstances. Once, that is, the CEO has proposed a transaction and agreed upon it with his counterpart in the other firm, the momentum for the transaction begins to build and the new vision of the combined firm takes hold among the two firms' decision-makers.<sup>293</sup> In essence, the concept of the *status quo* begins to

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291. This aspect of the proposed standard echoes recommendations of business practitioners attempting to identify the ingredients of merger success. See Viscio, *supra* note 95, at 22 ("Given the risky and challenging nature of mergers, the burden of proof should be on demonstrating how a potential merger is the best strategic option facing the company. There must be a good answer to the question, 'Why do we have to merge to achieve our strategic vision?'").

292. Boards routinely give as a reason for a merger that it was the best alternative in the circumstances. See, e.g., Exxon/Mobil Prospectus, *supra* note 227, at I-22, at I-24. One wonders, however, how much a factor is remaining independent for the firm that is the acquirer in the strategic merger. In any event, when a firm is the target of several bids, *Unocal* comes into play and would take precedence over the proposed standard.

293. As discussed above, for psychological and legal reasons, once the board has agreed upon the transaction and there has been a public announcement of it, the momentum turns into an avalanche or (in psychological parlance) a cascade. See SUNSTEIN, GROUP POLARIZATION, *supra* note 134, at 7-9; see also DAVID SCHKADE ET AL., ARE JURIES LESS ERRATIC THAN INDIVIDUALS? DELIBERATION, POLARIZATION, AND PUNITIVE DAMAGES 25-32 (Univ. of Chicago John M. Olin Law & Economics Working Paper No. 81) (2d Series, Sept. 1999)

change. Yet it is precisely at this moment, before the merger agreement has been signed, before the deal protection mechanisms come into play and before the force of the transaction becomes almost inexorable, that the board must assume a highly critical view of the merger, until managers can in effect rebut the presumption that the merger will destroy value.<sup>294</sup> The prong would impose upon board members the legal position of being presumptive opponents to or critics of the transaction.

It is important to emphasize the potential importance of the board activity to be stimulated by this prong in the dynamics of the merger decision-making. As discussed earlier, the momentum for the mega-merger is powerful, originating first from inside (and later from outside) each firm. The "cascade" of support for the transaction, primarily caused by managers' advocacy for it, pushes the board to vote to recommend the deal and to put it to a shareholder vote.<sup>295</sup> If their fiduciary duty obligates board members to take an opposition stance toward the transaction, this critical position would not always stop, nor is it meant in every circumstance to derail, the mega-merger. It could, however, at least introduce a friction within the board that could support those board members who might be skeptical about the transaction but who, for varying reasons, might not otherwise resist it vigorously, or that would itself generate board resistance. Even if the legally-encouraged board opposition did not stop some transactions in their tracks, it should make them harder for managers to negotiate, which would help ensure that most risks in the transaction are identified and rationally addressed.<sup>296</sup>

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(discussing phenomenon of "group polarization").

294. This legal approach seeks to create the kind of critical, opposition stance that, in the view of merger specialists, could help reduce the number of value-destroying mergers. Eccles, *supra* note 88, at 144-45 ("Poke holes in the arguments and see if they still hold up. What could go wrong? What if the assumptions about the direction of technology and prices are wrong? What regulatory changes could make the deal fail, and how likely are they to occur? How could competitors react to the deal in ways that could hurt you—even if they hurt themselves as well? Make sure that the group reviewing acquisition candidates includes strong skeptics with persuasive voices.").

295. *See supra* note 293.

296. *See* SUNSTEIN, GROUP POLARIZATION, *supra* note 134, at 27-28 (suggesting that heterogenous groups are better for decision-making because of the ability of strong opposing views to offset the tendency of a group to proceed to an extreme position).

A board's burden to show that its decision-making satisfied each prong of the proposed standard would be furthered by a showing that a majority of independent directors had made the decision. The ability of independent directors—who are now a part of U.S. corporate governance—to increase shareholder value, or at least to minimize losses of shareholder value, primarily by resisting and monitoring management is a subject of continuing theoretical and empirical debate.<sup>297</sup> It would appear, nevertheless, that the views of these directors, not themselves members of management nor those with ties to the firm apart from their director positions, and thus not immediately and “internally” predisposed to favor a proposed mega-merger, regarding the satisfaction of the proposed standard should be entitled to more court deference than those of an insider board. This approach of granting more authority to decisions made by an independent board, moreover, is well-accepted in Delaware corporate law, as the *Unocal* standard demonstrates.<sup>298</sup>

The limited enhancement of board fiduciary duties in a mega-merger arising from the proposed standard can draw upon well-accepted doctrinal support of past decisions of the Delaware Supreme Court. This Court has typically increased the standard of director behavior beyond the duty of care whenever it believes that in a particular situation self-interested director behavior could adversely affect decision-making. Indeed, this was a primary justification for adoption of the *Unocal* standard.<sup>299</sup> Similarly in a mega-merger, board members might well accede to a CEO's promotion of the transaction partly because it would guarantee their continued involvement in the combined company. For example, in *Paramount Communications v. Time*, Time and Warner proposed to combine their boards,<sup>300</sup>

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297. Again, the literature on this issue is voluminous. See, e.g., Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921 (1999) (discussing both theoretical and empirical literature on the value of independent directors for firm performance).

298. See *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1375 (Del. 1995).

299. Because the board of a company facing a hostile offer might be worried about maintaining its position, the potential “self-interest” allowed the Court to move to the intermediate level of review characteristic of *Unocal*. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

300. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1146 (Del. 1989).



and this strategy, which is common in recent mega-mergers, is justified on the grounds that a true merger of equals demands a unification of boards, as well as shareholders.<sup>301</sup> Under the same reasoning and despite value losses from the transactions, it would strain corporate law jurisprudence to impose on directors' mega-merger decisions the burden of the exacting "fairness" standard, where courts review both the procedural and substantive fairness of the transaction.<sup>302</sup> That standard of review has been applied exclusively in transactions (including mergers) where there is an allegation of a strong conflict of interest by board members or a controlling shareholder.<sup>303</sup> Because a target board's concern with maintaining its directorships did not justify application of the fairness standard in *Unocal*, it could hardly do so in the mega-merger.

The proposed standard can also look for support to *Revlon*, even if full application of that doctrine to either firm involved in a mega-merger would involve too much of a "leap" under the doctrine as currently formulated.<sup>304</sup> In the *Revlon* line of cases, the Delaware Supreme Court has emphasized how the enhanced standard of board conduct and court review arises from the shareholders' dependence upon the board in "sale of control" transactions. When shareholders are receiving their final chance at a control premium (because a change in control is occurring), the expertise and involvement of the board as negotiators for the shareholders are critical to ensure that they realize the maximum premium available for their shares.<sup>305</sup> A similar, although somewhat reverse, reasoning applies in a mega-merger. Because these transactions are fraught with dangers of catastrophic loss of value and are the product of a momentum afflicting the shareholders themselves, board scrutiny of, and resistance to, the merger are necessary to prevent, or at least to limit, a potential disaster to the

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301. See, e.g., HERLIHY, *supra* note 7, at 113-14.

302. See generally COX, *supra* note 34, at 608-10. The "classic" statement of this standard in the Delaware law context is *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. Ch. 1985).

303. See generally 1 BLOCK, *supra* note 22, at 377-400.

304. That jurisprudence of simply maximizing shareholder value has been applied exclusively to changes in control and in the nature of the corporate enterprise (i.e., a "break-up"). See *supra* notes 211-12 & accompanying text.

305. See *Paramount Communications, Inc. v. QVC Network*, 637 A.2d 34, 42-44 (Del. 1994).

shareholders. Just as in *Revlon* an active board maximizes shareholders' value through the auction, it would do much the same here by ensuring that shareholders do not massively lose value from the transaction.

Moreover, the proposed standard would impose enhanced duties upon board members *until the merger is closed* and in this approach is consistent with the recent Chancery Court decisions, discussed above, where courts have criticized deal-protection contractual provisions and have emphasized the importance of the continuous exercise of fiduciary duties by board members until consummation of the merger. The standard would admittedly extend those decisions out of their potentially narrow application to a situation of competitive bidding for one firm or market check on a firm's value. That is, there is an implicit judicial recognition in these cases that the case law and contractual provisions based on *Time* have limited the exercise of fiduciary duties by board members in mega-mergers once the boards have signed a merger agreement. The proposed standard would rely upon this recognition, but would not limit it to the requirement that board members (particularly of a firm that has agreed to a merger but that becomes the object of a third party offer) conduct discussions with (or even seek) other potential merger partners than the chosen one. This reading of the cases simply sanctions the mega-mergers (albeit with different merger partners).<sup>306</sup> Rather, the standard would argue that the fiduciary duty necessary in this situation is the ability and willingness not to enter into the mega-merger *or* to pull out of it without another bidder on the horizon. Application of the standard, then, might well result in contractual deal protection provisions pursuant to which there would be a large "break-up" fee if a merger partner proceeds with an alternative deal, but a lesser one if the partner pulls out of the deal itself without pursuing (and agreeing not to pursue for some specified time period) another transaction.<sup>307</sup>

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306. Another possibility is simply to apply *Revlon* in all cases whenever a merger is proposed—i.e., to maximize shareholder value at all costs. This might work for a true "target" firm, where the board would be under the *Revlon* duty in any case, but application of this standard would detract from the board's ability not simply to have to satisfy short-term shareholders and would even promote mega-mergers.

307. Current merger agreements allow a termination of the merger agreement prior to closing, but generally only when something materially

From a jurisprudential perspective, furthermore, the application of the new intermediate standard to board behavior in the mega-merger brings *Unocal* up to date. The hostile tender offer, often in leveraged buyout form, was the innovative transaction of the 1980s, and the development of the *Unocal* case law was necessary to spur directors not to approve passively managers' resistance to hostile offers that might prevent shareholders from benefitting from a value-enhancing transaction. While tender offers still occur, *Unocal* and its continuing jurisprudence are more than adequate to deal with innovative management defenses.<sup>308</sup> Indeed, it is fair to say that application of *Unocal*, together with other pressures, changed board behavior so that it is now part of the culture of boards not to acquiesce to management in the takeover context or even in an underperforming firm that is not the object of a bid.<sup>309</sup> The greatest threat to loss of shareholder value from boards now, however, is not board passivity in takeovers but in management mega-merger proposals. But there is no adequate legal standard available to respond to this threat, and the proposed standard would enable the courts to fill this void by forcing boards to assess critically managers' proposals regarding the relevant "problem" transaction of today.

It could be objected that the proposed standard, dealing with shareholder value and strategic alternatives in a complex business and financial setting, would invite inappropriate court second-guessing of decisions in which judges have no competence. Yet courts are certainly competent to handle the first prong regarding the findings

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adverse has happened to the merger partner (or if parties agree or if a condition to the merger, such as antitrust approval, has not been met). See, e.g., Joshua Jaffe, *Jilted Deal Partners Can Face Ruin*, DAILY DEAL, at [www.thedailydeal.com/topstories/A20605-2000Apr5.html](http://www.thedailydeal.com/topstories/A20605-2000Apr5.html) (Apr. 5, 2000) (discussing the importance of "material adverse change" out for mergers). Moreover, some break-up fees now have this proposed kind of structure (e.g., payment of part or none of break-up fee if no merger with a third party occurs for a set period following termination of the merger agreement). See, e.g., Exxon/Mobil Prospectus, *supra* note 227, at A-36.

308. See *supra* note 219.

309. What changed board behavior is a complex story, but *Unocal* had a major part. See David J. Denis & Timothy A. Kruse, *Managerial discipline and corporate restructuring following performance declines*, 55 J. FIN. ECON. 391 (2000) (observing that underperforming firms now restructure, and discipline management, even in the absence of takeovers).

of the value creation from the mega-merger, for they have shown themselves to be increasingly experienced with and sophisticated in valuation issues in other contexts, such as appraisal and substantive fairness.<sup>310</sup> The discussion of strategic business alternatives, particularly mergers, is familiar to courts, which have reviewed these decisions under the business judgment standard and which, under the proposed standard, must simply demand a greater showing by the board that the mega-merger was the best strategy in the circumstances, in light of a presumption that the firm should not engage in the transaction.

If experience under *Unocal*—also an intermediate standard of review—is any indication,<sup>311</sup> it is not likely that courts will often and readily substitute their own judgment for that of the directors on a merger and its alternatives, if and when a mega-merger decision is challenged. Under *Unocal*, a court does not ask whether *it* considers that a third party's offer constitutes a threat, but whether the board has articulated reasonable grounds for the board's determination that such a threat exists and whether the response to the threat (if established) is proportional. Similarly, under the proposed standard a court should defer to a board's particularized findings about the value of a mega-merger and about the appropriateness of the transaction in light of the alternatives. The proposal is certainly intended to result in more initial court scrutiny of the mega-mergers, until the standard begins to take effect. Yet, unlike review under a fairness standard, it is designed not to place the court's business judgment over that of the board as it is to ensure that the board has fulfilled its role of being a "Devil's Advocate" regarding the success of the transaction.

The proposed standard, moreover, is not intended to result in increased liability on directors, any more than is the current case under the application of *Unocal* or any standard short of a claim of conflict of interest, lack of good faith or illegality on a director's part. Indeed, a director's

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310. See *Cede & Co. v. Technicolor*, 684 A.2d 289 (Del. 1996).

311. There the court articulated a standard whereby a judge would have to review a board's determination how an offer constituted a threat to a corporate enterprise and whether the response to it was proportional and left it to the lower Delaware courts to develop the standard, which they have done successfully. See *Unocal Corp. v. Mesa Petroleum Corp.*, 493 A.2d 946, 955 (Del. 1985).

failure to satisfy the standard will likely not lead to any liability, given the availability to corporations of Section 102(b)(7)'s exemption for damages and directors' insurance and indemnification.<sup>312</sup> The standard, however, will affect board behavior even without an imposition of liability, as has been demonstrated by *Unocal*. In practice, shareholders of a firm involved in a mega-merger and opposing the transaction will seek an injunction following its announcement—or at any time before its closing—on the grounds that the board in question failed to satisfy its duties under the standard. The board would thus have its decision-making exposed to scrutiny shortly after having made the merger decision, or later before closing when it declines to revisit its merger decision. If the board's decision-making proves inadequate under the standard, the merger risks being delayed or even permanently enjoined. Directors, thus, have an adequate incentive, even without personal liability, to establish that they have fulfilled, and continue to fulfill, their position as merger skeptics so as to ensure that the mega-merger occurs, if it is indeed shown to their satisfaction to be one of the few transactions that are value-enhancing.

It could be argued that application of the standard would lead to unnecessary litigation by giving disgruntled shareholders (who do not represent a majority of the shareholders), and their attorneys, a weapon whereby they could unduly delay mergers and extort value from a merging firm. There is no question that, in the short term, the standard is likely to result in more litigation and thus more costs to firms, as courts elaborate and apply the standard, which is necessary if the standard is to produce the desired effect—changed behavior on boards' part. And, if the proposed standard achieves its goal, there will be fewer mega-mergers. It is unlikely, however, that, once the standard takes hold in the law and board behavior, it will cause undue delay for justifiable mergers or give opportunistic shareholders undeserved value from a merging firm. As it is, firms involved in mega-mergers are now sued under corporate law and federal securities law.<sup>313</sup>

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312. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (1999).

313. See, e.g., *Moran v. American Online, Inc.*, No. 17723 (Del. Ch., Jan. 14, 2000) (AOL shareholder challenging AOL/Time Warner merger under state corporate law); *Cohen v. Levin*, No. 17719 (Del. Ch., Jan. 10, 2000) (challenge of

Because the mega-mergers always involve delay (sometimes considerable) from agreement through consummation, primarily to obtain the necessary shareholder approval and the consent of antitrust and other regulatory authorities to the merger, any additional claims under the proposed standard can be handled by courts during this period, particularly because the subject matter of the suit is a very recent decision by the board. Indeed, rather than helping a small shareholder group, the suit could benefit all shareholders by exposing the flawed decision-making of a board.

It could also be argued that the proposed standard would do nothing more than lead to "stock" or "boilerplate" decision-making by boards, which would have no effect on the mega-mergers. Again, if *Unocal* is to stand as a model, this is an unlikely result in the long (although not the immediate) term, for it is clear that law can change the culture of board members. In the *very* long term, the issue is more complicated, for there is no question that, whenever a new legal rule is articulated, patterns of behavior change followed by an inevitable routinization. Lawyers are asked by their clients for simple guidelines on how to conform with the rule, and the pressure for standardization is particularly acute in business transactions where so much economic value is at stake for the companies involved. The application of *Unocal* exemplifies this process, for numerous books and materials instruct boards on the correct procedure to follow in erecting defenses to a hostile offer.<sup>314</sup> Yet the establishment of routines or simple rules does not mean that there is no substance to decision-making based upon them: successful human behavior (i.e., behavior that allows survival), particularly in complex situations, generally follows simple patterns or rules.<sup>315</sup> Indeed, encouraging boards to adopt a different decision-making routine for the mega-mergers may *routinely* help raise issues, such as alternatives to a merger, that are not now sufficiently placed in the foreground. And it is the strength of the common law courts to remain vigilant to the dangers

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Time Warner shareholder).

314. See, e.g., BLOCH, *supra* note 22, at 631-1202; LIPTON, *supra* note 49, at 1-30, 35-46.

315. See Hersh M. Shefrin & Richard H. Thaler, *The Behavioral Life-Cycle Hypothesis*, in QUASI-RATIONAL ECONOMICS, *supra* note 144, at 97.

of routines arising from legal practice and to articulate a new standard, or to enhance an existing one, where appropriate: this is clearly what the Delaware Chancery Courts are now doing in their new scrutiny on deal protection mechanisms in merger agreements.

Finally and significantly, it may seem doctrinally inappropriate to propose an enhanced standard of conduct for board decision-making when the decision is not final: a mega-merger does not occur unless shareholders of each company approve the transaction. That is, *Unocal's* enhanced scrutiny was justified because a board's defenses to a hostile offer could prevent shareholders from ever considering a tender offer.<sup>316</sup> The enhanced review mandated under *Blasius*<sup>317</sup> similarly focuses on situations where boards undermine the shareholder franchise.<sup>318</sup> Courts also apply the enhanced fairness scrutiny in situations, such as in freeze-out mergers, where no shareholder vote is required or where the vote is meaningless because of the number of votes possessed by the majority shareholder.<sup>319</sup>

There is a paternalistic aspect to the proposed standard. Its justification is that, in the current business climate with so much momentum for the mega-mergers, shareholders, even the sophisticated institutional owners, need some protection from their own tendency to jump aboard the bandwagon of these transactions. Although efforts can be made to affect the shareholders' decision, by the time they vote on the merger the outcome is usually a foregone conclusion (in the absence of competing offers).<sup>320</sup>

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316. See *Unocal Corp.*, 493 A.2d at 955.

317. *Blasius Industries v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

318. See generally *Chesapeake Corp. v. Shore*, 2000 Del. Ch. LEXIS 20, 62-82 (Del. Ch. 2000) (discussing the continued rationale for *Blasius* analysis in light of the fact that application of *Unocal* can achieve the same results of protecting the voting franchise since it bars preclusive defensive actions by boards).

319. Again, the classic example is *Weinberger v. VOP, Inc.*, 457 A.2d 701, 708 (Del. Ch. 1985).

320. One could argue that, by the time of a merger vote, shareholders disagreeing with a strategic merger have already expressed their disapproval by selling their shares. Accordingly, no enhanced protection is needed for the shareholders electing to remain in the capital of the firms involved in the merger. Such an argument would belittle *any* role for the board in a merger, which may agree with some economic analysis, but not with legal realities. Moreover, the paternalism argument suggests that even shareholders who

There is thus a need to slow down the momentum at the point where intervention would be most effective, the board's initial and continuing approval and recommendation of the merger *before* a shareholder vote. This proposal is therefore squarely based on a traditional understanding of the special fiduciary role of board members, which lies at the foundation of the board's fiduciary duties and which makes them stewards for the shareholders.<sup>321</sup> It may well be that, as a result of application of the standard, shareholders may not have the opportunity to vote on some mega-mergers (although this is likely to be the case more for shareholders of an ostensible acquirer than for those of a true target). But there is nothing jarring about this outcome from a jurisprudential perspective. Board members direct the management of firms and shareholders retain the right, at certain times, to remove them if dissatisfied with their behavior. It is difficult to understand why rational shareholders would object to board members who demand from management hard-nosed justifications for transactions that so frequently destroy the value of these shareholders.

### B. *Useful Supplements to the Proposed Standard*

The above corporate law reform, like any legal reform, would benefit if accompanied by other nonlegal and legal efforts to address the mega-mergers. Indeed, the current preferred U.S. response to problems with firm management (that is to say, corporate governance problems) is to awaken boards of directors to a problem and to encourage them, by legal and nonlegal means, to resolve it.<sup>322</sup> For example, in

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think that the transaction will be value enhancing need protection from their own errors.

321. See *Quickturn Design Sys. v. Shapiro*, 721 A.2d 1281, 1292 (Del. 1998) ("Therefore, we hold that the Delayed Redemption Provision is invalid under Section 141(a), which confers upon any newly elected board of directors *full* power to manage and direct the business and affairs of a Delaware corporation.") (footnote omitted); *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 ("The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders.") (citation omitted).

322. See, e.g., Roe, *Political Preconditions*, *supra* note 140, at 6; see also Bhagat & Black, *supra* note 297, at 923-34 (surveying trends in board independence); Sanjai Bhagat et al., *Director Ownership, Corporate Performance, and Management Turnover*, 54 BUS. LAW. 885 (1999) (reviewing



the 1980s boards of corporations became less tolerant of management's absolute resistance to tender offers because of the case law that enhanced their fiduciary duties in the takeover situation and because of pressure from institutional investors who worked with advisory groups to establish guidelines for director behavior in this situation.

This extralegal or consensual activism designed to affect the norms of board behavior would not alone be capable of dealing with—and has not even focused upon—the value-decreasing nature of mega-mergers, any more than it could have addressed board weaknesses in the 1980s in the absence of court decisions. Yet it can certainly supplement the proposed legal standard by providing additional encouragement to boards to evaluate critically the mega-mergers, to be highly suspicious of managers' reasons for entering into them and, in general, to do everything to resist the momentum for the transactions. Institutional investors and organizations supportive of them and/or devoted to formulating standards of board behavior, such as The Conference Board, the Institutional Shareholder Services, the Investor Responsibility Research Center, should add this topic to their policy agendas and begin to address it in their standards of director conduct.<sup>323</sup> This addition would make particular sense for their guidelines because many of their topics for board improvement have been acquisition-related as result of the developments in the hostile offer context.<sup>324</sup>

The focus and publicity that would arise from adding this issue to those of interest to institutional investors and the investor organizations would help make board members additionally aware of the problems associated with mega-mergers and help counter the overwhelming publicity in favor of the transactions.<sup>325</sup> The institutional investor

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issues of director ownership).

323. For the most part, current "consensual" standards of corporate governance are completely silent on the issue of mega-mergers. *See, e.g., CORPORATE GOVERNANCE: IMPROVING COMPETITIVENESS AND ACCESS TO CAPITAL IN GLOBAL MARKETS, A REPORT TO THE OECD BY THE BUSINESS SECTOR ADVISORY GROUP ON CORPORATE GOVERNANCE* (Organisation for Economic Co-operation and Development ed., 1988).

324. *See, e.g.,* Patrick S. McGurn, *Companies Continue to Pop Poison Pills in 1999*, 14 *ISSUE ALERT* 1 (No. 5, May 1999) (discussing institutional shareholder activism regarding poison pill defenses to a takeover).

325. *See, e.g.,* DR. CAROLYN KAY BRONCATO, *COMMUNICATING CORPORATE PERFORMANCE: A DELICATE BALANCE* 3 (1997) (discussing as one of the goals of

activism might also be of assistance to courts as the latter develop the proposed standard. For through their own research on board behavior the groups could help identify what are reasonable grounds for mega-mergers (with shareholder value in mind) and when a mega-merger is justified to the exclusion of other alternatives.

As discussed earlier, pooling accounting treatment may encourage companies to engage in the stock-for-stock mega-mergers, particularly among those companies that cannot raise cash through debt financing, and thus to avoid cash mergers where, as the evidence suggests, parties are more likely to do a value-enhancing transaction.<sup>326</sup> Accounting standard setters have proposed to eliminate pooling treatment in favor of the uniform application of purchase accounting to all mergers.<sup>327</sup> This development, it has been suggested, may significantly slow down the wave of stock-for-stock mega-mergers.<sup>328</sup>

Eliminating pooling would contribute to creating a resistance to the momentum of the mega-mergers and would thus be a useful addition to the proposed standard. It would not, however, be a substitute for a change in the law. As an initial note of caution, much can happen between an announcement of a reform to accounting standards, such as the elimination of pooling, by the FASB and its final implementation: the outcome of FASB's deliberations on any subject, which are subject to intense lobbying by industry groups affected by any proposed change, are by no means certain.<sup>329</sup> The pooling treatment should be

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the Global Corporate Governance Research Center to "develop benchmarks and best practices to attract international investment and manage successfully in global capital markets").

326. See *supra* notes 57-62 and accompanying text.

327. See *supra* note 38; see also FINANCIAL ACCOUNTING STANDARDS BOARD, BUSINESS COMBINATIONS: SUMMARY OF TENTATIVE BOARD DECISIONS THROUGH JUNE 2, 1999 (available June 25, 1999) ("Only the purchase method should be used to account for business combinations (the pooling method is therefore eliminated).").

328. See SUMMARY OF COMMENT LETTERS TO FASB EXPOSURE DRAFT: BUSINESS COMBINATIONS AND INTANGIBLE ASSETS 5 (2000) ("Many respondents did not specifically answer the question whether all business combinations are acquisitions but instead put forth public policy arguments for retaining the use of the pooling method for business combinations—namely, that the availability of the pooling method is critical to the continuation of the merger and acquisition activity in the United States.").

329. One has only to remember the controversy surrounding FASB's efforts to have stock options expensed on the income statement (which did not come to

eliminated because it encourages at least one irrational basis in board and shareholder decision-making regarding the mega-mergers. The popularity of pooling owes much to the continued focus of parties on the earnings per share ("EPS") number in the income statement, which pooling treatment (as opposed to purchase accounting) does not reduce, because it does not result in recognition of goodwill of the "purchase" that would then have to be amortized, thus reducing EPS, in the years following the merger. Yet EPS, like net income itself, is a somewhat illusory number since it does not reflect the cash-generating results of the company.<sup>330</sup> The elimination of pooling may thus reduce in the long term the number of stock-based mega-mergers that relied partly for their justification on improving the EPS number in the combined firm, and also force financial analysts and investors to evaluate all firms for their cash results, as they do in some industries.<sup>331</sup>

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fruition) to realize that opponents of any FASB proposal may have the political muscle to defeat it. Indeed, companies preferring the pooling method—and their banking and legal hired guns (who make much money from the mega-mergers)—are beginning to drum up opposition to FASB's effort in the political arena. *See, e.g.*, Letter of Adam D. Chinn, Wachtell, Lipton, Rosen & Katz, Mar. 3, 2000 (on file with the Buffalo Law Review) (arguing that elimination of pooling will undermine the "psychology of the deal" in mega-mergers of equals because neither company involved wants to accept that it is being acquired by another); Martha A. Matthews, *Economics of FASB Bid to End Pooling Considered by Senate Banking Panel*, BNA BANK. DLY., Mar. 6, 2000 (discussing hearing with testimony of supporters of pooling); Charles Sisk, *FASB Draws High-Tech Industry Flak*, DAILY DEAL, at [www.thedailydeal.com/topstories/A15195-2000Feb3.html](http://www.thedailydeal.com/topstories/A15195-2000Feb3.html) (Feb. 3, 2000) (reporting on threats of political action by high-technology firms opposed to the elimination of pooling); *see also* FINANCIAL ACCOUNTING STANDARDS BOARD, News Release, available at [www.rutgers.edu/Accounting/raw/fasb/news/NP12600.html](http://www.rutgers.edu/Accounting/raw/fasb/news/NP12600.html) (Dec. 6, 2000) (revising purchase accounting's treatment of goodwill in acquisitions so as to undermine much of the effect of the abolition of pooling).

330. That is, depreciation and amortization charges that go into determining net income do not represent the cash expenditure in a given year; the purchases to which they are attributable have already occurred.

331. *See generally* Rick Escherich, J.P. Morgan Securities Inc., *Quarterly Focus: Pooling versus purchase accounting: does goodwill really matter?* (Apr. 23, 1999). *See also* Elizabeth MacDonald, *Pooling's End Won't Clobber M&A Activity*, WALL ST. J., June 9, 1999, at C1; GABRIELLE NAPOLITANO & ABBY JOSEPH COHEN, PURCHASE VERSUS POOLING: THE DEBATE ON BUSINESS COMBINATIONS 1, (May 28, 1999) (observing that elimination of pooling will adversely affect mergers in some industries). Naturally, this does not mean to suggest that, if firms fear that pooling will be eliminated, they may not rush to take advantage of it in order to benefit from the investor focus on EPS. On the other hand, it is not as if purchase accounting eliminates manipulation of EPS

Disclosure under the federal securities laws will also support the proposed standard without any additional modifications of these laws. Pursuant to securities laws, companies already make considerable disclosure in their proxy statements about a mega-merger, their reasons for it and the risks presented by it.<sup>332</sup> In particular, these laws require companies to discuss in detail the decision-making history of the merger, generally with emphasis on meetings between, and the views of, senior executives of the merging firms.<sup>333</sup> If, in line with the proposed standard, an enhanced duty is placed on the board of each firm to justify a mega-merger, it follows that the disclosure in the Form S-4s and/or merger proxy statements will have to include more information about the board's specific articulation of the value-enhancing aspects of the transaction and its weighing of the transaction in light of alternatives, particularly the alternative of not engaging in the transaction. In reviewing, and commenting upon, the disclosure documents, moreover, the SEC staff could take a more aggressive position in challenging the basis, and requiring specific support, for statements about the benefits and risks of a mega-merger. This SEC position would encourage the board in its exercise of its fiduciary duty under the proposed standard.

Much of the force of the federal securities laws comes not just from the mandated disclosure but also through liability under these laws. Because the federal securities laws penalize companies and directors for non-disclosure and misrepresentation of material facts in their merger disclosure documents, they add weight to a proposal enhancing board duties. If, for example, board members do not adopt the critical position toward management's mega-merger proposal required by the proposed standard, their conduct risks being actionable under both corporate law *and/or* the federal securities laws. That is, a board that does not take an opposition stance toward executives in the merger decision is likely to approve for dissemination a registration or proxy statement that either is misleading

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in the acquisition context. See, e.g., Elizabeth MacDonald, *Merging Firms Are Renouncing R&D Write-Off*, WALL ST. J., Mar. 22, 1999, at C1 (discussing practice of acquiring firms writing-off much of acquired research and development expenses in the year of the acquisition, rather than over a longer period, which made the firm's results look better in ensuing years).

332. See *supra* notes 188, 191, 227, 290.

333. See, e.g., Exxon/Mobil Prospectus, *supra* note 227, at I-14 to I-19.

because it suggests that the board was more active and critical than was in fact the case, or shows that the board was not appropriately active, which would be a "roadmap" for a violation of fiduciary duty.<sup>334</sup>

It would, in fact, be encouraging to draw some support from federal securities laws for resistance to the mega-mergers because a recent SEC rule change has, in a misguided way, promoted stock-for-stock transactions. In 1999, the SEC significantly amended the rules governing tender offers in order to put offers that use stock as consideration on equal footing with cash offers.<sup>335</sup> Before the rule change, it was difficult to use stock as tender offer consideration for a number of reasons. Because a stock offering had to be registered under the Securities Act of 1933, the timing necessary for SEC review of the offering would generally exceed the short period for a tender offer. Moreover, restrictions on statements by a company making a stock offering under that Act would interfere with the publicity necessary to gather shareholder interest and support in a tender offer.<sup>336</sup> All this meant in effect that a stock tender offer could commence only upon effectiveness of a registration statement for the offered stock, i.e., following completion of SEC review of that statement. The rule change gives companies the choice of using stock or cash in an offer by easing restrictions on statements by a company that is using stock as tender offer consideration and by permitting such a company to make the offer conditional on effectiveness of the registration statement regarding the offered securities.<sup>337</sup> The outcome of this rule change, however, is to further the use of stock in a two-step

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334. Under *Santa Fe v. Green*, 430 U.S. 462 (1977), it is inappropriate for federal securities laws to interfere with corporate governance, which is a subject of State law. However, these laws in the merger context do what they do in many cases: indirectly deter inappropriate board behavior by giving the board a choice of either disclosing that it has acted inappropriately or misstating that it conducted its decision-making in the proper manner. It should be noted that the corporate law duty of disclosure would have this same effect. *See generally* 1 BLOCK, *supra* note 22, at 499-538.

335. *See* Regulation of Takeovers and Security Holder Communications, *supra* note 192.

336. *See id.* at 61,410-11.

337. *See id.* at 61,411-13, 61,419-20; 17 C.F.R. §§ 230.162, 165, 166 (2000) (rules on communications regarding mergers before effective date of registration statement, on conditionality of offer prior to effectiveness).

merger, which can only facilitate the mega-merger trend.<sup>338</sup>

## VI. CONCLUSION

A week rarely passes now without the announcement of a new mega-merger. Generally, the business media, adopting CEOs' "spin" on the transaction, present the merger as likely to result in new synergies and hitherto unimagined connections between companies and portray the CEOs as visionaries. Enormous companies often appear almost overnight in the spotlight, having grown tremendously from previous mergers. Politicians have remained mainly silent about the phenomenon of the mega-mergers in this era of prosperity and full employment, which contrasts sharply with their widespread condemnation of the LBOs of the 1980s.

Lost in the euphoria of the mega-mergers is the reality that most of these transactions are value-decreasing both for the acquirer's shareholders and for those of the target companies who hold onto the acquirer's shares. The financial and economic evidence overwhelmingly suggests that companies destroy shareholder value in these stock-for-stock transactions. For primarily behavioral and psychological reasons, CEOs are not realistic about the possibilities of success in the mega-mergers, and, for generally the same reasons, boards of directors, financial analysts and investors go along with them, which generates an almost irresistible momentum for the transactions.

Law does little to slow down, and in fact promotes, the mega-mergers. In the absence of competing bidders for one or the other of the merger partners, the standard of court review of board decision-making on the transactions is the highly deferential business judgment examination, which focuses simply on the information-gathering process of the board's decision. In an ironic and perverse outcome, moreover, the case law of the 1980s on board duties in hostile transactions (which were uniformly value *enhancing*) encouraged parties to engage in stock-for-stock mega-mergers. Taking their guidance from this case law,

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338. See, e.g., Yvette Kantrow, *Reluctant Trailblazer*, DAILY DEAL, at [www.thedailydeal.com/features/diary](http://www.thedailydeal.com/features/diary) (Feb. 23, 2000) (discussing initial use of SEC "fast track" rules for stock tender offers in Computer Associates' acquisition of Cullinet Software).

practicing corporate lawyers have surrounded the mega-merger with many deal-protection provisions that add to the transaction's momentum by making it difficult for the board to reevaluate the deal, once it has made the decision to enter into a merger.

This Article argues that the law must impose an enhanced standard of board conduct in approving the mega-merger in order to address the significant problem transaction of the 1990s and of the beginning of the new millennium and to counter *legally* the momentum of the mega-mergers. The standard would compel a board to articulate particular grounds for believing that the mega-merger maximizes shareholder value and to justify that the transaction is the best alternative among those available to the company, particularly the *status quo* of not engaging in the transaction. This legal change is no panacea for the mega-mergers and should be accompanied by other nonlegal and legal actions that would support it and slow down the momentum of these transactions. The proposed standard will not bring every mega-merger before courts or transform judges into merger experts. It is designed only to force board members to be an opposing, critical group to a transaction that has all the force of CEO popularity and support behind it, as well as (once announced) media and investor pressure, a group that would squarely raise and face the potentially negative evidence about the deal and resist the mega-merger. If the standard succeeds in bringing sobriety about the mega-mergers into boards in this intoxicating time, and, frankly, in halting their trend, its benefits should outweigh its costs.