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The 1980s—Did We Save the Stockholders While the Corporation Burned?

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THE 1980s—DID WE SAVE THE STOCKHOLDERS WHILE THE CORPORATION BURNED?

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I. INTRODUCTION

Throughout the 1980s, the Delaware Supreme Court decided cases involving some of the largest takeovers and mergers in corporate history. Our decisions served to redefine the role of a director and to usher in a new era of director responsibility. The far-reaching impact of the court's decisions has led some to refer to the 1980s as the golden age of corporate law. However, from what we now know and are learning daily, it might be more accurate to call it the gold-plated age of corporate law. And the luster is wearing off.

Companies that first gained national attention as the battles for corporate control raged in the Delaware courts are once again in the headlines. This time, however, the headlines read: layoffs, record losses, defaults, bankruptcy, and pervasive financial manipulation by those on Wall Street and in Beverly Hills. Recalling the economic history of the 1920s, we observe, with deep concern for the future, the excesses, scandals, and ruined reputations spawned by the decade of the eighties. Thus, the haunting words of George Santayana remind us that: "Progress, far from consisting in change, depends on retentiveness. . . . Those who cannot remember the past are condemned to fulfill it."[1]

Even in hindsight, the 1980s were an exciting period for the corporate bar. Struggles for corporate control that began in the early 1980s as an effort to capitalize on depressed stock prices soon exploded into a takeover frenzy. With millions to be made in breakups and exorbitant fees, acquirors and their financial advisors, who cared little or nothing for the corporation itself, plotted new forms of attack that made virtually any company a takeover candidate. In an effort to fend off hostile bidders, both actual and perceived, corporations employed newly devised radical

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1. 1 GEORGE SANTAYANA, LIFE OF REASON (ch. xii, FLUX AND CONSTANCY IN HUMAN NATURE) (1905-06).

defensive strategies. The players and the playing field appeared to change on a daily basis.

Although the long-range ramifications of the takeover craze are not yet known, one thing is clear: the 1980s changed the way American corporations do business. I suspect that the effects of the era have changed or will change the way in which America looks at corporations.

In retrospect, many ask why this era of mega-mergers happened and why nothing was done to control events that seemed to be endangering the entire economy and the livelihood of millions. In order to appreciate these events, however, it is necessary to understand the environment in which they occurred.

II. The 1980s Corporate Environment and Attempts at Regulation

As we entered the 1980s, stock prices of corporations were undervalued, and interest rates began declining. Many of America's largest corporations had little debt and a surplus of cash. In addition, the political climate was rapidly changing. The election of Ronald Reagan heralded an atmosphere of free enterprise without any serious threat of government intervention. Many potential mergers that predated the Reagan Administration, both friendly and hostile, foundered on antitrust concerns. In the 1980s, such barriers all but disappeared. The Reagan Administration believed that free markets worked best, and that government should interfere in business and finance as little as possible. Laissez-faire was the call of the day. No longer was "bigness badness." No longer was a market defined in terms of American companies competing in the American market. The 1980s marked a change into a new world market. Accompanying this change was the deregulation of many industries, including broadcasting, transportation, banking, savings and loan, and oil and gas. The deregulation allowed for increased competition and for previously prohibited combinations.

Another major development marking this era of corporate law was the changing nature of the investor. More than fifty percent of the outstanding shares of Fortune 500 companies were held by institutional investors with professional portfolio managers. Arbitrageurs amassed huge positions in potential targets—hoping to put companies "in play." Many such efforts were intentionally manipulative and illegal. With the changing investor came a new corporate focus. Success was measured in short-run returns rather than long-term gains. For the first time, corporations were compelled to maximize short-term profitability at the expense of long-term goals.

With these changes—lower interest rates, a new world market, an altered pattern of stock ownership, a changed political environment, and rampant misconduct on Wall Street—virtually no company, no matter how large, was immune as a potential takeover target.

This changing economic and political climate did not go unnoticed. It became open season on corporations, and acquirors moved in for the kill. Some of them soon became household names, and corporate management ran scared.

To satisfy their seemingly insatiable appetite for the corporate treasury, bidders turned to Michael Milken and his high yield "junk bond" financing. With access to the junk bond market, it was now possible for persons with relatively small resources to finance even the largest and riskiest ventures while investing almost none of their own capital. Theoretically, the debt would be paid by selling portions of the acquired corporation, resulting in both profit to the acquiror and a leaner, more efficient corporation. Realistically, the acquirors and their advisors were often more concerned with their own financial profits and not with the corporation being acquired—or with the welfare of its stockholders.

As new takeover techniques developed, the boards of target corporations were forced to counter with new defenses. Directors began restructuring their companies even before they became a target. Corporations began acquiring other companies in an effort to consume their excess capital resources that so invited a hostile takeover. Other responses to a perceived takeover threat included the adoption of "shark repellents": classified boards, poison pills, supermajority voting requirements, and fair price provisions. Terms such as "asset lockups," "crown jewel," "white knights," "bear hugs," and "greenmailer" became commonplace. Such defensive measures, however, posed an inherent conflict of interest since they also had the effect of entrenching management.

With all of the attention and energy focused on corporate America, one might conclude that this was a period of significant corporate growth. I seriously doubt it. Instead, the 1980s marked a period of massive wealth shifting, but little wealth creation. The "best and the brightest" now went to work for investment banking firms; business, as such, was viewed as passé. Although bidders and their entourage of advisors were making billions of dollars, the nagging question arose: was American enterprise selling out its long-term future for short-term gains? Saddled with huge debts, American corporations found it more difficult to compete with their cash-rich counterparts in Asia, which were expending more effort developing new technologies as opposed to developing new takeover strategies or defenses. Thus the balance of world economic power was slowly shifting from the West to the East.

Amid this changing takeover environment, many large corporations ironically turned to Washington for protective federal regulation. Although many reforms were proposed in the early to mid-1980s, none would become law.

In February 1983, the Securities and Exchange Commission (SEC) was directed to submit a proposal on takeover regulation to Congress. The SEC established a tender offer advisory committee comprised of corporate management, shareholders, market professionals, investment bankers, and prominent lawyers. The committee recommended numerous changes, but cautioned that "there is insufficient basis for concluding that takeovers are either per se beneficial or detrimental to the economy."[2] The SEC reviewed these recommendations and then submitted its proposals to Congress. In May, 1985, however, the SEC voted unanimously not to seek new legislation and withdrew all of its earlier proposals for change.[3]

Offering no support, the White House also believed that there was no need for additional takeover regulations. In fact, White House economists claimed that takeovers and corporate restructurings were increasing American productivity. Indeed, according to the President's chief economist, the *only* abusive tactics in takeover contests were defensive measures employed by management of target corporations. What a marvelous sequel to "Alice in Wonderland"! Thus, federal regulation of takeovers was described as "premature, unnecessary and unwise."[4]

Given these circumstances, the regulation of corporate takeovers was left to the Delaware courts. As a result, the Delaware Court of Chancery and the Delaware Supreme Court were called upon to decide many unique and difficult legal and economic questions that became (for better or worse) hallmarks of the era.

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2. SEC Advisory Committee on Tender Offers—Report of Recommendations (July 8, 1983), *excerpted in* Sec. Reg. & L. Rep. (BNA) No. 28, at 1375 (July 15, 1983).

3. JOHN BROOKS, THE TAKEOVER GAME 269 (1987).

4. COUNCIL OF ECONOMIC ADVISORS, 1985 ECONOMIC REPORT OF THE PRESIDENT 216 (1985).

III. The Cases

A. *Smith v. Van Gorkom*[5]

Before a certain Delaware Supreme Court decision in 1985, the role of directors was mostly perfunctory. Rarely did a director challenge management's initiative or even closely question management on issues coming before the board. In accordance with the theory, known to academics as structural bias and to others as the "country club" mentality, many directors understood that their duties required only a modicum of service. The thought of being exposed to millions of dollars in personal liability rarely seemed a serious threat.

Irving Olds, Chairman of U.S. Steel from 1940 to 1952, is quoted as saying: "Directors are merely the parsley on the fish."[6] In the 1980s, that idea underwent a major change.

The watershed of this era of director responsibility was *Smith v. Van Gorkom* (also known as the Trans Union case). *Van Gorkom* involved the cash-out merger of Trans Union into a corporation owned by the Pritzker brothers. The Delaware Supreme Court, in a 3-2 decision in which I joined the majority, held that the directors of Trans Union had breached their fiduciary duties to their stockholders by the hasty and uninformed manner in which they irretrievably committed themselves to the sale of the company.[7]

Never before had such a judgment been visited upon such prominent directors of a large corporation. Needless to say, the decision was not generally well received by the corporate bar.

In large part, however, *Van Gorkom* is one of the most misunderstood cases in corporate law. *Van Gorkom* was not new law. It was the application of well-established legal principles to egregious facts. It is said that the case pushed aside the business judgment rule and a court substituted its own business judgment for that of the corporation's directors. That is incorrect. *Van Gorkom* was much more a case about process in the takeover environment than anything else. The Court said to directors that the protection of the business judgment rule is not a birthright of directors but, rather, is given in return for care, loyalty, and unyielding good faith to the corporation.[8]

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5. 488 A.2d 858 (Del. 1985).
6. ARTHUR FLEISCHER, JR. ET AL., BOARD GAMES 3 (1988).
7. *Van Gorkom*, 488 A.2d at 893.
8. *Id.* at 872.

There was one aspect of *Van Gorkom* that the Court found especially troublesome. Trans Union's directors were stalwart in their unified defense of what occurred.[9] This position was taken even though it was obvious that certain directors were more culpable than others, and in the face of the Court's invitation that they take separate positions with a clear hint of exoneration for all but the most culpable insiders. Indeed, one of the directors was ill and did not even attend the meeting at which the merger was approved. In a way, they were "daring" us to find them all liable in a strategic maneuver to save certain insiders. In light of our decision finding all the directors liable, the strategic maneuver to cast down the gauntlet before the Delaware Supreme Court hardly appears to have been among the wisest decisions in the annals of corporate America.

The Trans Union case, however, was not the harbinger of director upheaval many predicted. Indeed, *Van Gorkom* provided valuable guidance to directors at a most opportune time—just before the takeover winds of the 1980s gained hurricane force. If anything, it became the beacon by which directors, faced with the inherent conflicts imposed by hostile tender offers, steered their companies through the shoals of either defensive tactics or auctions intended to maximize shareholder values. The club-like attitude in the board room gave way, without becoming unsupportive, to a searching, questioning concern for the merits of corporate actions.

Our opinion in *Smith v. Van Gorkom* was released on January 29, 1985. Its principles were soon tested in the first major hostile tender offer case addressed by the Delaware Supreme Court in the 1980s.

B. Unocal[10]

On February 14, 1985, Mesa Partners, led by T. Boone Pickens, announced that it had acquired 7.9 percent of Unocal's stock. Unocal was one of America's largest oil companies. Although Mesa alleged that it was acquiring the stock for "investment purposes," it soon became evident that Unocal was Mesa's next target. Shortly after expressing its interest in Unocal, Mesa announced a two-tier, front-end-loaded, classically coercive, bust-up, junk-bond-fueled tender offer. Unocal's board of

9. Indeed, the Court even asked counsel whether there existed a distinction among the members of Trans Union's board of directors. Counsel for the directors agreed that there was "none whatsoever." *Id.* at 899 (on motions for reargument).

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

directors questioned Mesa's motives and found the offer both inadequate and coercive.

This was the very sort of takeover device that had caused such a hue and cry in Congress and before the SEC—and as to which neither body had done anything. Consequently, Unocal's board rejected Mesa's bid, and in response offered to repurchase fifty million shares of its own stock at seventy-two dollars a share, specifically excluding Mesa from its offer. For the first time, a corporation defending against a hostile takeover launched its own self-tender and excluded the hostile acquiror.

The Delaware Supreme Court thus had before it issues of vast national legal and economic import. It was clear that in this context, with the inherent conflicts faced by the directors, that ordinary principles of business judgment were inadequate to decide such issues. Due to this inherent conflict, the Court abandoned traditional concepts of business judgment, and established two criteria that must be met before the protection of the business judgment rule will be conferred.

First, directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.[11] This burden is satisfied by showing good faith and reasonable investigation.[12]

Second, the defensive measures must be reasonable in relation to the threat posed.[13] This became the test by which all defensive mechanisms were judged in takeover cases. We also announced for the first time that in taking such measures the board could consider the interests of the corporate enterprise, which includes shareholders, as well as various constituencies—creditors, customers, employees, and perhaps even the community generally.[14] The board also was permitted to consider inadequacy of the price, nature and timing of the offer, questions of illegality, risk of nonconsummation, quality of securities being offered, and the bidder's identity and background.[15]

In addition, with all due respect to the Chicago School, we rejected the notion that a board should be a passive instrumentality in the face of a takeover threat.[16]

11. *Id.* at 955.

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.* at 955-56.

16. *Id.* at 954-55 nn.8-10. *See also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 n.16 (Del. 1986).

Another interesting aspect of the Court's decision in *Unocal* is that it signaled the end of the coercive, two-tier, junk-bond-fueled tender offer. The Court's opinion made it clear that such offers, usually couched in terms of "benefitting" stockholders, were per se coercive and subject to strong defensive measures.[17] The Court's message was not lost on bidders who had popularized the device at the expense of shareholders whose interests they claimed to serve.

This led to all-cash tender offers financed by the sale of junk bonds to the public. These bonds were sold to financial institutions that presumably understood the risks involved. Actually, the bonds were peddled to institutions drawn in by the high rates, with little regard for the substantial risks being taken and imposed on their own investors. This was ideal for bidders. They could now structure their bids using publicly issued junk bonds while engaging in all-cash tender offers whose coercive effect was considered minimal.

This situation was less than ideal for the U.S. economy. As the junk bond market began to collapse, it became apparent that many of these securities had been acquired by insurance companies or savings and loans that now are suffering unprecedented losses or have already collapsed. In order to protect depositors, the United States government has been forced to bail out many insolvent thrifts. Thus, while the raiders and those encouraging them made billions in the process, substantial risks and costs of these free-wheeling debacles have been passed to the United States taxpayers.

C. *Revlon*[18]

After *Unocal*, there was concern in the corporate community that directors, upon perceiving a threat, had unlimited discretion to invoke whatever defensive tactics they could devise. Soon after *Unocal*, the battle for control of Revlon by Pantry Pride and Forstmann Little provided the Delaware Supreme Court with an opportunity to address this concern.

The battle began with Pantry Pride's unsolicited bid for Revlon. Not wishing to sell the company, at least not to Mr. Perleman of Pantry Pride, and perceiving a threat, Revlon's board adopted a poison pill and other defensive measures. The Delaware Supreme Court found these

17. *Unocal*, 493 A.2d at 956.

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

board actions to be consistent with the *Unocal* standards.[19]

However, as the battle intensified, so did Revlon's defenses. As Pantry Pride increased its bid, Revlon sought a white knight. It found one in Forstmann Little. In consideration of a bid one dollar per share greater than Pantry Pride's latest but admittedly not final offer, Revlon's board agreed effectively to stop the bidding. Forstmann was given an asset lock-up option for two of Revlon's divisions and guaranteed a substantial break-up fee if the transaction did not occur. In addition, Revlon's board agreed not to "shop" the company.

The Court found that when Revlon's board began to negotiate with Forstmann, the sale of the company became inevitable and their responsibilities changed. Unlike *Unocal*, one thing was clear: the company was for sale. At this point, defensive measures became moot and the directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders.[20] Viewed in this light, we found that Revlon's board effectively "stopped the show" prematurely and that the directors breached their fiduciary duties to the stockholders.[21]

Purporting to rely on *Unocal*'s reference to various constituencies, the directors argued that Forstmann's offer benefitted Revlon's note holders, which had the additional effect of protecting the directors from potential personal liability to those creditors. In rejecting the directors' arguments, we observed that when giving consideration to other constituencies there must be rationally related benefits accruing to the stockholders.[22] Without this nexus, such actions by the directors violate their duties of loyalty and care. This principle distinguishes Delaware law from so many of the new antitakeover "other constituencies" statutes, through which directors are statutorily permitted to breach their most fundamental fiduciary duties by totally disregarding the interests of shareholders in favor of the interests of other constituencies.

Revlon did not, however, answer the often subtle questions—when is a company for sale, and when do the directors' responsibilities shift to those of "auctioneers"? Was any transaction that invited an unwanted participant now going to result in a fire sale to the highest bidder? The answer, if it ever really came, was not to come for several years.

19. *Id.* at 180-81.
20. *Id.* at 182.
21. *Id.* at 182-84.
22. *Id.* at 182-83.

D. *Time-Warner*[23]

The responsibilities of directors faced with a potential change-of-control transaction established in *Van Gorkom*, *Revlon*, and *Unocal* were further clarified in the friendly transaction between Time, Inc. and Warner Communications.

The circumstances leading up to the Time-Warner transaction were much different from either *Revlon* or *Unocal*. Time's board began considering expanding Time's operations into the entertainment industry as early as 1983. To accomplish this, Time established a special committee of executives to consider and propose corporate strategies for the 1990s. The committee prepared a "comprehensive long-term planning document" that included a reference to, and a description of, Warner as a potential merger or acquisition candidate. Following considerable research, debate, and two years of negotiations, Time's board finally agreed to a merger with Warner in March 1989.

Upon learning of the friendly merger between Time and Warner, Paramount announced an all-cash offer for Time at $175 per share. Time's board rejected the offer as inadequate. Paramount countered by raising its bid to $200 per share. Once again, the board rejected the offer as inadequate. In further response to Paramount's unsolicited offer, Time's board changed the structure of the merger with Warner from a stock swap to a cash offer. This response eliminated the necessity of a shareholder vote, thereby allowing Time to pursue its long-range plans.

In response to Time's defensive actions, Paramount asked the Delaware Court of Chancery to enjoin the proposed merger. The injunctive relief was based on both *Revlon* and *Unocal*.

Paramount initially argued that once Time's board agreed to a merger with Warner, it effectively put the company up for sale. Therefore, under *Revlon*, it breached its fiduciary duties by not maximizing shareholder value. However, throughout the merger negotiations, Time steadfastly maintained that it was not for sale. The Court held that, generally speaking, there are two circumstances that require the board to act as an auctioneer: 1) when the corporation initiates the bidding process, seeking to sell itself or to effect a reorganization involving a change in control or a clear breakup of the company; and 2) when, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative

23. Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

transaction that also involves the breakup of the company.[24] Finding neither of these situations to exist, we held that the board's reaction to Paramount's offer was merely a defensive response and not an abandonment of Time's continued existence.[25] Therefore, the action of Time's board should be evaluated under the standards of *Unocal* rather than those of *Revlon*.

Turning to the *Unocal* claim, the Delaware Supreme Court found that Time's board properly perceived Paramount's uninvited offer as a threat to the corporate enterprise.[26] Paramount argued that since its offer was all cash, the only reasonable "threat" that could be perceived was inadequate value. Indeed, this assertion found support in some Chancery Court decisions.[27]

The Delaware Supreme Court rejected Paramount's argument and reiterated its belief that when evaluating the threat posed by a tender offer, a variety of factors other than price could be considered. For example, Time perceived as a threat the possibility that a shareholder would tender into Paramount's cash offer in ignorance of the strategic benefit that Time's combination with Warner might produce.[28] It is important to note that in *Time*, we were not faced with a hip-pocket plan concocted at the eleventh hour. Rather, Time was able to document a long-term strategy originating years before the contested maneuvers occurred. Certainly the legitimacy of a long-range plan is important when determining whether a board reasonably views and reacts to an acquiror as a threat.

E. Review

Obviously, the Court played a significant role in the battles for corporate control. What is not clear, however, is the nature of that role: did the decisions of the Court feed the takeover frenzy or serve to limit it?

There is no easy answer to this question because it is necessary to understand the type of controversy that typically was before the Court. We did not approach cases with the question of whether to allow the corporation to continue in its present form or to permit someone else to acquire the company. Typically, either management or a third-party had made an offer in response to an initial offer. Thus, the question before

24. *Id.* at 1150.
25. *Id.* at 1150-51.
26. *Id.* at 1153.
27. *See, e.g.*, City Capital Assocs. v. Interco, Inc., 551 A.2d 787 (Del. Ch. 1988).
28. *Time, Inc.*, 571 A.2d at 1153.

the Court was whether the directors acted properly in accepting or rejecting the competing offers. Regardless of the Court's decision, the resulting company would be dramatically different.

Although the Court could not stop a corporation from incurring huge debts, it could try to ensure that the directors acted in the shareholders' best interests. While sale of the corporation to the highest bidder satisfied the director's fiduciary duties, the stark fact often remained that the resulting corporation was so highly leveraged that its future was questionable. As long as the directors adhered to their fiduciary duties, it would have been most inappropriate for any court to intrude upon a board's business decision. No court has a role in disciplining directors for the proper exercise of business judgment, even if it turns out to be wrong.

However, based on the nature of the transactions before us and the scope of our review, we did establish the rules by which the battles were fought.

IV. Conclusion

As we consider these matters in retrospect, it is rather staggering to realize that profound changes have occurred. Now we are paying the price for what happened to companies in the 1980s—all in the name of *saving* them from bidders who could easily muster the financial resources to put virtually any company in play. There is mounting evidence that the actions of bidders and their investment bankers were not in pursuit of the pious claim of returning value to the shareholders. It appears that frequently they were the naked display of awesome financial power fueled by greed and the basest of motives.

Clearly, we are left with many unanswered and dangerous questions with heavy portent for the nineties: did the intense focus on next quarter's earnings, at the expense of meeting competition and developing and selling a product, so divert American business that it suffered a disastrous decline in world markets? Is the efficient market theory really valid, or is it the old, discredited, predepression concept of laissez-faire trooped out in new colors? Did courts lend balance to an otherwise runaway situation, or, according to their critics, abandon restraint to interfere either with the operations of a free market or the proper business decisions of corporate management?

We now have time to reflect on these questions. One can only hope that, as we try to discern the solutions, those who come after us will not have to relearn either the questions or their answers.