# Commentary on Fischel

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The stated thesis of Professor Fischel's Article,[1] that "courts should rely more heavily on market prices when resolving valuation disputes than has occurred to date,"[2] is important and largely persuasive. Judges are too quick to dismiss or to minimize the significance of market evidence in determining valuation, including during appraisal proceedings. Instead, courts have come to rely on valuation techniques that are of dubious validity and are easily subject to manipulation by interested parties.

But Professor Fischel's Article goes beyond its stated thesis and makes a much more far-reaching argument: directors who authorize a takeout transaction at a premium to the prevailing market price should be immune from liability because public shareholders are not entitled to anything more than the market value of their stock at that moment, which represents the collective price level at which buyers and sellers are willing to transact. But such a rule converts the willing buyer/willing seller standard from a useful heuristic device to an absolute standard that effectively guts the fiduciary obligation of corporate directors, thereby significantly transforming the landscape of corporate law. This approach would not only deprive shareholders of an asset that is rightly theirs but also yield absurd results in certain circumstances.

## I. MARKET EVIDENCE IN VALUING SECURITIES

Professor Fischel's basic thesis, that courts do not give sufficient weight to market value in appraisal cases, is quite persuasive. Courts frequently express a cavalier attitude, if not disdain, for using market data to establish valuation. The fact that courts take this view is especially puzzling because the very appraisal professionals to whom courts defer acknowledge that their job is to determine how the market would value a particular asset. Virtually every appraisal report invokes IRS Revenue Ruling 59-196, which defines fair market value as "the price at which the property would change hands between a will-

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1 Daniel R. Fischel, *Market Evidence in Corporate Law*, 69 U Chi L Rev 941 (2002).

2 Id at 941.

ing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[3] In light of this, Professor Fischel is right to question why courts are so quick to disregard evidence of what actual willing buyers and willing sellers are doing in the marketplace.

Courts instead engage in costly, time-consuming, and ultimately inconclusive valuation exercises, using such valuation metrics as forward and trailing multiples of price to earnings and revenues, book value and forecasted discounted cash flow models. Such metrics ostensibly enable the court to determine how the market "should" price an asset, without explaining why the market does not in fact attribute such value. For example, last spring, Harnischfeger Industries, Inc., a manufacturer of mining equipment, was close to emerging from bankruptcy under a reorganization plan that cancelled the outstanding stock and gave bondholders equity in place of their bonds.[4] Harnischfeger's emergence from bankruptcy was delayed for months by a challenge brought by equity holders who argued that the value of the ongoing Harnishfeger business exceeded the bondholders' claims. The bonds of Harnischfeger had consistently traded at approximately fifty cents on the dollar, which should have indicated that the value of the business was well below the face value of Harnischfeger's outstanding debt and that equity holders therefore had no legitimate claim to any payment in the reorganization. While there was no reason to believe that the market for these bonds was inefficient, the court nevertheless delayed confirmation of the plan, allowed wasteful discovery, and held a trial on the equity holders' frivolous claim.

Indeed, one does not have to be a fervent believer in the efficient market hypothesis to come to the conclusion that market prices are the best way to determine the value of an asset. Even if markets misprice assets for a sustained period of time, there is no reason to believe that valuation experts will do a better job. The market reflects the consensus of willing buyers and sellers, who risk their own capital based on their views of the value of a given security at a given time.

## II. PREMIUM AS A DEFENSE TO LIABILITY

Professor Fischel's Article goes beyond his stated thesis, however, when he applies that thesis to actual cases. In his critique of the Dela-

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3 Rev Rul 59-196, 1959-1 Cum Bul 56.

4 See *Harnischfeger Emerges from Bankruptcy, Changes Name*, Bus J 3 (July 12, 2001), available online at <http://milwaukee.bizjournals.com/Milwaukee/stories/2001/07/09/daily32.html> (visited Mar 31, 2002) (describing Harnischfeger's reorganization as Joy Global, Inc., and the issuance of Joy's common stock, senior notes, and cash to creditors with allowed claims).

ware Supreme Court's decisions in *Weinberger v UOP, Inc*[5] and *Smith v Van Gorkom*,[6] Professor Fischel does not merely question the Delaware Supreme Court's approach to valuation questions. Instead he uses the willing seller/willing buyer standard as the basis for a substantive doctrine that protects directors from liability in the context of corporate takeovers and minority squeezeouts so long as the takeover or squeezeout occurs at a premium to prevailing market prices. This theory, if adopted, would radically reshape the landscape of corporate law, redefine the meaning of fiduciary duty, and deprive shareholders of an asset that belongs to them.

In *Weinberger*, the Delaware Supreme Court upheld a challenge to a transaction in which Signal, the majority shareholder of UOP, agreed to buy out the public shareholders. The court concluded that the UOP directors had not fulfilled their duties to ensure that the minority shareholders had received a fair price. Professor Fischel argues that the fact that minority shareholders of UOP received a 50-percent premium for their shares should be dispositive in determining whether the directors had fulfilled their fiduciary duties.

Likewise, Professor Fischel argues that the court should have dismissed "summarily"[7] (which is to say, without taking evidence on the directors' conduct) the claim in *Van Gorkom*. In *Van Gorkom*, the court held that the directors had failed to inform themselves of the value of the company before agreeing to a merger. Professor Fischel criticizes the decision because the "directors acted properly in approving the merger based on the premium paid over the pre-existing market price."[8] Thus, Professor Fischel argues that the very fact that investors received a premium in the transactions at issue in *Weinberger* and *Van Gorkom* is sufficient reason to justify the transactions and absolve the directors of any wrongdoing.

To be sure, *Weinberger* and *Van Gorkom* seem like easy cases because the 50-percent premia that their shareholders received were large; one could argue that the size of a premium is probative evidence that shareholders are not harmed by the directors' conduct. But this is not what Professor Fischel argues. He focuses on the mere fact that the shareholders received premia for their shares, not on the significance inherent in the magnitude of such premia. But there is no way to distinguish as a matter of law between premia of 50 percent and 1 percent. Both are above the market value of the stock—where buyers and sellers are freely trading—and if that is the measure by which directors' conduct is adjudged, then there is no coherent way to

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5 457 A2d 701 (Del 1983).

6 488 A2d 858 (Del 1985).

7 Fischel, 69 U Chi L Rev at 952 (cited in note 1).

8 Id.

articulate a standard other than the sufficiency of *any* premium above market. Thus, under Professor Fischel's analysis, directors would be immune from liability as long as the shareholder received *any* premium,[9] because a minority shareholder should not be entitled to more than his shares are presently worth in the market place.

Professor Fischel rejects the notion that a shareholder is entitled to receive more than the market value of her shares as follows:

> No such entitlement can be derived from the willing buyer/willing seller standard, *which mandates the opposite result.* Minority status is just as much a characteristic of an investment as the firm's management or its business strategy, and is equally factored into the price the investor paid in the first place. No reason exists why some, but not all, of the economic components of an investment should be considered when setting its value.[10]

Later, in discussing *Van Gorkom*, Professor Fischel states:

> The most charitable interpretation is that the court chastised the directors for failing to consider the value of the company sold as a whole rather than focusing on the trading price of a single share. But, as discussed [in the passage quoted above], this distinction is specious and, in any event, the market price of shares also reflects the prospect that the company as a whole will be sold at a given price.[11]

But the fact that a shareholder's minority status is factored into the stock price should not exclusively govern how a director conducts herself in a sale of some or all of a company. The directors have been charged with the duty to manage the company for the benefit of the shareholders. When directors agree to a merger, they are in effect selling a collective asset of the shareholders, namely the potential difference in the value between the individual shares in the market place and, depending on the transaction, the minority block (which would not include a control premium)[12] or the company as a whole (which would include a control premium).[13]

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9 Professor Fischel's position is consistent with his previously expressed view that directors should have no duty to auction a company before agreeing to sell it. See Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv L Rev 1161, 1175–77 & n 40 (1981) (arguing that auctions, like other forms of management resistance, are wasteful and can have adverse consequences). However, his criticism of *Van Gorkom* and *Weinberger* goes even further. Not only do directors not have a duty to conduct an auction, but they also do not even have to negotiate. Once the directors have identified a bidder who is willing to pay a premium to the market, they have fulfilled their fiduciary duty.

10 See Fischel, 69 U Chi L Rev at 946 (cited in note 1) (emphasis added).

11 Id at 952–53.

12 See, for example, John C. Coates IV, *"Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions*, 147 U Pa L Rev 1251, 1273 (1999):

Directors should be expected to conduct themselves as if they were selling their own asset, in other words, to negotiate hard to get the best possible deal. Since a court is not equipped to value the asset and determine an appropriate premium, the best it can do is demand that the directors undertake the same process that any sensible businessperson would when selling a business: inform herself about the available options and negotiate aggressively. In this sense, the *Van Gorkom* and *Weinberger* courts quite appropriately inquired whether the directors had taken commercially reasonable steps to get a good deal for their constituents.

Professor Fischel's justification of his position, based on the fact that the market price of a stock factors in the discounted present value of a possible takeover into the stock price, is unpersuasive. In addition to the cash-generating and liquidation value of the assets, the market price reflects the probability-weighted takeover averages at which the company may be bought. Significantly, this includes the very real possibility that the company may not be purchased at all. As the takeover becomes more likely, however, the increased probability of the takeover should be reflected in the stock price. But since takeover negotiations typically are not public, the stock price very likely does not accurately reflect such probabilities and takeover prices at many points in time. Professor Fischel's thesis, therefore, proves too much. Under his theory, directors should never be liable for anything because director misconduct is factored into the stock price so shareholders are not hurt when the misconduct actually occurs.

Of course, the real question is not whether the willing buyer/willing seller standard mandates a rule that immunizes directors for approving any transaction with a premium. The real question is whether such a rule is desirable. The answer to that is clearly no. Immunizing directors in transactions in which shareholders receive a premium to the market price of a stock is troublesome because such a rule would distort share prices. This is true both for mergers, as was the case in *Van Gorkom*, and minority squeezeouts, as was the case in *Weinberger*.

To see how this distortion will occur, consider a public company that is controlled by a majority shareholder. The public shareholder has effectively written a call option to the majority owner, which allows the majority owner to buy the minority shares whenever it wants.

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[C]ontrol premiums exist in the financial markets and represent the empirical difference between (1) prices that buyers are willing to pay for stock that will give a buyer control of a corporation ("control shares") and (2) prices that buyers are willing to pay for stock that does not convey control of the corporation ("minority shares").

13 Even though minority shareholders are not ordinarily entitled to a control premium, the fact is that buyers are willing to pay a premium for large minority blocks.

If Professor Fischel's view were to prevail, the strike price for this option is (at the option holder's decision) anywhere above market price at the time of the exercise. This option has value, at the very least, because there is a possibility that the holder of the option has non-public information and would exercise the option opportunistically.[14] Given that the minority shareholder has effectively written this option to the majority shareholder, the market price of the minority shares includes a discount to the underlying value of the stock to reflect the short call that is embedded in the stock. However, since the call is struck at any premium above market value, the decrease in the market price of the stock will increase the value of the call. As Bebchuk and Kahan have shown persuasively, this phenomenon will cause the stock to spiral down to the lowest possible value.[15]

Likewise, in the context of a non-majority controlled company, the fact that the directors are immune from liability so long as they get any premium will reduce the likelihood that directors will seek the fullest premium. Simply put, there would be no downside in taking the first offer that a bidder makes. This in turn will reduce the market value of stocks, because share prices reflect the possibility of a takeover at a premium. This will then have the same spiraling effect as in the squeezeout case, as stock prices reflect the lowered incentives to seek the greatest premium.

## III. Absurd Consequences of the Premium Rule

Not only does a rule immunizing directors so long as a transaction receives a premium deprive shareholders of their rightful claim to a share of the premium on the sale of the company or a large block thereof, but such a rule could lead to absurd results. Consider the following examples based on the recent stock prices of some publicly traded companies.

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14 See Lucian Arye Bebchuk and Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, in Randall K. Morck, ed, *Concentrated Corporate Ownership* 247, 251 (Chicago 2000) ("A controlling shareholder will generally have private information about the value of the company that is not available to the public.").

15 See id at 251–52:

> [I]f the controlling shareholder has the power to freeze out the minority shareholders by paying them the prefreezeout market price, she will use that power strategically to effect a freezeout only if her private information indicates that the value of the minority shares is above their market price. This strategic use of the power . . . results in an adverse selection effect that causes the market price of minority shares to spiral downward [to the lowest possible market value].

A. Palm/3Com

In March 2000, 3Com Corporation sold 20 percent of its subsidiary Palm, Inc., in an initial public offering ("IPO") at a price of $38. The stock price rose dramatically during the initial day of trading, closing at approximately $95. In the registration statement for the IPO, 3Com stated its intention to distribute the balance of its stake in Palm to its shareholders in a tax-free spin-off shortly after the IPO. In the spin-off, each 3Com shareholder would receive approximately 1.5 shares of Palm per share of 3Com with no adverse tax or other consequences.[16] Simple multiplication yields the following: At the close of trading on the day of the Palm IPO, each shareholder of 3Com had approximately $142.50 worth of Palm stock embedded in each share of 3Com. Yet, the closing price of 3Com stock on that day was $81.81. Thus the market implied that the value of all 3Com's assets other than Palm was negative $60.69.

This situation should have presented an arbitrage opportunity in which an investor could have bought 3Com shares, sold short 1.5 Palm shares, and locked in a profit (upon distribution of the Palm shares) equal, at the very least, to the negative implied value of 3Com. Had this arbitrage been possible, in all likelihood the shares of Palm and 3Com would have converged so that 3Com would not have had an implied negative value. In fact this did not happen because it was very difficult to execute a short sale of Palm, as it was impossible to borrow Palm stock, a necessary prerequisite to a short sale. As a result, the negative value of 3Com's non-Palm assets persisted for months, not, as finance theory would assume, minutes.

Imagine that during the period that the implied value of 3Com's assets other than its Palm stock was negative, the board of directors of 3Com agreed to a merger at a price that was below the implied value of its Palm holdings ($142.50 plus any value associated with the 3Com assets) but above the then-prevailing 3Com price. Management would then be selling 3Com for a "premium," but for $60 less than the value of its Palm holdings (to say nothing of the value of the rest of its business)! Under Professor Fischel's view, the directors would be immune from challenge. Indeed, this would be true even if the board of directors agreed to *pay* management to take the business off their hands. Despite this absurd outcome, the case would be, to borrow Professor Fischel's term, a "no-brainer."

16 For news reports covering this transaction, see Marisa Torrieri, *3Com Still in Running Despite Palm's Jumpstart*, Wireless Data News (Mar 15, 2000); *3Com Launches Palm IPO*, Bus Wire (Mar 2, 2000); Scott Thurm, *Palm, Inc. Gets Ready for New Hands*, Wall St J B1 (Feb 28, 2000).

B. Terra ADR/Ordinary Shares

Likewise, in May 2000, as the Internet bubble was bursting, Terra Network S.A., a Spanish Internet company controlled by the Spanish telecom giant, Telefónica S.A., agreed to acquire Lycos, Inc., a U.S.-based Internet portal company.[17] Terra's shares trade both in Spain and the United States (in the form of American Depository Receipts, or ADRs). Both the ordinary shares and the ADRs represent identical claims on the assets of Terra. Under the agreement, shareholders of Lycos were to receive Terra stock, either in ordinary shares or ADRs, at the shareholders' election, in exchange for their Lycos shares.

Typically, Terra's ordinary shares and ADRs trade at very similar (currency-adjusted) prices. This makes sense because they represent identical claims to the same assets and ADRs can be exchanged into ordinary shares at the holders' election. If the share prices of the ADRs and ordinary shares deviate in value, there is an arbitrage opportunity, and the market should quickly bring the prices of the two securities back in line with each other.[18] For example, if the ordinary shares trade at a higher currency-adjusted value than the ADRs, an arbitrageur can buy the ADRs, sell short the ordinary shares, hedge the currency risk, convert the ADRs into ordinary shares, cover the short position with the converted shares, and lock in a riskless profit net of transaction costs. But after the Lycos merger was announced, this mechanism for maintaining parity between the ordinary shares and ADRs stopped functioning.

Typically when a merger is announced, the stock of the target trades at a discount to the value that the stockholders will receive at the close of the merger. This discount is generally a function of the time that it will take for the merger to close and the risk of the lost premium if it does not close. To capture this discount, or spread, in a stock for stock merger, arbitrageurs buy shares of the target of the merger and sell short an appropriate number of shares of the acquiring company, thereby locking in the discount or spread because the target shares will be converted into shares of the acquirer if the merger closes as anticipated.

In the wake of the announcement of the Terra/Lycos merger, the shares of Terra in the United States began to trade at an enormous (as

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17 For news reports discussing the Terra Network-Lycos transaction, see Kara Swisher, *Boom Town: Lycos Chief's New Strategy: Yankee, Go Abroad*, Wall St J B1 (May 22, 2000); William Lewis, *Terra Closes on Lycos Takeover*, Fin Times 1 (May 15, 2000).

18 Differences in share prices between related securities that trade in different market places do not always trade in line. For a fascinating discussion of this subject, see Kenneth A. Froot and Emil M. Dabora, *How Are Stock Prices Affected by the Location of Trade?*, 53 J Fin Econ 189, 190, 206–08 (1999) (discussing disparity in prices between shares of Siamese-twin corporation).

large as 30 percent) discount to the shares in Spain, even though the ADRs represented a claim to the same assets. What was the reason for this discount? As a result of the announcement of the merger, it became very difficult to borrow shares of Terra in Spain, so merger arbitrageurs who were buying Lycos and selling short Terra to capture the spread were short-selling the Terra ADRs, thereby driving down the price of Terra shares. Since it was impossible to short sell the Spanish shares, there was no arbitrage mechanism to bring the Terra shares back into line with the ADRs. Once the merger closed, the discount between the ADRs and ordinary shares disappeared.

To highlight the anomaly that would result under Professor Fischel's approach, imagine if Telefónica, the majority shareholder of Terra, had decided to freeze out the minority shares at a price in between the price of the U.S. shares and the Spanish shares. Under Professor Fischel's suggested rule, the U.S. shareholders would have lacked a legal claim against Telefónica, as they received a premium over the value of their shares. The Spanish holders, however, would have had a legal claim. This would seem to be an anomalous result, as the U.S. holders and Spanish holders are in a perfectly equivalent position.

## CONCLUSION

Professor Fischel correctly argues that courts should be more willing to consider market evidence in reaching decisions on valuation. But his argument is weaker when he expands that thesis to argue that market evidence should govern substantive rules of director liability. As I have tried to show, the rule he advocates would be disadvantageous to shareholders. Moreover, market evidence is sometimes inconclusive and can lead to absurd results. One could infer from the examples that I have cited that markets are not always efficient in the short run. Thus, Professor Fischel's suggestion that courts rely entirely on market evidence would gut the fiduciary duties of directors, distort stock prices, and could lead to absurd results in those situations where markets have not instantly assimilated all relevant information. Hence, Professor Fischel's rule should not be adopted by the courts of Delaware, or any other court.