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Article

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> I have been in dozens of board meetings in which acquisitions have been deliberated, often with the directors being instructed by high-priced investment bankers (are there any other kind?). Invariably, the bankers give the board a detailed assessment of the value of the company being purchased, with emphasis on why it is worth far more than its market price. In more than fifty years of board memberships, however, never have I heard the investment bankers (or management!) discuss the true value of what is being given. When a deal involved the issuance of the acquirer's stock, they simply used market value to measure the cost. They did this even though they would have argued that the acquirer's stock price was woefully inadequate—absolutely no indicator of its real value—had a takeover bid for the acquirer instead been the subject up for discussion.
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> . . . .
>
> I can't resist telling you a true story from long ago. We owned stock in a large well-run bank that for decades had been statutorily prevented from acquisitions. Eventually, the law was changed and our bank immediately began looking for possible purchases. Its managers—fine people and able bankers—not unexpectedly began to behave like teenage boys who had just discovered girls.[1]

INTRODUCTION

Acquisition transactions are often the most significant activity undertaken by corporations. News about large-scale acquisitions dominates the financial press and inspires extensive research by scholars on the causes and consequences of acquisitions. Not only are acquisitions heavily publicized and studied, but they are also heavily regulated by law.[2]

Despite the plethora of acquisitions, scholars and investors have long debated the true value of acquisition transactions. In an acquisition, the acquirer may significantly alter its business and the acquirer's shareholders' investment can fundamentally change.[3] "[A] bad deal—whether the failure is rooted in the

1. Letter from Warren Buffett, Chairman of the Bd., Berkshire Hathaway, Inc., to Berkshire Hathaway, Inc., S'holders (Feb. 26, 2010), *available at* http://www.berkshirehathaway.com/letters/2009ltr.pdf.

2. *See* DALE A. OESTERLE, THE LAW OF MERGERS AND ACQUISITIONS 1 (3d ed. 2005).

3. *E.g.,* OHIO REV. CODE ANN. § 1701.832(A)(2) (LexisNexis 2009) ("[A] change in corporate control accompanying a large accumulation of shares will very often result in a fundamental change in the ongoing business of the corporation and a concomitant fundamental change in the nature of the shareholders' investment in it."); *see also* Lucian A. Bebchuck & Ehud Kamar, *Bun-*

concept [i.e., the 'logic of the deal,' that is, the business justification for the proposed acquisition], the price, or the execution—is probably the fastest legal means of destroying [the company's value]."[4] Investors and the popular press often use well-known acquisition debacles, such as the combination of America Online and Time Warner, as a reference for the potential dangers of acquisitions.[5] More recently, the financial press has chronicled the troubles of Bank of America stemming from a string of questionable empire-building acquisitions, including the $4 billion acquisition of Countrywide that has saddled the bank with an estimated $30 billion in mortgage-related losses.[6]

The destruction of acquirer shareholder value is not just a theoretical possibility or the fallout from a few well-known debacles. Various empirical studies on the overall return to acquisitions find that they may lead to destruction of value, particularly for shareholders of the acquiring firm, who suffer significant losses.[7] For example, a recent study found that from 1998 to 2001, acquirer shareholders lost 12% for every dollar spent on acquisitions, for a total of $240 billion.[8] This loss far exceeded the loss of 1.6% per dollar spent, for a total of $7 billion, during the 1980's merger wave.[9]

Scholars have sought to empirically examine the roots of the acquirer overpayment problem, recognizing that acquisitions tend to highlight the inherent conflict of interest between

dling and Entrenchment, 123 HARV. L. REV. 1549, 1563–65 (2010) (discussing the different ways a company might change in a hypothetical merger).

4. Ken Smith, *The M&A Buck Stops at the Board*, MERGERS & ACQUISITIONS: DEALMAKER'S J., Apr. 2006, at 48, 49, *available at* 2006 WLNR 5570070.

5. *See* ROBERT F. BRUNER, DEALS FROM HELL: M&A LESSONS THAT RISE ABOVE THE ASHES 265–91 (2005) (providing a detailed description of the AOL-Time Warner transaction as "possibly the most notorious" deal from hell); Steven M. Davidoff, *A Slow Demise for a Deal from Hell*, N.Y. TIMES DEALBOOK (Apr. 29, 2009, 11:21 AM), http://dealbook.nytimes.com/2009/04/29/spins-splits-and-time-warners-deal-from-hell/ ("That the AOL-Time Warner deal was one of the worst, if not the worst, in history, is a sad truism for the markets and mergers and acquisitions classrooms everywhere.").

6. *E.g., Strife of Brian*, ECONOMIST, Sept. 17, 2011, at 77.

7. *See, e.g.*, Ulrike Malmendier & Geoffrey Tate, *Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction*, 89 J. FIN. ECON. 20, 34, 43 (2008); *see also infra* Part I.A.

8. Sara B. Moeller et al., *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave*, 60 J. FIN. 757, 757 (2005).

9. *Id.*

managers and shareholders in large public corporations.[10] Some of the reasons for the diminution in the acquiring firm's value include agency problems.[11] Studies have shown that, in many transactions, the acquirer's directors and management benefit significantly from the deal, whether it is through increased power, prestige, or compensation—including bonuses and/or stock options.[12] Studies have also found that managements' acquisition decisions can be affected by various behavioral biases such as management overconfidence about the value of the deal (i.e. the "hubris hypothesis"),[13] or managements' overestimation of and over-optimism regarding their ability to execute the deal successfully.[14]

Curiously, corporate law has been largely silent in the face of this evidence. Delaware courts[15] have described the merger

10. Beginning with Berle and Mean's seminal work, agency cost problems have long dominated debates in U.S. corporate law about the conflicts between shareholders and managers. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 4–5, 119–25 (1932); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

11. *See* BERLE & MEANS, *supra* note 10, at 122; Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323, 328 (1986).

12. *See infra* Part I.B.1. For more on such "empire building," see Christopher Avery et al., *Why Do Managers Undertake Acquisitions? An Analysis of Internal and External Rewards for Acquisitiveness*, 14 J.L. ECON. & ORG. 24, 24–28, 42 (1998); Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 627–28 (1989); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1167–69, 1224–29, 1269–80 (1984) [hereinafter Coffee, *Regulating*]; John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 29 (1986); Jensen, *supra* note 11.

13. *See* Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197, 212 (1986); *infra* Part I.B.2.

14. *See* RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 50–62 (1992); Black, *supra* note 12, at 601–05, 624; Richard H. Thaler, *Anomalies: The Winner's Curse*, 2 J. ECON. PERSP. 191, 193–201 (1988); Mark L. Sirower & Mark Golovcsenko, *Returns from the Merger Boom*, MERGERS & ACQUISITIONS: DEALMAKER'S J., Mar. 2004, at 34, *available at* 2004 WLNR 18181954.

15. Delaware is the leading state for U.S. corporate law, and has been recognized as the national leader for new and existing companies. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 6–8 (1993). Over 50 percent of U.S. publicly listed firms and 63 percent of the Fortune 500 are incorporated in Delaware. DEL. DIV. OF CORP., http://corp.delaware.gov/ (last visited Oct. 14, 2011). Most acquisition agreements are governed by Delaware law. *See* Albert H. Choi & George G. Triantis, *Strategic Vagueness in Contract De-*

provisions of Delaware corporate law as "expressly provid[ing] for a balance of power between boards and stockholders which makes merger transactions a shared enterprise and ownership decision."[16] In reality, however, there is little balance between the power of the acquirer's board and its shareholders.[17] Unlike robust judicial doctrines and statutory protections enjoyed by shareholders of selling firms, shareholders of acquiring firms are largely ignored. Under Delaware law and jurisprudence, acquirer shareholders are often excluded from any decision-making role in acquisitions and are equally unable to seek any redress through the courts.[18] Acquirers' directors are not often the subject of shareholder litigation.[19] If they are, these are of-

sign: The Case of Corporate Acquisitions, 119 YALE L.J. 848, 866 (2010); Matthew Cain & Steven M. Davidoff, Delaware's Competitive Reach 4 (Aug. 18, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1431625. Moreover, the Delaware courts are widely recognized as having an experienced and sophisticated judiciary along with well-developed corporate case law. *See* Cain & Davidoff, *supra*, at 2–3.

16. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 930 (Del. 2003).

17. The decision to acquire another business rests squarely within the province of the board, and shareholders cannot initiate an acquisition without the board first approving such a transaction. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(c) (Supp. 2010) (requiring that the board propose mergers for shareholder approval). Furthermore, in many such transactions, acquirer shareholders are expressly excluded from this acquisition decision. *See* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 9.1 (3d ed. Supp. 2009) (explaining the requirement of shareholder votes for corporations constituent to the merger); *id.* § 9.5; *infra* Part II.A. For example, transaction planners often use the triangular merger structure, in part, to deprive acquirer shareholders from a right to vote on the transaction. THERESE H. MAYNARD, MERGERS AND ACQUISITIONS 92–95 (2d ed. 2009); *see also* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 613–14 & nn.5–7 (2d ed. 2003) (explaining the potential benefits of triangular mergers).

18. In general, voting rights for acquirer shareholders of Delaware corporations only seem to arise due to stock exchange rules which require voting when a public company listed on the New York Stock Exchange or the NASDAQ Stock Market is issuing more than 20 percent of its outstanding shares. *See* NASDAQ, NASDAQ STOCK MARKET RULE 5635(a)(1)(B) (2011), *available at* http://nasdaq.cchwallstreet.com/ (follow "Rule 5000" hyperlink; then follow "5600. Corporate Governance Requirements" hyperlink; then scroll down to Rule 5635); NYSE, LISTED COMPANY MANUAL § 312.03(c)–(d) (2011), *available at* http://nysemanual.nyse.com/lcm/ (follow "Section 303A.00" hyperlink). The voting requirements under both the NYSE and NASDAQ rules do not require a vote of a majority of the outstanding shares. *See* NASDAQ, *supra*, R. 5635(e) (requiring a majority of votes cast on a particular proposal); *id*. R. 5620(c) (requiring at least one-third of all voting shares to be present for purposes of a quorum); NYSE, *supra*, § 312.07 (requiring a majority of the voting shares for approval, so long as over 50 percent of the voting shares participate in the vote).

19. *See infra* Part II.B.2.

ten derivative claims, which tend to be unsuccessful and dismissed for lack of particularized evidence of fiduciary duty breaches.

Evidence of acquirer overpayment, together with the relative silence of corporate law, suggests a problem in need of careful inquiry by legal scholars. Nevertheless, while scholars have long agonized over the impact of acquisition transactions on shareholders of the seller and the fiduciary obligations and role of the board of directors of the selling company in an M&A transaction,[20] commentary on the effect of acquisitions on acquirers has been somewhat sparse.

This is not to say that scholars have fully ignored the acquirer overpayment problem or the agency costs and behavioral biases that can lead to overpayment.[21] Several prominent legal scholars have suggested potential reforms to address corporate law's shortcomings in responding to the acquirer overpayment problem. In the 1980s Professors John C. Coffee and Bernard S. Black each suggested exploring the possibility of providing acquirer shareholders with voting rights.[22] Other scholars, such as Professor James A. Fanto, have suggested a greater role for

20. The extensive debate regarding sellers and seller boards is in part due to the Delaware Supreme Court's landmark decision in *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009). In *Van Gorkom*, the court held that a director's fiduciary duty of care extends to her review and approval of merger agreements. *Id.* (explaining that the seller board's duty of care in the context of a merger transaction required that it "act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders"). The court's decision has been heavily criticized by some scholars. *See, e.g.*, Daniel R. Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1455 (1985) (referring to the case as "one of the worst decisions in the history of corporate law"); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1, 1 (1985) ("The Delaware Supreme Court in *Van Gorkom* exploded a bomb. . . . [Moreover, the] corporate bar generally views the decision as atrocious."). *But see* Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U. L. REV. 675, 687–93 (2002) (defending *Van Gorkom* on the grounds that the imposition of nominal costs on directors to inform themselves before acting promotes altruistic behavior to the benefit of shareholders).

21. *See, e.g.*, George W. Dent, Jr., *Unprofitable Mergers: Toward a Market-Based Legal Response*, 80 NW. U. L. REV. 777, 784 (1986); Miriam P. Hechler, *Towards a More Balanced Treatment of Bidder and Target Shareholders*, 1997 COLUM. BUS. L. REV. 319, 348–68.

22. Black, *supra* note 12, at 652; Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 561 (2002); Coffee, *Regulating*, *supra* note 12, 1269–72.

independent directors.[23] In addition, both Professors Fanto and Lawrence A. Hamermesh, have argued for greater judicial scrutiny of acquirer boards in large value-destroying acquisitions.[24] Professor Hamermesh, for example, has argued that "the acquirer's directors' decisions should be at least as, if not more, suspect and deserving of judicial inquiry as the decisions of the target directors."[25]

While these potential solutions are worthy of greater discussion, Professor Donald C. Langevoort notes, "[t]hose familiar with corporate law will know that none of these is much of a check on value-destruction."[26] There are several problems with these proposed solutions in that none deal with the causes of the acquirer overpayment problem. Some of these proposed solutions are simply ex-post solutions that potentially treat value-enhancing and value-destroying transactions alike and are expensive to implement. None directly addresses the agency cost problems that arise from asymmetric information between management and shareholders. Furthermore, none of the proposed solutions adequately provides a mechanism for management to internalize the cost of their own biases.

This Article proposes a novel solution to alter the stark imbalances in power between managers and shareholders of acquiring firms: a shareholders' put option.[27] A put option provides its owner, here the shareholders, the right to sell stock at a specified exercise price on a specified exercise date.[28] This Article proposes that in "fundamental" acquisitions,[29] the acquirer

23. *E.g.,* James A. Fanto, *Braking the Merger Momentum: Reforming Corporate Law Governing Mega-Mergers*, 49 BUFF. L. REV. 249, 341–44 (2001) [hereinafter Fanto, *Braking the Merger Momentum*].

24. *See id.* at 347; Lawrence A. Hamermesh, *Premiums in Stock-For-Stock Mergers and Some Consequences in the Law of Director Fiduciary Duties*, 152 U. PA. L. REV. 881, 900–11 (2003). *But see* Ryan Houseal, Note, *Beyond the Business Judgment Rule: Protecting Bidder Firm Shareholders from Value-Reducing Acquisitions*, 37 U. MICH. J.L. REFORM 193, 223–36 (2003) (arguing that business judgment rule adequately protects bidder shareholders).

25. Hamermesh, *supra* note 24, at 909.

26. Donald C. Langevoort, *The Behavioral Economics of Mergers and Acquisitions*, 12 TRANSACTIONS: TENN. J. BUS. L. 65, 75 (2011) [hereinafter Langevoort, *Behavioral Economics of M&A*].

27. For a detailed description of the shareholders' put option, see *infra* Part IV.A.

28. *See* Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 544 (8th ed. 2006); *see also* Ronald C. Lease et al., Dividend Policy: Its Impact on Firm Value 159–60 (2000).

29. For a more detailed discussion of fundamental transactions, see *infra* Part IV.A.

sell to its own shareholders a limited put option granting them the right to sell their shares back to the acquirer at a market-determined pre-acquisition announcement price. The mechanics of the shareholders' put option would work similarly to an already utilized mechanism, an issuer put option used in connection with repurchase programs.[30] More importantly, exercising the put option would only be attractive to shareholders if they believed that the acquisition transaction was value-destroying so that after the acquisition the acquiring firm's shares would be worth less than the pre-acquisition announcement price.

A shareholders' put option seeks to address head-on the underlying causes of the acquirer overpayment problem. First, the market pricing and shareholder direct participation contemplated by this proposal offer a referendum and monetary mechanism through which acquirer shareholders can participate in acquisition decisions. Second, this proposal provides a market-oriented incentive and a process through which acquirer boards can meaningfully consider the decision to acquire another firm and properly value the consideration being used in such acquisitions. Offering the put option would require greater acquirer board involvement in acquisitions and enhanced disclosure to acquirer shareholders so that they could accurately determine whether they should purchase and exercise the put option. Moreover, the shareholders' put option would provide a mechanism through which boards can demonstrate to the firm's shareholders the board's confidence in its acquisition plan. Third, if it is exercised, a shareholders' put option provides a mechanism through which the acquirer's management would be forced to internalize the costs of a value-destroying acquisition. If successfully used, a shareholders' put option may be an optimal way to alter the balance of power in acquisition transactions to address and lessen the risk of the destruction of value suffered by acquirer shareholders.

This Article proceeds as follows. Part I offers a summary of empirical literature on the harms suffered by acquirers as a result of acquisition transactions. After examining the literature on overpayment, Part I describes various studies that suggest that agency problems and behavioral biases lead to the acquirer overpayment problem.

30. For a more detailed discussion of the mechanics of the shareholders' put option, see *infra* Part IV.D.

Part II then summarizes the statutory and doctrinal treatment of shareholders of the acquirer. Part II.A examines the statutory treatment of acquirer shareholders to show that they are generally given a minimal role in acquisition transactions and must rely on the processes undertaken by the board. Part II.B then examines the doctrinal treatment of acquirer board decisions and the lack of meaningful review by courts of acquisition decisions.

Part III surveys proposed solutions—voting rights for acquirer shareholders, greater independent director control of acquisition transactions, and increased judicial scrutiny—to the acquirer overpayment problem. Part III discusses the benefits and shortcomings of each of these mechanisms.

Part IV then turns to the shareholders' put option—first by describing the design of the put option and then exploring benefits of the proposal. In addition, this Part examines the incentives for boards and shareholders to adopt the shareholders' put option, as well as the regulatory issues raised by the proposal. Part IV concludes by addressing several potential objections to the shareholders' put option proposal.

I. THE IMPACT OF ACQUISITIONS ON ACQUIRER SHAREHOLDERS

Acquisition transactions are often the most significant activity undertaken by corporations. Despite the continuing plethora of acquisition transactions, numerous empirical studies suggest that acquisitions, particularly large-scale transactions involving public companies, result in significant losses for acquiring firms and their shareholders. Section A below summarizes results from both classic empirical studies of returns from acquisition transactions as well as several important recent studies addressing the shareholder wealth effects of more recent transactions. Sections B and C then examine the two lines of literature which seek to explain why acquirer shareholders lose in certain transactions. Finance scholars have attributed these losses to managerial agency costs (such as personal benefits in the form of increased compensation for management) and behavioral biases (such as ego and hubris) of boards and management.

A. A SURVEY OF THE EMPIRICAL LITERATURE: EVIDENCE OF OVERPAYMENT

Finance scholars have extensively researched the effects of mergers and acquisitions (M&A) on shareholder wealth. There has generally been little argument that acquisition transactions provide value for the acquired companies' shareholders. In her unequivocal defense of takeovers, Professor Roberta Romano noted based on early studies of deals from the 1970s and 1980s that "[o]ne important, and undisputed, datum about acquisitive transactions should be noted from the outset: acquisitions generate substantial gains to target company shareholders."[31] Recent empirical literature on returns from takeovers confirm these early studies.[32] Targets continue to receive substantial premiums in acquisition transactions, in particular when the acquirer is a public company.[33]

Whether shareholders of acquirers gain from acquisitions, however, is debatable, with results from numerous studies finding much more complexity than with respect to target shareholders. Scholars continue to generate extensive empirical research on the effects of acquisitions on acquirer shareholders and on how the interests of acquirer management affect these transactions. While several early studies reported that acquirer shareholders benefit from acquisitions, others reported losses. A significant body of more recent finance literature finds evidence that many, although clearly not all, acquisitions destroy value for long-term acquirer shareholders.[34] This is particularly

31. Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. ON REG. 119, 122 (1992) ("All studies find that target firms experience statistically significant positive stock price responses to the announcement of takeover attempts or merger agreements."). Professor Romano cited as support several important finance studies. *See* Gregg A. Jarrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49 (1988); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

32. For a comprehensive overview of studies on acquisition transactions, see generally Sandra Betton et al., *Corporate Takeovers*, *in* 2 HANDBOOK OF CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 291 (B. Espen Eckbo ed., 2008).

33. *Id.* at 407 tbl.15.

34. *See* Gregor Andrade et al., *New Evidence and Perspectives on Mergers*, J. ECON. PERSP., Spring 2001, at 103, 110–11; Tim Loughran & Anand M. Vijh, *Do Long-Term Shareholders Benefit from Corporate Acquisitions?* 52 J. FIN. 1765, 1773–89 (1997); Sara B. Moeller et al., *Firm Size and the Gains from Acquisitions*, 73 J. FIN. ECON. 201, 202, 226 (2004); Moeller et al., *supra* note 8, at 781; Gunther Tichy, *What Do We Know About Success and Failure of Mergers?*, 1 J. INDUSTRY, COMPETITION & TRADE 347, 366–68 (2001). Some

true in the case of takeovers of publicly traded targets by publicly traded acquirers.[35]

1. The Early Literature on Acquirer Overpayment

In a 1989 paper on acquirer overpayment, Professor Black provided a summary of several early finance studies regarding shareholder returns from takeovers.[36] Using the cumulative abnormal returns methodology, these early studies showed significant returns to shareholders of the acquired company.[37] Professor Black noted that while the evidence of returns to targets was uniformly positive, the evidence of returns to acquirer

scholars argue that acquisition activity is driven by overvalued stock and that acquisitions by acquirers with overvalued stock can benefit the acquirer's shareholders in the long run, as long as the target firm's stock is less overvalued. Andrei Shleifer & Robert W. Vishny, *Stock Market Driven Acquisitions*, 70 J. FIN. ECON. 295, 301–02 (2003). Other scholars posit that "the premium paid and negative operating synergies typically make deals by overvalued acquirers considerably less attractive for long-term acquirer shareholders." Fangjian Fu et al., Acquisitions Driven by Stock Overvaluation: Are They Good Deals? 5 (Feb. 22, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1328115. These same scholars suggest that acquirer shareholders "would possibly be better off if an overvalued firm does not pursue an acquisition." *Id.* at 6; *see also* Feng Gu & Baruch Lev, Overpriced Shares, Ill-Advised Acquisitions, and Goodwill Impairment 2, 36 (Aug. 26, 2008) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1130940.

35. *See, e.g.*, Jensen & Ruback, *supra* note 31; Moeller et al., *supra* note 8, at 771–72. There is some evidence that acquisition of nonpublic targets result in positive returns for shareholders of acquirers. *See* Micah S. Officer et al., *Target-Firm Information Asymmetry and Acquirer Returns*, 13 REV. FIN. 467 (2009).

36. *See* Black, *supra* note 12, at 601–04. These finance studies consisted primarily of "event studies" which measure the effect of an acquisition on shareholder wealth by looking at the transaction parties' stock price in the days or weeks preceding and following the announcement and completion of the transaction in question. *See id.* at 601–02, 604. The amount of time before and after the transaction announcement (commonly referred to as a "window") is used for computing shareholder returns. *See id.* at 601. Several earlier papers also addressed losses by acquirer shareholders. Peter H. Malatesta, *The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155, 155–56 (1983); Roll, *supra* note 13, at 198. *But see* Jensen & Ruback, *supra* note 31, at 5 ("[E]vidence indicates . . . that bidding firm shareholders do not lose.").

37. *See* Black, *supra* note 12, at 601 (noting that early studies showed returns in the 30 to 35% range for target shareholders in the case of tender offers and around 20% in the case of mergers). Cumulative abnormal returns methodology measures stock performance relative to the market as a whole over a "window" period around the announcement date of a transaction. *Id.*

shareholders was "more complex."[38] In early studies of returns from acquisitions of public companies in the 1970s and 1980s, acquirer shareholders experienced losses when studies used a narrow window of one to four days around the transaction announcement date.[39] In many of these studies, the abnormal returns were significant.[40] When researchers looked at a wider window of eleven to forty-one days around the announcement date, the studies, while reporting negative acquirer returns, generally did not report statistically significant abnormal results.[41] Based on these finance studies, Professor Black summarized that, at least with respect to results from finance studies, "since 1975, takeover bidders have earned at best a zero, and perhaps a slightly negative, net-of-market return."[42]

In addition to finance studies, other studies of post-acquisition experiences of acquirers have shed doubt on synergy gains from mergers. In an important 1984 article, Professor Coffee noted that such studies "have typically found that the expected synergy seldom materializes in the form of higher profits."[43] Professor Black also cited some later longitudinal studies of acquirer's post acquisition performance, which also found that acquisitions did not produce the expected gains following completion of the transaction.[44] Although, as noted by

38. Professor Romano somewhat discounts the studies finding negative returns to bidder shareholders, arguing that

> [t]here are . . . theoretically plausible reasons for not finding positive abnormal returns to bidders even when acquisitions are value-maximizing transactions. First, acquiring firms are typically much larger than target firms, making it more difficult to measure abnormal returns. Second, a bid may reveal information about the bidding firm unrelated to the particular acquisition confounding the stock price effect. Third, if the takeover market is competitive then bidders will earn only normal returns, as abnormal profits are competed away.

Romano, *supra* note 31, at 123–24.

39. *See* Black, *supra* note 12, at 602–03.

40. *Id.* at 602. A statistically significant abnormal return represents the market's valuation of the event (its impact on shareholder wealth). *Id.* For a review of the methodology, see generally Stephen J. Brown & Jerold B. Warner, *Using Daily Stock Returns: The Case of Event Studies*, 14 J. FIN. ECON. 3 (1985).

41. Black, *supra* note 12, at 602.

42. *Id.*

43. Coffee, *Regulating*, *supra* note 12, at 1166.

44. Black, *supra* note 12, at 605–06; *see also* Richard E. Caves, *Effects of Mergers and Acquisitions on the Economy: An Industrial Organization Perspective*, *in* THE MERGER BOOM 149, 150 (Lynn E. Browne & Eric S. Rosengren eds., 1987); Richard E. Caves, *Mergers, Takeovers, and Economic*

Professor Black, some of this accounting data has been "criticized as a noisy and potentially misleading measure of profitability."[45]

Despite the somewhat equivocal findings of early studies, the popular wisdom has been that while targets gain from acquisition transactions, acquirers lose value.[46] Much of this is driven by stories of classic "deals from hell" such as Time Warner's merger with AOL,[47] as well as several well-known studies of posttransaction performance from the late 1990s. For example, a 1999 study of the top 700 cross border acquisition transactions between 1996 and 1998 found that "only 17% of deals had added value to the combined company, 30% produced no discernible difference, and as many as 53% actually destroyed value. In other words, 83% of mergers were unsuccessful in producing any business benefit as regards shareholder value."[48] An influential McKinsey & Company study found that 81% of acquisitions were failures because they did not earn a sufficient return on the funds invested.[49]

Efficiency, 7 INT'L J. IND. ORG. 151, 167 (1989). For further discussion of accounting studies, see generally Edward S. Herman & Louis Lowenstein, *The Efficiency Effects of Hostile Takeovers*, *in* KNIGHTS, RAIDERS AND TARGETS 211 (John C. Coffee, Jr. et al. eds., 1988).

45. Black, *supra* note 12, at 605.

46. *See* STEVEN M. DAVIDOFF, GODS AT WAR: SHOTGUN TAKEOVERS, GOVERNMENT BY DEAL, AND THE PRIVATE EQUITY IMPLOSION 229–30 (2009); Robert G. Eccles et al., *Are You Paying Too Much for That Acquisition?*, HARV. BUS. REV., July–Aug. 1999, at 136, 136 ("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, every year."); 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.").

47. *See* BRUNER, *supra* note 5, at 265–91 (describing the Time Warner-AOL merger).

48. KPMG, UNLOCKING SHAREHOLDER VALUE: THE KEYS TO SUCCESS 2 (1999); *see also The Case Against Mergers*, BUSINESSWEEK, Oct. 30, 1995, at 122, 124–25 (providing similar statistics and stating that "most transactions fall below expectations").

49. TIM KOLLER ET AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES 114–15 (4th ed. 2005) (finding in a study of 501 acquisitions in Europe and the United States, only 276 showed statistically significant reactions in price, and of those statistically significant, half decreased in value in the ten day window around the transaction announcement).

2. Recent Studies of Acquirer Overpayment

Several recent finance studies have built on these classic studies from the 1970s and 1980s to shed further light on the acquirer overpayment problem.[50] These more recent studies somewhat confirm the argument that mega-mergers may be "bad investments for most of the companies involved in them and thus value-decreasing transactions for the shareholders of the surviving firm . . . ."[51]

In a recent surveys of the empirical literature on takeover bids for U.S. targets from 1980 to 2005, the authors summarize sixteen relatively recent large-sample studies of acquirer returns.[52] The authors' conclusion from their sample evidence on the effect of acquisitions on acquirer shareholders is as follows: acquirer announcement-period cumulative average abnormal stock returns are close to zero for the overall sample of studies, with 49% of the acquirers having negative cumulative abnormal stock returns.[53] For acquirer shareholders, the combination of a large acquirer paying all-stock, and the target being a public company represents a "worst-case scenario" with average acquirer announcement-period cumulative abnormal returns of a significant loss of 2.21%.[54] The study finds that while acquirer announcement returns tend to be positive and significant when the acquirer is small and the target is a private firm, these returns are negative for large acquirers bidding for public targets.[55]

A recent empirical study by Professors Sara B. Moeller, Frederik P. Schlingemann, and René M. Stulz demonstrates the extent of acquirer shareholders losses. The study of 9841 transactions from 1991 to 2001 finds that acquirer shareholders lost an aggregate of $216 billion, more than fifty times the

50. For a comprehensive overview of finance studies on acquisition transactions, see generally Betton et al., *supra* note 32, *passim*.

51. Fanto, *Braking the Merger Momentum*, *supra* note 23, at 256.

52. The findings from these studies contrast with the neoclassical theory of merger and acquisitions, which asserts that the acquirer's profit motive will drive the ownership of assets to their highest value use and that because of this motivation, the acquirer's shareholders will benefit from such transactions. *See* Gráinne Collins, *The Economic Case for Mergers: Old, New, Borrowed, and Blue*, 37 J. ECON. ISSUES 987, 988 (2003). For a comprehensive discussion of the value-maximizing efficiency explanations of acquisitions, see Romano, *supra* note 31, at 125–29.

53. Betton et al., *supra* note 32, at 407 tbl.15.

54. *See id.*

55. *Id.*

$4 billion that they lost during the merger wave of the 1980s, even though acquirers spent only about six times as much on acquisitions during the 1990s.[56] Furthermore, the study found that acquirer shareholders lost 12% for every dollar spent, for a total of $240 billion, on acquisitions from 4136 transactions from 1998 to 2001, a loss that far exceeded the losses of the merger wave of the 1980s that resulted in a loss of 1.6% for every dollar spent.[57] These losses were due primarily to acquirer overpayment in large acquisitions involving public companies.[58] With respect to these large-loss deals, the study found that these significant losses cannot be explained by industry or market returns or unrelated announcements.[59] Moreover, the study suggests that losses were not just a redistribution of wealth from acquirer shareholders to target shareholders, but a destruction of aggregate wealth.[60]

Other studies support the notion that firm size matters in acquisition returns. For example, a study of 12,023 acquisitions by public companies from 1980 to 2001 finds that the equally weighted abnormal-announcement return is 1.1%, but acquirer shareholders lose $25.2 million on average upon announcement.[61] The study also finds that the announcement return for acquirer shareholders is roughly two percentage points higher for small acquirers irrespective of the form of financing and whether the target entity is public or private.[62] The study thus suggests that "[l]arge firms make large acquisitions that result in large-dollar losses."[63] In fact, the study provides evidence that managers of large firms pay more for acquisitions, and that premiums paid to targets increase with firm size, even after controlling for firm and deal characteristics.[64]

The above studies grapple with the difficulty of empirically assessing whether acquisitions destroy or create value for acquirer shareholders. The concern is that using the announcement effect as a proxy for the impact of the transaction "may underestimate the value creation of a merger due to price pres-

56. Moeller et al., *supra* note 8, at 758.
57. *Id.* at 757.
58. *See id.* at 759.
59. *Id.* at 768.
60. *Id.* at 769–70.
61. Moeller et al., *supra* note 34, at 202.
62. *Id.* at 201.
63. *Id.* at 202.
64. *Id.* at 220.

sure around mergers."[65] In addition, measuring the long-term returns to acquisitions can be difficult: "it is hard to measure what portion of the returns can be attributed to a merger decision rather than other corporate events or market movements."[66]

B. Why Do Some Acquirers Overpay?

1. Agency Costs and Acquirer Overpayment

There are a number of theories explaining value-destroying acquisitions from an agency cost perspective. In other words, these theories focus on understanding the acquirer overpayment problem by looking at divergent shareholder-manager incentives in acquisition transactions, and the difficulties that shareholders, as the principals, have in effectively monitoring management.

Scholars have explored the hypothesis that acquisition transactions intensify conflicts of interest between managers and shareholders in public corporations, and provide ample opportunity for managers to achieve personal gains at the expense of shareholders.[67] Several legal scholars have examined

65. Ulrike Malmendier et al., Winning by Losing: Evidence on Overbidding in Mergers 2 (Mar. 15, 2011) (unpublished manuscript) *available at* http://ssrn.com/abstract=1787409.

66. *Id.* To address this empirical difficulty, Professors Malmendier, Moretti, and Peters construct a data set of all acquisition transactions with overlapping bids between 1983 and 2009. *Id.* They argue that bidding contests where at least two acquirers have a chance of acquiring the target "help to address the identification issue: the post-merger performance of the loser allows [it] to calculate the counterfactual performance [of] the winner without the merger." *Id.* at 1. The study finds that while the stock returns of the two bidders did not differ prior to the bidding contest, after the acquisition, the winners—i.e. the ultimate acquirer—underperform losers over a three-year horizon, although the effect is not significant. *Id.* at 3. The study also looks at a subsample of deals where at least two bidders have a significant chance at winning. With respect to this subset, the authors find that for long-lasting bid contests where "either bidder was ex ante likely to win the contest, losers outperform winners, while the opposite is true in cases with a predictable winner." *Id.* at 1.

67. This argument is in line with "literature on the economies of the firm [which] has long argued that managements seek to maximize growth even when it is contrary to the shareholders' best interests." Coffee, *Regulating*, *supra* note 12, at 1157. Professor Coffee cites as support seminal pieces in theories of the firm by scholars such as William Baumol, John Kenneth Galbraith, Oliver Williamson, Robin Marris, and Harvey Leibenstein. *Id.* Together, these works set forth a model that demonstrates "(1) a tendency for growth maximization to be preferred by managers over profit maximization, (2) substantial opportunities for managerial discretion, including the discretion to consume perquisites, (3) a desire to expand staff, and (4) a failure to pursue cost mini-

the agency costs line of literature with respect to acquirer overpayment. In a 1984 article, Professor Coffee explored the early empirical data suggesting that "the most important conflict of interests in corporate control contests may be on the bidder's side of the transaction—between the interests of the bidder's management and those of its own shareholders."[68] Relying on this literature, Professor Black noted:

> [M]anagers may want to increase the size of their firms and to diversify, even if this reduces the return on the shareholders' investment . . . .
>
> Incentives to increase size include . . . managers' desire for greater prestige and visibility, the desire of the chief executive officer to leave a legacy and not be a mere caretaker, and compensation structures that reward growth in sales and profits.[69]

In an article addressing mega-mergers, Professor Fanto reviewed the significant literature that established that merged companies generally underperform the market with respect to their industry benchmark, while executives received significant and disproportionate advantages as a result of these transactions, such as cash and stock bonuses for completing acquisitions and/or generous "golden handshakes."[70]

Numerous finance studies have empirically explored whether acquisitions and acquirer overpayment can be explained by managers' incentives to grow their firm in order to either increase the resources under their control (i.e., empire-building), or to derive personal benefit, such as increased compensation. In a now-classic article, Michael Jensen set forth a free cash flow hypothesis that can be summarized as arguing that "managers realize large personal gains from empire building and predicted that firms with abundant cash flows but few profitable investment opportunities are more likely to make value-destroying acquisitions than to return the excess cash flows to shareholders."[71] Other scholars have identified several types of acquisitions (including diversifying acquisitions and acquisitions of high-growth targets) that can yield substantial benefits to managers, while harming shareholders.[72]

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mization strategies, except in times of severe financial constraint." *Id*. at 1157 n.24.

68. *Id.* at 1168.

69. Black, *supra* note 12, at 627.

70. *See* Fanto, *Braking the Merger Momentum*, *supra* note 23, at 251–57.

71. Ronald W. Masulis et al., *Corporate Governance and Acquirer Returns*, 62 J. FIN. 1851, 1852 (2007).

72. Randall Morck et al., *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 31–32 (1990).

More recently, several studies explore the agency problems that can lead to acquirer overpayment. In a study of completed cash-only deals from 1990 to 2005 consisting of 407 deals by private acquirers and 885 deals by public company acquirers, the authors show that public acquirers pay significantly higher premiums than private acquirers.[73] In investigating this difference, the study finds evidence that is consistent with earlier arguments that managers may gain from acquisitions that do not benefit shareholders and thus may be willing to offer targets greater premiums than would shareholders.[74] The study finds that the premium difference is highest when private acquisitions are compared to acquisitions by public firms with low managerial ownership.[75]

An important recent study by Professors Jarrad Harford & Kai Li finds that CEOs benefit personally from making acquisitions even when such acquisitions have poor outcomes for shareholders.[76] The authors posit that acquisitions provide the board and the CEO a "natural opportunity" to increase the CEO's compensation since the increase in firm size and operations allows "the CEO to argue for more pay and for pay that is less sensitive to performance for the first few years of the acquisition."[77]

Harford and Li suggest that not only do acquisitions provide a natural juncture for compensation renegotiation and in-

73. *See* Leonce Bargeron et al., *Why Do Private Acquirers Pay So Little Compared to Public Acquirers?* 1–2 (Fisher Coll. of Bus., Working Paper No. 2007-03-011; ECGI–Fin., Working Paper No. 171/2007; Charles A. Dice Ctr., Working Paper No. 2007-8, 2007), *available at* http://ssrn.com/abstract=980066.

74. *See id.* at 3.

75. *See id.* at 23 ("[D]ifferences in managerial ownership between the different types of acquirers can explain why target shareholders prefer to be acquired by public bidders.").

76. Jarrad Harford & Kai Li, *Decoupling CEO Wealth and Firm Performance: The Case of Acquiring CEOs*, 62 J. FIN. 917, 919 (2007); *see also* Yaniv Grinstein & Paul Hribar, *CEO Compensation and Incentives: Evidence from M&A Bonuses*, 73 J. FIN. ECON. 119, 121 (2004) (showing that CEOs who have more power to influence board decisions receive significantly larger M&A bonuses, but these bonuses are not related to deal performance); Eliezer M. Fich et al., CEO Deal-Making Activity, CEO Compensation and Firm Value 35 (Dec. 22, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1108593 (finding that executive compensation schemes often motivate CEOs to engage in deal-making activities and that total CEO compensation increases upon the completion of many large corporate transactions, including acquisitions, even when the deals are not expected to improve firm value).

77. Harford & Li, *supra* note 76, at 918.

crease, but because acquisitions generally follow a period of superior performance, the CEO has greater bargaining power vis-à-vis the board in connection with an acquisition.[78] Other studies have similarly found that acquirer CEOs "enjoy a considerable increase in their wealth after acquisitions," and in particular, CEOs in acquisitions using overvalued acquirer stock "experience the largest increase in wealth despite having the poorest acquisition performance."[79]

Scholars have not only documented the managerial agency costs that arise in acquisitions, but their studies also suggest that the specter of self-interest is stronger in acquisition transactions than in other transactions involving significant capital expenditures.[80] For example, in their study of CEO compensation following 1508 acquisitions completed between 1993 and 2000, Harford and Li find that even in mergers where the acquirer shareholders are worse off, the firm's CEOs are better off the vast majority of the time.[81] The study shows that acquirer CEOs are rewarded with substantial acquisition-related stock and option grants and that these grants "offset the negative effect of poor merged-firm stock performance on their pre-acquisition portfolio of own-firm stock and options."[82] Consequently, "CEO's pay and wealth are completely insensitive to poor post-acquisition performance, but CEO's wealth remains sensitive to good post-acquisition performance."[83] Harford and Li's study also demonstrates that firms with stronger boards "retain the sensitivity of their CEOs' compensation to poor performance following the acquisition."[84] Harford and Li's study suggests that both boards and CEOs treat investments and ac-

78. *Id.* at 919.

79. Fu et al., *supra* note 34, at 29.

80. Some scholars argue that there are fundamental differences between acquisitions and capital expenditures. For example, Gregor Andrade and Erik Stafford analyze industry patterns in acquisitions and internal investments and find them to be driven by different factors, concluding that they are not substitutes. *See* Gregor Andrade & Erik Stafford, *Investigating the Economic Role of Mergers*, 10 J. CORP. FIN. 1, 29 (2004).

81. *See* Harford & Li, *supra* note 76; *see also* Fu et al., *supra* note 34, at 28–29 ("CEOs . . . experience large increases in wealth despite the fact their acquisitions appear to destroy value for acquirer shareholders."). *But see* Sudip Datta et al., *Executive Compensation and Corporate Acquisition Decisions*, 56 J. FIN. 2299, 2334–35 (2001) (suggesting that governance mechanisms, such as executive stock options, that effectively align shareholder-manager incentives, lead to more profitable acquisition decisions).

82. Harford & Li, *supra* note 76.

83. *Id.*

84. *Id.*

quisitions differently.[85] In comparing their findings for CEO pay following acquisitions to CEO pay following substantial capital expenditures, Harford and Li find that, unlike acquisition transactions, CEOs are not necessarily rewarded in connection with capital expenditures and that compensation changes based on capital expenditures are "more sensitive to performance than those following acquisitions."[86]

Other scholars studying the impact of corporate governance mechanisms on the profitability of acquisitions have found that acquirers with more antitakeover provisions, and hence less discipline from the market for corporate control, experience significantly lower announcement period abnormal stock returns.[87] The authors of one such study thus argue that "managers at firms protected by more antitakeover provisions are less subject to the disciplinary power of the market for corporate control and thus are more likely to indulge in empire-building acquisitions that destroy shareholder value."[88]

2. Behavioral Accounts of Acquirer Overpayment

Numerous finance scholars have studied the role that non-economic forces, such as ego and hubris, play in corporate transactions.[89] Other scholars have also identified additional non-economic factors as potentially affecting overbidding by acquirers, such as the desire to win or sunk cost biases.[90] Other

85. *Id.*

86. *Id.* Andrade and Stafford's study also submits that external and internal expansion decisions are treated fundamentally differently by the firm. *See* Andrade & Stafford*, supra* note 80, at 16–29.

87. *See* Masulis et al., *supra* note 71, at 1853. Other studies show that firms with entrenched managers tend to acquire targets with low synergies. Jarrad Harford et al., *The Sources of Value Destruction in Acquisitions by Entrenched Managers*, J. FIN. ECON. (forthcoming 2012) (manuscript at 4), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1562247.

88. Masulis et al., *supra* note 71, at 1851.

89. *See, e.g.*, James D. Cox & Harry L. Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (1984); Claire A. Hill & Brett H. McDonnell, *Disney, Good Faith and Structural Bias*, 32 J. CORP. L. 833 (2007); Donald C. Langevoort, *Ego, Human Behavior, and Law*, 81 VA. L. REV. 853 (1995); Donald C. Langevoort, *Taming the Animal Spirits of the Stock Markets: A Behavioral Approach to Securities Regulation*, 97 NW. U. L. REV. 135 (2002); Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635 (2003).

90. *See, e.g.*, Vicki Bogan & David Just, *What Drives Merger Decision Making Behavior? Don't Seek, Don't Find, and Don't Change Your Mind*, 72 J. ECON. BEHAV. & ORG. 930, 932 (2009) (noting that confirmation bias, "a situation in which an individual attaches too much importance to information that

than the significant work done by Professor Fanto over a decade ago,[91] legal scholars have given "little attention . . . to integrating behavioral findings into mergers and acquisitions . . . law."[92] This is despite the fact that hubris and other cognitive biases have long been identified as leading factors in acquirer overpayment.[93]

In an early article on behavioral biases, economist Richard Roll hypothesized that managers engage in acquisitions in part due to hubris, preferring to leave cash flows within companies because they assume that they can better use the cash than shareholders.[94] Roll argued that managers suffering from hubris tend to be overly optimistic in their valuation of the target company and accordingly engage in value-destroying acquisitions.[95]

Mathew Hayward and Donald Hambrick examine hubris as a determinant of the size of premiums that CEOs will pay for acquisitions.[96] In their examination of 106 large acquisitions, Hayward and Hambrick find "losses in acquiring firms' shareholder wealth following an acquisition, and the greater the CEO hubris and acquisition premiums, the greater the

supports his views," impacts merger decisions); Deepak Malhotra, *The Desire to Win: The Effects of Competitive Arousal on Motivation and Behavior*, 111 ORG. BEHAV. & HUM. DECISION PROCESSES 139, 139 (2010) (examining "when and why potentially self-damaging competitive motivations and behaviors will emerge"); Deepak Malhotra et al., *When Winning is Everything*, HARV. BUS. REV., May 2008, at 78, 80 (identifying "three principal drivers of competitive arousal in business settings: rivalry, time pressure, and audience scrutiny").

91. *See* Fanto, *Braking the Merger Momentum*, *supra* note 23; James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L.J. 1333 (2001) [hereinafter Fanto, *Quasi-Rationality in Action*].

92. Langevoort, *Behavioral Economics of M&A*, *supra* note 26, at 68.

93. *See id.* at 70–71; *see also* BRUNER, *supra* note 5, at 80–84 (identifying cognitive biases such as optimism, and cognitive errors, such as inattention, ignorance of trends, and failures of coordination, as elements in M&A failures).

94. *See* Roll, *supra* note 13; *see also* Black, *supra* note 12, at 624 ("Managers who are successful in one business may be especially prone to overestimate their ability to run another business.").

95. *See* Roll, *supra* note 13, at 199–201.

96. More recent studies have also associated target CEO narcissism with higher acquisition premiums and lower bidder abnormal returns. *See* Nihat Aktas et al., CEO Narcissism and the Takeover Process: From Private Initiation to Deal Completion 3–5 (Nov. 19, 2010) (unpublished manuscript) *available at* http://ssrn.com/abstract=1638972. The study by Aktas et al. does not find "any evidence that highly narcissistic acquirer CEOs generate lower cumulative abnormal returns for their shareholders." *Id.* at 21.

shareholder losses [following an acquisition]."[97] Moreover, the study also indicates that the relationship between acquisition premiums and CEO hubris is stronger in cases where the board has a high proportion of inside directors and a CEO who also serves as chair of the board.[98]

Similar to the investigation in the Hayward and Hambrick study, Professor Fanto studies the presence of psychological factors, such as myopia and overoptimism, in the ten largest announced U.S. stock-for-stock mergers for each of the years 1998, 1999, and 2000.[99] Using a detailed analysis of SEC filings by the merger parties, the study provides evidence of behavioral biases during the CEO decision-making process in mega-mergers. For example, the study reports a strong degree of "over-optimism bias" in eleven mega-mergers between 1998 and 2000.[100] In addition, the study presents evidence of shareholder value destruction in these mega-mergers and explores the suggestive causal relationship found between the behavioral biases and value destruction.[101]

A more recent empirical study by Ulrike Malmendier and Geoffrey Tate looks at whether CEO overconfidence helps to explain merger decisions.[102] The authors hypothesize: (1) "[i]n firms with abundant internal resources, overconfident CEOs are more likely to conduct acquisitions than non-overconfident CEOs;"[103] and (2) "[i]f overconfident CEOs do more mergers than rational CEOs, then the average value created in mergers

97. Mathew L.A. Hayward & Donald C. Hambrick, *Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris*, 42 ADMIN. SCI. Q., 103, 103 (1997). Hayward and Hambrick identify four indicators of CEO hubris as relevant to the acquisition premium, "the acquiring company's recent performance, recent media praise for the CEO, a measure of the CEO's self-importance, and a composite factor of these three variables." *Id.*; *see also* Arijit Chatterjee & Donald C. Hambrick, *It's All About Me: Narcissistic CEO's and Their Effects on Company Strategy and Performance*, 52 ADMIN. SCI. Q. 351, 351–52 (2007) (arguing that narcissistic CEOs favor strategic dynamism and grandiosity, and tend to deliver extreme and volatile performance for their organizations).

98. Hayward & Hambrick, *supra* note 97 at 117–18.

99. *See* Fanto, *Quasi-Rationality in Action, supra* note 91, at 1350–52.

100. *See id.* at 1369.

101. *Id.* at 1374–76.

102. *See* Malmendier & Tate, *supra* note 7, at 20; *see also* Ulrike Malmendier & Geoffrey Tate, *CEO Overconfidence and Corporate Investment*, 60 J. FIN. 2661, 2661 (2005) ("Overconfident managers overestimate the returns to their investment projects and view external funds as unduly costly.").

103. *See* Malmendier & Tate, *supra* note 7, at 22.

is lower for overconfident than for rational CEOs."[104] The study tests these hypotheses using a sample of Forbes 500 firms from 1980 to 1994.[105] Using two proxies for overconfidence—CEOs' personal over-investment in their company and their press portrayal—the study finds that the odds of making an acquisition are 65% higher if the CEO is classified as overconfident, and that the effect is largest if the merger is diversifying and does not require external financing.[106] The study suggests that the market reaction for merger announcements by an overconfident CEO is significantly more negative than for announcements by non-overconfident CEOs.[107]

In the legal literature, Professor Black has put forth an "overpayment hypothesis" to explain that target shareholders tend to win from takeovers because acquirers overpay.[108] Professor Black argues that even if managers believe that they are behaving in ways that are faithful to their duties to shareholders, overpayment may occur unintentionally.[109] Similar to the behavioral biases and agency costs literature described above, Professor Black identifies three primary factors that lead managers to overpay in acquisitions. First, since a target's real value is unknown at the time of the acquisition, "habitually optimistic [managers are] therefore likely to overestimate a target's value."[110] Second, managers may overpay because they are ignorant of bidding theory and are vulnerable to the "winner's curse."[111] Thus, on average, for an asset whose value is unknown, the winning bid is the one that overestimates the value of the asset. Third, managers may overpay in acquisitions because of incentives to achieve growth, diversification, and success.[112] In other words, in addition to the compensation-related benefits identified above, managers may be eager to complete acquisitions in order to gain greater prestige, to leave a legacy, and to be seen as winners of a takeover battle. Likewise, the "alternative of paying cash to shareholders may be rejected, or pursued only in part, because it shrinks the company's capital

104. *Id.* at 23.
105. *Id.*
106. *See id.* at 20.
107. *Id.*
108. *See* Black, *supra* note 12, at 599.
109. *See id.* at 623–24 ("In most cases, the overpayment is likely unintentional—the bidder's managers believe wrongly that the deal is a good one.").
110. *Id.* at 624.
111. *Id.* at 625.
112. *See id.* at 627–28.

and thus the managers' sphere of influence."[113] These desires may create willingness on the part of managers to "consciously or subconsciously discount risks and exaggerate potential gains."[114]

It may be hard to overcome the factors leading to overpayment, even for repeat acquirers.[115] Since the ramifications, and the degree of failure, of an acquisition for the acquirer are most likely not readily obvious, "overpayment can be hidden by, or wrongly ascribed to, changes in economic conditions, unforeseen new technology, lack of due diligence (presumably correctable the next time), mistakes in integrating the two businesses (also presumably correctable), or other factors."[116] Moreover, advisers to acquirers, such as investment bankers, are often incentivized to encourage the completion of acquisitions, and generally do not act as a constraint on managerial overpayment.[117]

II. THE ROLE OF THE BOARD AND SHAREHOLDERS OF ACQUIRING FIRMS—A BRIEF OVERVIEW

Much of state corporate law vests the power to manage the corporation in the hands of directors and managers, without any direct involvement of the shareholders.[118] Some areas of state corporate law, however, are designed to address the managerial agency costs that arise as a result of the separation of ownership and control in corporations.[119] For example, in the

113. *Id.* at 627.

114. *Id.* at 628.

115. *See id.* at 626 ("[S]uccess or failure [of an acquisition] may not be obvious for a number of years. This is ample time for the old CEO to make more mistakes or a new CEO to be appointed.").

116. *Id.*

117. *See id.* at 626, 650–51.

118. Section 141 of the General Corporation Law of Delaware (DGCL) provides that the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." *See* DEL. CODE ANN. tit. 8, § 141 (Supp. 2010); *see also* MODEL BUS. CORP. ACT § 8.01 (2011) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation . . . .").

119. For most U.S. public companies, dispersed shareholders delegate to professional managers the power to run the company. As famously articulated by Jensen and Meckling, this separation of ownership and control creates managerial agency costs because the interests of these managers do not always coincide with those of the shareholders. Jensen & Meckling, *supra* note 10, at 309. Managerial agency costs can be addressed through many channels, such as corporate governance mechanisms, labor or product market controls, the market for corporate control, or other legal rules, such as state corporate

acquisition transaction context, shareholder approval may be necessary. Under state corporate law, the board often cannot undertake a merger unilaterally.[120] Moreover, directors are seen as exercising their fiduciary role when undertaking the decision to enter into an acquisition transaction.[121] As such, shareholders may be able to bring suits challenging the actions of the board in connection with an acquisition and to enforce their rights under state corporate law.

While the statements above give a broad overview of shareholder rights in acquisition transactions, there are significant disparities in the statutory and doctrinal treatment of shareholders of the acquirer versus shareholders of the seller. As described in Section A below, there are several ways to structure acquisitions so as to avoid activating acquirer shareholders' voting rights. Furthermore, Section B makes clear that acquirer shareholders are also historically unsuccessful in using litigation as an avenue for protection. The Delaware courts have historically viewed a board's decision to acquire another company as an ordinary business decision that is protected under the business judgment rule.[122]

law. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 14 (1991) ("[The] advantage[s] among devices for controlling agency costs differs across firms and shifts from time to time.").

120. *See, e.g.*, CAL. CORP. CODE § 1201 (West Supp. 2011) (addressing shareholder approval requirements in corporate reorganizations); DEL. CODE ANN. tit. 8, § 251(c) (Supp. 2010) (requiring that the merger agreement be submitted to shareholders of the constituent parties for their approval in order for the merger to become effective).

121. *See infra* Part II.B.

122. The Delaware courts' caselaw on board fiduciary duties dominates debates about, and analysis of, U.S. corporate governance. A rich body of academic literature assesses the role of Delaware courts in controlling agency costs. Some scholars have long argued that Delaware corporate law has led to a "race to the bottom" in which Delaware law offers shareholders suboptimal corporate regulation and that Delaware courts "stifle shareholder complaints and facilitate managerial abuses of investors." Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 VAND. L. REV. 133, 165 n.146 (2004); *see* William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 663 (1974). Others argue that Delaware is in fact a leader in the "race to the top" and that the experience and knowledge of the Delaware courts is unmatched. Thompson & Thomas, *supra*; *see* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256–58 (1977). Meanwhile, other scholars posit that there is no race among the states or that Delaware competes with the federal government. *See* Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 (2002); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 593 (2003).

A. STATUTORY TREATMENT OF ACQUIRER SHAREHOLDERS

Under state corporate codes, completion of a merger transaction is nominally dependent on approval by a majority of the outstanding stock of the constituent parties to the transaction.[123] In acquisitions involving Delaware corporations, however, there are several ways to structure transactions in order to avoid voting rights for acquirer shareholders. These include (1) triangular mergers, (2) small-scale mergers, (3) tender offers, and (4) asset acquisitions. In all of these transaction structures, except for the tender offer where target shareholder voting is unnecessary, shareholders of the target entity are largely guaranteed voting rights under state statutory schemes.[124] Nevertheless, transaction planners can, and often do, plan deals to eliminate a shareholder vote for the acquirer's shareholders.

1. Triangular Mergers

Over the past several decades, the triangular merger structure has emerged as one of the most popular—if not the most popular—form of acquisition transaction.[125] Perhaps the most important consideration for Delaware public companies and their counsel in using the triangular structure is the ability to deprive the acquirer's shareholders of voting rights.[126] In a tri-

123. *See, e.g.*, CAL. CORP. CODE § 1201 (addressing shareholder approval requirements in corporate reorganizations); DEL. CODE ANN. tit. 8, § 251(c) (requiring that the merger agreement be submitted to shareholders of the constituent parties for their approval in order for the merger to become effective); MODEL BUS. CORP. ACT § 11.04(c) (explaining that "the board of directors must submit the [merger] plan to the shareholders for their approval"). The majority voting requirement is subject to the company's charter which may require more than a majority of the outstanding shares in order to effect the transaction. Moreover, the state corporate law of certain states, such as California, may also impose class voting rights if the corporation party to the acquisition has more than one class of outstanding stock. *See* CAL. CORP. CODE § 1201. Delaware law, in general, does not require a class vote in connection with a merger transaction unless the rights or preferences of a class of preferred stock will be changed in the transaction. *See* DEL. CODE ANN. tit. 8, § 251.

124. *See, e.g.*, DEL. CODE ANN. tit. 8, § 251.

125. *See* WILLIAM J. CARNEY, MERGERS AND ACQUISITIONS: THE ESSENTIALS 60–61 (2009); MAYNARD, *supra* note 17, at 92–95.

126. *See* STEPHEN M. BAINBRIDGE, MERGERS AND ACQUISITIONS 55–56 (2d ed. 2009) [hereinafter BAINBRIDGE, MERGERS]; MAYNARD, *supra* note 17, at 94. Another advantage of the triangular merger is that the liabilities of the target entity vest in the surviving entity so that the acquirer's assets are shielded from any such liabilities, except for the unlikely event that the surviving entity's (i.e. the old target's) creditors can pierce the corporate veil up to the acquirer. *See* MAYNARD, *supra* note 17, at 37. The triangular acquisition structure also has other advantages related to tax and accounting issues. *See*

angular merger, the acquiring company forms a wholly owned subsidiary that is then capitalized with the consideration to be used in the acquisition (for example, the shares of the acquiring company or the cash to be issued as acquisition consideration).[127] The merger then occurs between the target and this wholly owned subsidiary.[128] Thus, under Delaware corporate law, the acquirer technically is not a party to the merger.

For public-company acquirers, the ability to avoid the vote of their shareholders is somewhat limited in transactions where the acquirer aims to use its own stock as acquisition consideration.[129] First, if the acquirer does not have sufficient authorized and unissued shares in its charter, the company will need to obtain a shareholder vote to amend its charter to authorize additional shares.[130] While this shareholder vote is technically not a vote on the acquisition, such a vote is a "de facto referendum on the deal" since "shareholders will be voting on the amendment with full knowledge that the amendment is

STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 630 (2002) (discussing triangular merger as a technique to limit successor liability).

127. *See* BAINBRIDGE, MERGERS, *supra* note 126; CARNEY, *supra* note 125, at 16–17.

128. Following the merger, the surviving entity—either the acquisition subsidiary in a forward triangular merger or the target in a reverse triangular merger—becomes a wholly owned subsidiary of the acquirer. *See* BAINBRIDGE, MERGERS, *supra* note 126.

129. Neither of the circumstances described in this paragraph would provide acquirer shareholders with appraisal rights. Appraisal rights provide a shareholder the opportunity to demand that the corporation repurchase the shareholder's shares at a fair value when the shareholder dissents in an acquisition transaction. DEL. CODE ANN. tit. 8, § 262. With respect to mergers, most statutes provide that appraisal rights exist only when voting rights exist as to the actual merger transaction. Even in a direct merger, acquirer shareholders may be deprived of appraisal rights because of the "stock market exception" which precludes the use of the appraisal remedy to stockholders of publicly traded entities who continue to hold publicly traded shares following the merger transaction. *See id.* § 262(b)(1). Appraisal has often been seen as a little-used remedy in Delaware. *See* Randall S. Thomas, *Revising the Delaware Appraisal Statute*, 3 DEL. L. REV. 1, 22 (2000) (finding that from 1977 to 1997, a total of 266 appraisal cases were filed in the Delaware Chancery Court for New Castle County—an average of fewer than fourteen cases per year); Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1, 17, 23 (1995); Thompson & Thomas, *supra* note 122, at 170.

130. Stephen Bainbridge, *How and Why Kraft is Evading Shareholder Voting in the Cadbury Deal*, PROFESSORBAINBRIDGE.COM (Jan. 21, 2010, 11:27 AM) http://www.professorbainbridge.com/professorbainbridgecom/2010/01/evading-shareholder-voting-in-a-merger.html.

necessary to effect the deal as structured."[131] Second, the use of the acquirer's shares may trigger shareholder voting rights under stock exchange rules that require a shareholder vote in transactions where the acquirer issues stock amounting to more than 20% of its outstanding shares.[132]

Nevertheless, acquirers and their counsel can draft acquisition agreements in order to avoid triggering the above-described shareholder votes.[133] As Professor Stephen Bainbridge explains, for most transaction planners it is imperative to avoid the shareholder vote due to the "cumbersome and expensive" voting process for public companies.[134] A firm can issue cash instead of shares to avoid any share authorization requirements under its charter. It also is common in transactions where the acquirer is using its own shares to include a provi-

131. *Id.*

132. *See* NASDAQ, *supra* note 18; NYSE, *supra* note 18, R. 712(b). The MBCA also has a similar shareholder voting rule, based primarily on two objectives: (1) to apply a uniform voting rule to all fundamental transactions and (2) to conform to the voting requirements of the stock exchanges. *See* 1 MODEL BUS. CORP. ACT ANN. § 6.21 cmt. n.3 (2011); Comm. on Corporate Laws, *Changes in the Model Business Corporation Act—Fundamental Changes*, 54 BUS. LAW. 685, 685 (1999); Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 750 (2001). A few states, most notably California, have been inspired by the NYSE rule to provide voting rights for acquirer shareholders, including shareholders of the parent entity in a triangular merger. *See, e.g.*, CAL. CORP. CODE § 1201(b) (West Supp. 2011). In enacting Section 1201, the California legislature had

> two basic objectives: (1) to permit shareholders to vote on a transaction and provide dissenters with compensation, but only if the transaction will significantly dilute their control of the enterprise or change their rights; and (2) to create a statutory framework under which both the form of the transaction and the entity chosen to be the acquiring or surviving corporation are determined by considerations other than avoidance of stockholders' voting and appraisal rights.

Marshall L. Small, *Corporate Combination Under the New California General Corporation Law*, 23 UCLA L. REV. 1190, 1190–91 (1976). The number of publicly traded corporations which are California entities is significantly less than those incorporated in Delaware. *See* HAROLD MARSH, JR. ET AL., MARSH'S CALIFORNIA CORPORATION LAW § 1.02, at 1-22 (2010).

133. Since the penalty for failing to hold a shareholder vote required under the stock exchange listing agreement is delisting, an acquirer that no longer needs to remain listed can ignore the listing requirement, although this would be a rather extreme measure to avoid shareholder voting. Parties can also use other creative ways to circumvent the NYSE voting rules, such as issuing non-voting preferred shares that can convert into common stock. *See* Steven M. Davidoff, *Warren Buffett's Lost Vote*, N.Y. TIMES DEALBOOK (Jan. 21, 2010, 9:05 AM) http://dealbook.nytimes.com/2010/01/21/warren-buffetts-lost-vote/.

134. BAINBRIDGE, MERGERS, *supra* note 126, at 55.

sion in the acquisition agreement which states that the maximum number of shares to be issued in the transaction shall be limited to no more than 19.9% of the acquirer's issued and outstanding shares.[135]

Avoiding the vote for acquirer shareholders has other benefits for transaction planners: the lack of a vote translates into a lack of significant disclosure to acquirer shareholders regarding the company's motivations for undertaking the deal. Hence, shareholders of public-company acquirers are often left with the cursory disclosure required by the Form 8-K rules.[136] Acquirers will also communicate with their shareholders about the transaction through other means, such as press releases, analyst calls, or media communications.[137] Such communications, however, are far less detailed and illuminating than the extensive disclosure required by the proxy rules, particularly with respect to the reasons for and the background to the acquisition.[138]

2. The Small-Scale Merger Exception

The small-scale merger exception deprives acquirer shareholders of the right to vote in acquisitions where the acquirer is using cash or less than a certain percentage of its outstanding stock—generally 20%. For example, under Section 251(f) of the Delaware General Corporation Law (DGCL), the vote of the stockholders of the surviving corporation is not necessary

135. *See, e.g.*, Agreement and Plan of Merger Among Pfizer Inc., Wagner Acquisition Corp., and Wyeth § 1.8(b) (Jan. 25, 2009), *available at* http://sec.gov/Archives/edgar/data/78003/000091412109000324/0000914121-09-000324.txt. This contractual limitation often arises in transactions where the company is issuing a combination of cash and stock. *See* Davidoff, *supra* note 133.

136. A current report on Form 8-K must be filed within four business days from the date when the company enters into a definitive material agreement, including a merger agreement by companies subject to the periodic reporting requirements of the Securities and Exchange Act of 1934. For the current rules under Form 8K, see Form 8-K Current Report, Exchange Act Release No. 33-9136, Fed. Sec. L. Rep. (CCH) ¶ 31,001 (Nov. 15, 2010), *available at* http://www.sec.gov/about/forms/form8-k.pdf; Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Exchange Act Release No. 49424, [2003–2004 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶87, 158 § 1, Item 1.01, (Mar. 16, 2004).

137. MAYNARD, *supra* note 17, at 268–69.

138. In cases where the acquirer is purchasing a private-company target—without a shareholder voting requirement—acquirers may even avoid the minimal disclosure requirements under the SEC's 8-K rules. *See* Usha Rodrigues & Mike A. Stegemoller, *An Inconsistency in SEC Disclosure Requirements? The Case of the 'Insignificant' Private Target*, 13 J. CORP. FIN. 251, 252 (2007).

where, in the case of a merger, there is no amendment of the corporation's charter or stockholder rights, and where the transaction results in no more than a 20% increase in the corporation's outstanding stock.[139]

Section 251(f) of the DGCL was a significant break from prior Delaware law with respect to acquirer shareholder voting. Historically, the stockholders of each participating corporation in a merger had to approve the transaction by two-thirds vote.[140] In the 1960s, Delaware's statutory advisers began to formulate rules to exempt from shareholder voting requirements the case of a corporation making "small" acquisitions.[141] By 1970, acquisitions involving less than 20% of the acquirer's securities became exempt from the voting requirement.[142] One of the reasons for these changes was to "ease the burden of effecting the merger."[143] These changes also aligned the legal requirements for mergers with those for asset or stock acquisitions.[144] Additionally, the Delaware legislature amended the DGCL to require the vote of only a majority of outstanding stock instead of two-thirds of the outstanding shares to bring mergers in parity with votes on the "sale of assets, dissolution and certain other actions requiring stockholder approval."[145]

For Delaware corporations, the combination of these changes made the exception into the rule; acquirers' shareholders now only have the right to vote in a limited number of circumstances.[146] Other states have generally followed the Delaware model, and the Model Business Corporations Act (MBCA) similarly adopted such a provision.[147]

3. Asset Acquisitions and Tender Offers

In many transactions involving a purchase of assets or a tender offer by the acquirer, the shareholders of the acquirer are deprived of voting rights under state corporate law. In Del-

139. DEL. CODE ANN. tit. 8, § 251(f) (Supp. 2011).

140. *See* ERNEST L. FOLK, III, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 318 (1972); Joel Edan Friedlander, *Overturn* Time-Warner *Three Different Ways*, 33 DEL. J. CORP. L. 631, 641 (2008).

141. *See* FOLK, *supra* note 140, at 330 n.34; Friedlander, *supra* note 140.

142. *See* FOLK, *supra* note 140, at 319–20; Friedlander, *supra* note 140, at 641–42.

143. FOLK, *supra* note 140, at 323.

144. *Id.* at 320.

145. *Id.* at 323.

146. *See* Friedlander, *supra* note 140, at 643.

147. *See, e.g.*, 1 MODEL BUS. CORP. ACT § 6.21(f)(ii) (2011).

aware, Section 271 of the DGCL, which governs asset deals, contemplates voting only by the shareholders of the seller.[148] Delaware corporate law does not contemplate acquirer shareholder voting in tender offer transactions.[149] Thus, unless the acquirer does not have enough authorized unissued shares in a stock for asset transaction or a stock-for-stock tender offer, the shareholders of the acquirer have no voting rights under state corporate law.[150] The previously discussed stock exchange rules may be the only protection afforded to acquirer shareholders.[151]

In addressing the public policy justification underlying the shareholder voting rules of the stock exchanges in M&A transactions, Professor Therese H. Maynard explains that such rules reflect "the difficulties inherent in valuing the non-cash consideration to be received by [the acquirer] in exchange for this large block of its shares."[152] The combination of the stock exchange rules and the federal proxy requirements means that the acquirer's management must provide disclosure to the firm's shareholders about the basis for their decision to purchase the target firm and the valuation determination.[153] From a corporate governance perspective, such disclosure allows the shareholders of the acquirer "to hold management accountable for their boardroom decision making."[154] Although theoretically possible, as explained in Section B below, acquirer shareholders are often unable to use litigation as a tool for holding management accountable.

148. *See* DEL. CODE ANN. tit. 8, § 271 (Supp 2010).

149. *See* Friedlander, *supra* note 140, at 643. Unlike Delaware, some jurisdictions, such as California, do contemplate a vote for the shareholders of the acquirer in both (1) stock-for-asset transactions, or (2) in tender offers where the consideration consists of the stock of the acquirer's shareholders. Similar to the voting rules in other types of acquisition transactions, the exception under Section 1201(b) of the California Corporations Code provides that approval is not needed by the shareholders of an entity which will own more than 83.3% (or five-sixths) of the voting power of the surviving corporation immediately after the transaction. *See* CAL. CORP. CODE § 1201 (West Supp. 2011).

150. *See* Friedlander, *supra* note 140, at 641–43.

151. *See id.* at 643.

152. MAYNARD, *supra* note 17, at 313.

153. *See* BAINBRIDGE, MERGERS, *supra* note 126, at 138–45.

154. *Id.*

B. THE ROLE OF THE ACQUIRER'S BOARD IN ACQUISITION TRANSACTIONS

1. The Statutory Role of the Acquirer's Board

State corporate law generally envisions a primary role for the board of directors of the companies that are a party to an acquisition transaction. Approval of the board of the target entity is almost always necessary in order to undertake such a transaction.[155] The statutory role given to directors in acquisitions has resulted in extensive target board involvement in the M&A process.[156] Directors of target corporations, in particular, have long been sensitive to their role and their fiduciary duties in M&A transactions. In most transactions, particularly those involving public companies, the directors of target corporations run through a detailed process, assisted by a litany of advisers.[157]

The role formally given under the states' corporate laws for the acquirer board is fairly limited. For example, Section 251 of the DGCL requires acquirer board approval in order to effect a statutory merger, but for many other transactions, such as triangular mergers, asset acquisitions, and tender offers, Delaware law does not specifically require such approval.[158] Despite the lack of a statutorily defined role for the acquirer board for most transaction structures, in the majority of public company transactions, the corporate norm is that the board of the acquirer will vote on the acquisition.[159] The acquirer board's voting role arises out of the corporate norm that the directors manage the affairs of the corporation and must act in the best interest of the corporation and its shareholders to fulfill their fiduciary duty obligations.[160]

155. *See* CAL. CORP. CODE § 1200 (West Supp. 2011); DEL. CODE ANN. tit. 8, § 251 (Supp. 2010); MODEL BUS. CORP. ACT § 11.04(a) (2011).

156. BAINBRIDGE, MERGERS, *supra* note 126, at 56.

157. *Id.* at 56–62.

158. *See* DEL. CODE ANN. tit. 8, § 251.

159. *See* MAYNARD, *supra* note 17, at 17.

160. *See* DEL. CODE ANN. tit. 8, § 141; MODEL BUS. CORP. ACT § 8.01. Directors' fiduciary duty to the corporation encompasses two specific duties: the duty of loyalty and the duty of care. The duty of loyalty requires directors to consider the best interest of the corporation and its shareholders in making business decisions. If the director has a chance to benefit personally (and apart from benefits to the company) from a transaction, the director should remove himself from the transaction so as to avoid violation of his duty of loyalty to the company. The directors' duty of care requires them to inform themselves of all critical information available to them prior to approving an acqui-

2. Fiduciary Duties of the Acquirer's Board

The general norm for public company boards to approve acquisition, despite the lack of a statutory requirement, means that in theory the board may be vulnerable to shareholders challenging the decision on fiduciary duty ground.[161] Indeed, scholars have argued that fiduciary duty litigation can make boards and managers function more effectively and "can increase investor confidence that corporate insiders will perform their jobs ably and loyally."[162] While shareholder litigation can address managerial agency costs, at least to an extent, acquirer shareholders have predominantly been unwilling or unsuccessful in using shareholder litigation as such a tool.[163]

There are several reasons for acquirer shareholders' inability to use litigation as a means to address managerial agency costs if there is no clear conflict of interest/duty of loyalty violation. First, for public company directors, there is little likelihood that shareholders will be able to bring a damages claim against an uninformed board since most public companies have within their charter a statutory exculpation provision limiting the directors' damages in duty of care claims.[164] Second, given

sition. This includes evaluating, investigating, and understanding expert opinions and terms for a transaction. Once the board is "informed" on a decision, directors must act with the requisite care in performing their duties. *See* COX & HAZEN, *supra* note 17, at 203–04.

161. Directors can be subject to fiduciary duty suits arising out of acquisition transactions. For example, Professors Thompson and Thomas found that more than 80% of the fiduciary duty suits filed in Delaware between 1999 and 2000 were class actions against listed companies challenging director misconduct in M&A decisions and that "acquisition-oriented suits are now the dominant form of corporate litigation." Thompson & Thomas, *supra* note 122, at 135, 137.

162. *Id.* at 143.

163. In their study of shareholder litigation in the Delaware courts, Professors Thompson and Thomas posit that "[s]tate court litigation remains a valuable tool to check managerial agency costs." *Id.* at 141. Their study, however, shows that the majority of fiduciary duty suits challenge director actions in the sale of a company, and not director actions with respect to the decision to acquire a company. *Id.* at 167.

164. *See* DEL. CODE ANN. tit. 8, § 102(b)(7). Approximately 40 other states have also enacted similar statutory exculpation provisions. *See* CHARLES R.T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS 350 (6th ed. 2010). Arguably, shareholders could assert that an uninformed board may have violated its duty to act in good faith. Hillary A. Sale, *Delaware's Good Faith,* 89 CORNELL L. REV. 456, 494 (2004); *see also In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 134–35 (Del. Ch. 2009) (discussing the possibility that a bad faith failure to be informed that results in misleading disclosures could also support a claim of disloyalty). While good faith claims are not subject to statutory exculpation provisions,

that in acquisition transactions the acquirer's shareholders are not losing their status as shareholders, they are generally limited to bringing derivative lawsuits on behalf of the corporation when alleging that directors have violated their fiduciary duties to the corporation.[165] Shareholders, however, face significant procedural hurdles when bringing derivative suits.[166] Third, and perhaps even more importantly, acquirer shareholders have been unable to overcome the broad discretion and deference afforded to the board by courts that begin any analysis of a board's decision by applying the presumptions of the business judgment rule.[167]

Due to the aforementioned challenges, no established body of case law examines fiduciary duties of the acquiring firm's board.[168] Few, if any, shareholder actions are brought by acquirer shareholders and none appear to have succeeded.[169] While target shareholders can, and frequently do, bring acquisition-oriented class action suits in state court alleging that directors of the target company breached their fiduciary duties in

shareholders have rarely been successful asserting a good faith claim against boards. Furthermore, the Delaware courts have articulated an extremely high burden for showing a violation of the board's duty to act in good faith. *See infra* notes 212–13 and accompanying text.

165. Shareholders can bring fiduciary duty claims directly if they, rather than the corporation, suffered the injury. *See* Robert B. Thompson, *Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue*, 62 LAW & CONTEMP. PROBS. 215, 218 (1999). Such direct claims tend to be limited to claims brought by shareholders of target companies. *See* Thompson & Thomas, *supra* note 121, at 167–68.

166. *See* Thompson & Thomas, *supra* note 121, at 136, 149–52; *infra* notes 201–11 and accompanying text.

167. The business judgment rule is a judicial presumption that holds that directors' decisions have been made "on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the corporation and its shareholders." Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695 (Del. 2009). The burden is on the plaintiff to prove that a majority of the directors breached their fiduciary duties in reaching the decision. *See id.* When breaches of fiduciary duties occur in board action, Delaware law applies the "entire fairness" test, which requires a judicial determination of whether the transaction is entirely fair to shareholders. *See* O'KELLEY & THOMPSON, *supra* note 164, at 347–48. In determining this fairness, courts will consider "fair dealing" and "fair price." *See id.* In assessing overall fairness, courts consider: the process that the board followed, the quality of the result the board achieved, and the quality of disclosures made to the shareholders. MAYNARD, *supra* note 17, at 489–90.

168. *See* Hamermesh, *supra* note 24, at 909.

169. *See* Thompson & Thomas, *supra* note 121, at 167.

the decision to sell the company,[170] acquirer shareholders are generally unable to bring such suits.[171] Thus, acquirer shareholders may need to rely on derivative litigation, with its substantial hurdles, to bring a fiduciary duty claim against the directors of the acquirer in making an acquisition decision.[172] Even if shareholders can overcome the demand futility requirements to proceed with a derivative claim, they face significant hurdles in Delaware courts. For example, acquirer shareholders rarely bring cases alleging that the acquirer's directors committed corporate waste by paying too much for a target company.[173] This may be because the burden of bringing a waste claim is extremely high.[174] Moreover, definitions of corporate waste would be difficult to meet in acquisition transactions where the acquirer is receiving something of value for the consideration, even if the consideration that it pays is too high.[175]

The Delaware courts have historically tended to view a board's decision to acquire another company as an ordinary business decision that is protected under the business judgment rule.[176] In other words, with respect to director actions to

170. *See* C.N.V. Krishnan et al., *Litigation in Mergers and Acquisitions* (Vanderbilt Law and Econ. Research Paper No. 10-37; Georgetown Law and Econ. Research Paper No. 11-22, 2011), *available at* http://ssrn.com/abstract=1722227.

171. Shareholders are able to bring state law class action suits in two types of cases:

> (1) a purchase or sale transaction where one side is the issuer or an affiliate, and the other side is exclusively holders of the issuer's equity securities, and (2) recommendations or other communications "with respect to the sale of securities of the issuer" made to equity holders by or on behalf of the issuer or an affiliate concerning (a) voting, (b) acting in response to a tender or exchange offer, or (c) exercising dissenters' or appraisal rights.

Thompson, *supra* note 165, at 231 (quoting 15 U.S.C. § 77p(d)(1)(B) (2006)). Because acquisitions do not involve the acquirer making a purchase or sale of its own from its own shareholders, and because acquirer shareholders often do not receive voting or appraisal rights, acquisition decisions tend to fall outside of these two kinds of cases. *See id.* at 231–32; *supra* Part II.A.

172. *See, e.g.*, *infra* notes 248–58 and accompanying text.

173. *See* Hamermesh, *supra* note 24, at 909. With respect to a director-approved action, a finding of waste constitutes a finding by the court that the directors violated their fiduciary duties in approving the transaction. O'KELLEY & THOMPSON, *supra* note 164, at 285.

174. *See* William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1317–18 (2001) (noting that "no Delaware case of which [the authors] are aware has ever held that a properly ratified transaction constituted waste").

175. *See* Saxe v. Brady, 184 A.2d 602, 610 (Del. Ch. 1962).

176. *See* MAYNARD, *supra* note 17, at 487–88.

undertake an acquisition, the courts have begun with a presumption that "directors are better equipped than the courts to make business judgments and that the directors acted without self-dealing or personal interest and exercised reasonable diligence and acted with good faith."[177] As a practical matter, it is highly unlikely that a plaintiff can rebut one of these three elements absent a showing of a conflict of interest. As stated above, even a showing of grossly negligent conduct—i.e. a violation of the duty of care—provides little relief to acquirer shareholders given statutory exculpation provisions.[178] Furthermore, there is little room for acquirer shareholders to attempt to argue a lack of good faith with respect to board approval of an acquisition. Recently the Delaware Supreme Court provided important insights into the plaintiff's heavy burden in successfully pleading bad faith claims against independent, disinterested directors, stating that "bad faith will be found if a 'fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.'"[179] The court added that,

> In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties. . . . Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. . . .[180]

Despite the prevalence of the business judgment rule as the standard of review in state fiduciary duty litigation, the Delaware courts have created a few exceptions to allow for closer review of board action in acquisition transactions. In numerous opinions, known well to both M&A practitioners and scholars, the Delaware courts have applied enhanced judicial scrutiny of the target board's actions in sale transactions. As demonstrated by cases such as *Unocal Corp. v. Mesa Petroleum, Inc.*,[181] *Revlon, Inc., v. MacAndrews and Forbes Holdings*,[182] and

177. Gries Sports Enters., Inc. v. Cleveland Browns Football Co., 496 N.E.2d 959, 963–64 (Ohio 1986).

178. For a detailed analysis of the directors' exculpation provisions, see Dale A. Oesterle, *The Effect of Statutes Limiting Directors' Due Care Liability on Hostile Takeover Defenses*, 24 WAKE FOREST L. REV. 31, 32–40 (1989).

179. Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243 (Del. 2009). For an excellent discussion of the concept of good faith as a vital component of the duty of loyalty, see generally Leo E. Strine et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629 (2010).

180. *Lyondell Chem. Co.*, 970 A.2d at 243–44.

181. 493 A.2d 946 (Del. 1985). In *Unocal*, the Delaware Supreme Court held that an enhanced-scrutiny framework applies in situations where there is

Omnicare, Inc. v. NCS Healthcare, Inc.,[183] a heightened level of scrutiny often exists when evaluating the target board's consideration of a proposal to sell the company. Why this heightened scrutiny of the board's fiduciary duties? Fiduciary duties presumably respond to concerns over "vulnerability to agency costs."[184] Typically, commentators have assumed that in M&A transactions, it is the target company's shareholders that need heightened protections. As one commentator noted, "[t]he greater scrutiny of the target board's behavior . . . arises from the greater significance of an acquisition to the target and a concern that the target board may act out of self-interest."[185] But it is not at all clear that the acquiring firm or its shareholders always have less interest in an acquisition, or that the specter of self-interest is not present with respect to the acquirer's board and management.[186]

To date, this enhanced scrutiny framework has applied solely to cases where plaintiffs have alleged violations of fiduciaries duties by boards of target corporations. The few cases addressing acquirer boards' duties make clear that the risk of liability for violation of the board's duties is extremely limited. The Delaware courts have expounded on these duties in two important cases: *Ash v. McCall*,[187] and *In re Dow Chemical Co. Derivative Litig*ation[188] Although in all of these actions, the

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a "specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders . . . ." *Id.* at 954. *Unocal* set forth a two-prong test for evaluating director actions. First, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed" when they undertook their action. *Id.* at 955. Second, they must establish that the defensive measure in question was "reasonable in relation to the threat posed." *Id.* at 949. In making that consideration, the Delaware Supreme Court has said that the board can consider long-term and strategic business matters. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1153–55 (Del. 1989).

182. 506 A.2d 173, 182 (Del. 1985) (holding that where a break-up of a corporate enterprise is inevitable or there is a change of control, the selling board has a duty to seek out the highest price reasonably available for shareholders).

183. 818 A.2d 914, 928 (Del. 2003) ("When a board decides to enter into a merger transaction that will result in a change of control, however, enhanced judicial scrutiny under *Revlon* is the standard of review.").

184. Hamermesh, *supra* note 24, at 907.

185. Stewart Landefeld et al., *Advising the Board of Directors in Acquiring a Business*, INSIGHTS, Mar. 2005, at 13.

186. *See* Hamermesh, *supra* note 24, at 907 (stating that "it is not clear . . . [that] target firm shareholders are more vulnerable to director misbehavior than acquiring firm shareholders").

187. No. 17132, 2000 WL 1370341 (Del. Ch. Sept. 15, 2000).

188. No. 4349-CC, 2010 WL 66769 (Del. Ch. Jan. 11, 2010).

shareholders' suit was ultimately unsuccessful, the court's opinions bear further scrutiny and reinforce the extremely limited opportunity for acquirer shareholders to pursue fiduciary litigation in connection with acquisition transactions.

a. Ash v. McCall

Ash made clear the Delaware Chancery Court's response to shareholder litigation by acquirer shareholders. In *Ash*, a shareholder derivative suit alleging violations of a board's oversight duties, breach of duty of care, and corporate waste was brought against the directors of McKesson Corporation in connection with the purchase of HBO & Company (HBOC) in a stock-for-stock merger to form the new McKesson HBOC.[189] A few months after closing the transaction, McKesson HBOC discovered that certain HBOC managers had falsified the company's financial statements and accordingly announced a series of financial restatements attributed to these accounting irregularities.[190] The ensuing shareholder derivative action alleged that "McKesson's directors breached their fiduciary duties by failing to discover the HBOC accounting irregularities before the merger and committed corporate waste by entering into the merger."[191] Applying the principles of the business judgment rule, the court held for the defendant directors.[192] The court refused to second-guess the business judgment of a board which had relied on expert advice—including a major accounting firm and global investment bank—and undertaken a thorough board process.[193]

Ash singularly affirmed Delaware's deference to the decisions of the board.[194] Thus, regardless of how "disastrous [an] acquisition may have proven to be in hindsight," plaintiffs' only avenue is to attack the board's decision-making process rather than the actual business result.[195] Then-Delaware Chief Justice Norman Veasey noted in a speech:

> The decision in *Ash v. McCall* thus reinforces many of the traditional themes of Delaware law—deference to the business judgment of directors, protection for directors who properly rely on independent ex-

189. *Ash*, 2000 WL 1370341, at *1.
190. *Id.* at *2–3.
191. Stephen A. Radin, *The New Stage of Corporate Governance Litigation: Section 220 Demands*, 26 CARDOZO L. REV. 1595, 1620–21 (2005).
192. *Ash*, 2000 WL 1370341, at *15–16.
193. *Id.* at *14.
194. Landefeld et al., *supra* note 185, at 14.
195. *Id.*

> perts, avoidance of crude hindsight judgments, careful scrutiny of a board's response once clear red flags arise, and apparent problems need to be addressed at the board level. The ruling signals that, while Delaware will continue to allow shareholders to pursue genuine claims arising out of directors' actual knowledge of wrongdoing (or gross negligence in failing to oversee), Delaware will not second-guess the good faith decisions of directors who approve an acquisition based on expert advice and appropriate board process. McKesson/HBOC is a timely reminder that thoughtfulness and good process are as important from an acquiring board's perspective as from a seller's.[196]

Justice Veasey's statements reinforce the view that while good process is important for acquirer boards, there will be little opportunity for acquirer shareholders to question board action in acquisition decisions.

b. In re Dow Chemical Company Derivative Litigation

The Delaware Chancery Court's most recent pronouncements on the fiduciary duties of acquirer boards was articulated in the *In re Dow Chemical Co.* case. In the case, Dow stockholders sought to recover for the company its losses arising from its acquisition of Rohm & Hass Company (Rohm).[197] The *Dow* court's reasoning for dismissing the acquirer shareholders' derivative complaint resembled the reasoning of the *Ash* court.[198]

The events at issue revolved around Dow's $18.8 billion acquisition of Rohm, and a failed joint venture between Dow and a Kuwaiti company (K-Dow) which the plaintiffs alleged impeded Dow's ability to finance the acquisition.[199] Dow did not condition the closing of the acquisition on obtaining financing, and, even though it clearly planned to rely on billions of dollars of financing, Dow represented in the acquisition agreement that it would have the necessary funds for closing.[200] Nevertheless, prior to the scheduled closing of the acquisition, Dow announced that it would not move forward with the closing due to "the continued crisis in global financial and credit markets combined with the dramatic and stunning failure of . . . the

196. E. Norman Veasey, *Law and Fact in Judicial Review of Corporate Transactions*, 10 U. MIAMI BUS. L. REV. 1, 11 (2002).

197. *In re* Dow Chem. Co. Derivative Litig., No. 4349-CC, 2010 WL 66769, at *1 (Del. Ch. Jan. 11, 2010).

198. *Id.* at *15; *Ash*, 2000 WL 1370341, at *16.

199. *In re Dow Chem.*, 2010 WL 66769, at *5.

200. *See* Steven M. Davidoff, *Dow's Surprise*, N.Y. TIMES DEALBOOK (July 11, 2008, 12:15 PM), http://dealbook.blogs.nytimes.com/2008/07/11/dows-surprise.

formation of the K-Dow joint venture."[201] Rohm immediately filed suit in the Delaware Court of Chancery alleging that Dow intentionally breached the acquisition agreement and seeking specific performance of the agreement.[202] It quickly became clear that Dow's failure to contract for a financing condition, even when "[t]he potential problem of financing was a known quantity,"[203] jeopardized its existing covenants in its short-term debt financing. On the eve of the trial, facing the risk of triggering defaults on its other loans, Dow agreed to close the transaction on amended terms.[204]

In addition to Rohm's suit, two Dow shareholders filed derivative action suits in February 2009.[205] The plaintiffs alleged several derivative claims, including that Dow directors breached their fiduciary duties with respect to the approval of the Rohm acquisition.[206] The defendants filed a motion to dismiss the complaint for failure to properly plead demand futility under Chancery Court Rule 23.1.[207] On January 11, 2010, the

201. Press Release, Dow Chem. Co., Dow Chemical Confirms Rohm and Haas Acquisition Will Not Close On or Before January 27, 2009 (Jan. 26, 2009), *available at* http://www.sec.gov/Archives/edgar/data/29915/0000029915 09000006/eightk.htm. Dow had received word that the Kuwait Supreme Petroleum Council had decided to reverse its prior approval of the K-Dow joint venture. Press Release, Dow Chem. Co., Dow Chemical Receives Notification of Kuwait Decision to Cancel K-Dow Partnership (Dec. 28, 2008), *available at* http://www.sec.gov/Archives/edgar/data/29915/000094787108000660/ss54352_ex9901.htm.

202. Complaint, Rohm & Haas Co. v. Dow Chem. Co. (Del. Ch. Jan. 26, 2009) (No. 4309-CC), 2009 WL 247606.

203. Steven M. Davidoff, *A Hard Look at Dow's Answer to Rohm*, N.Y. TIMES DEALBOOK (Feb. 3, 2009, 3:17 PM), http://dealbook.blogs.nytimes.com/2009/02/03/a-hard-look-at-dows-answer-to-rohm.

204. Steven M. Davidoff, *Lessons from the Dow-Rohm Battle*, N.Y. TIMES DEALBOOK (Mar. 10, 2009, 9:30 AM), http://dealbook.nytimes.com/2009/03/10/lessons-from-the-dow-rohm-battle/.

205. *In re* Dow Chem. Co. Derivative Litig., No. 4349-CC, 2010 WL 66769 at *1 (Del. Ch. Jan 11, 2010).

206. *Id.* at *11.

207. *Id.* at *1; *see also* Aronson v. Lewis, 473 A.2d 805 (Del. 1984), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244 (Del. 2000). Delaware Chancery Court Rule 23.1 requires plaintiffs in derivative actions to either make a pre-suit demand on the corporation's board (under the theory that management of the corporation is entrusted to the directors, who are in the best position to manage and control the affairs of the corporation, including the decision to bring litigation) or allege demand futility. The demand-futility doctrine enables shareholders to dispense with pre-suit demand if demand would be futile. *Aronson*, 473 A.2d at 814.

Delaware Court of Chancery granted the defendants' motion and dismissed the plaintiffs' claims without prejudice.[208]

The difficulty for the Dow plaintiffs to move their case forward demonstrates the substantial hurdle faced by acquirer shareholders in challenging a board's acquisition decision. The court rejected the plaintiffs' contention that demand on the board would be futile. First, the court found that the plaintiffs failed to meet their burden under *Aronson v. Lewis'* first prong, which requires that the plaintiffs raise a reasonable doubt that a majority of the directors who approved the transaction were disinterested and independent.[209] The court found that none of the outside directors stood on both sides of the transaction or received a personal financial benefit from the Rohm acquisition.[210]

The court then proceeded to analyze the plaintiff's case under *Aronson*'s second prong, which requires plaintiffs to plead "particularized facts sufficient to raise (1) a reason to doubt that the action was taken honestly and in good faith or (2) a reason to doubt that the board was adequately informed in making the decision."[211] The court found that nothing in the plaintiffs' complaint questioned "the procedure employed to make an informed business judgment by a majority of the disinterested and independent board members," rather the main thrust of the claim involved the substantive provisions of the Rohm acquisition, including the board's decision to approve an acquisition agreement without a financing condition.[212] As in other Delaware cases, the court refused to second-guess the merits of the Dow directors' business decision even in a "bet the

208. *In re Dow Chem.*, 2010 WL 66769, at *15.

209. *Aronson*, 473 A.2d at 814. Disinterested "means that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Id.* at 812. "Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." *Id.* at 816; *see also* David A. Skeel, Jr., *The Accidental Elegance of* Aronson v. Lewis, *in* THE ICONIC CASES IN CORPORATE LAW 165, 187 (Jonathan R. Macey ed., 2008) ("Only if a majority of the board is either interested or can be shown to be controlled by the interested director is demand excused under *Aronson*'s first prong.").

210. *In re Dow Chem.*, 2010 WL 66769, at *9.

211. *Id.* (quoting *In re* J.P. Morgan Chase & Co. S'holder Litig., 906 A.2d 808, 824 (Del. Ch. 2005)).

212. *Id.* at *5.

company transformational transaction," stating that such decisions are "vested in the board, not the judiciary."[213]

The plaintiffs also failed in their attempt to allege bad faith on the part of the Dow board members. Under the Delaware Supreme Court's 2009 *Lyondell Chemical Co. v. Ryan* decision, bad faith, in a transactional context, requires an "extreme set of facts . . . premised on the notion that disinterested directors were intentionally disregarding their duties."[214] Accordingly, the Dow plaintiffs needed to overcome a very high burden by establishing that the Dow board "completely and utterly failed to even attempt to meet their duties."[215] The court found that the plaintiffs alleged no particularized facts sufficient to overcome this high burden.[216] Therefore, the court held that the plaintiffs could not meet either prong of *Aronson*.

c. Summary of Judicial Review

Each of the above cases demonstrates that while acquirer boards do have fiduciary obligations to acquirer shareholders, such shareholders have little room to pursue fiduciary litigation in the courts. Delaware courts have consistently reviewed the decision of acquirer boards under the deferential business judgment standard. Without a showing of a violation of the duty of loyalty (including bad faith),[217] acquirer shareholders are relegated to relying on allegations of the violation of the duty of

213. *In re Dow Chem.*, 2010 WL 66769, at *10. Delaware courts have extensively commented on their unwillingness to second-guess the substantive decisions of directors through their embrace of the deferential business judgment rule. *See Aronson*, 473 A.2d at 808; *In re Dow Chem.*, 2010 WL 66769, at *9; *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 121–22 (Del. Ch. 2009); *In re* Caremark Int'l Derivative Litig., 698 A.2d 959, 967–68 (Del. Ch. 1996).

214. *Id.* (quoting Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 243–44 (Del. 2009)).

215. *Id.*

216. *Id.* at *6.

217. In *Stone v. Ritter*, the Delaware Supreme Court clarified that good faith did not constitute a separate fiduciary duty, but was instead encompassed within the directors' duty of loyalty. 911 A.2d 362, 370 (Del. 2006); *see also* Lyondell*,* 970 A.2d at 243–44 (holding that directors supervising the sale of the company may breach their duty of care if they "fail[] to do all that they should . . . under the circumstances," but they breach their duty of loyalty only "if they knowingly . . . fail[] to undertake their responsibilities"); Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. DAVIS L. REV. 457, 527 (2009) (explaining that "[f]ollowing *Stone v. Ritter*, the fiduciary duty of good faith was absorbed by the duty of loyalty").

care.[218] But shareholders have little room to litigate a case where the acquirer board made an informed decision, even if such decision has been extremely harmful to the acquiring corporation. Furthermore, while acquirer shareholders may be able to access the courts in cases alleging a violation of the board's duty of care under *Smith v. Van Gorkom's* process and deliberation model if they can show gross negligence by the acquirer board in making an acquisition decision, even this route is limited by Section 102(b)(7)'s statutory exculpation provision.[219]

III. EXISTING REFORM PROPOSALS

Despite the last decade's significant explosion of public company acquisitions and numerous studies of their somewhat dubious value, there has been little response by corporate law. Some legal scholars have argued that "a majority of mergers and acquisitions could . . . represent a failure of managerial accountability and a huge transfer of wealth from a company and its shareholders to its managers, directors, investment bankers and lawyers."[220] Nevertheless, potential legal solutions have been scant.

The last extensive effort to address the problem of acquirer overpayment was done nearly a decade ago.[221] Since then, scholars have generally tended to favor three solutions. One solution is to change the laws that govern M&A to require shareholder votes more frequently. Another solution is to give independent directors greater power. A third solution is to provide more rigorous judicial review of the acquirer board's actions. In the next sections, this Article highlights each of these potential

218. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

219. *See* Malpiede v. Townson, 780 A.2d 1075, 1094–95 (Del. 2001) (finding that, absent "a loyalty violation or other violation falling within the exceptions to the Section 102(b)(7) exculpation provision," a director is not liable for his conduct in approving a merger); *see also* WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 256–57 (3d ed. 2009) (confirming that Section 102(b)(7) protects corporate directors from liability for losses arising from violations other than duty of loyalty violations); Strine et al., *supra* note 179, at 661 (discussing the drafting of Section 102(b)(7)).

220. Cynthia A. Williams & John M. Conley, *An Emerging Third Way? The Erosion of the Anglo-American Shareholder Value Construct*, 38 CORNELL INT'L L.J. 493, 498 n.21 (2005).

221. In two important articles, Professor Fanto addressed the law's failure to respond to the acquirer overpayment problem. *See* Fanto, *Braking the Merger Momentum*, *supra* note 23; Fanto, *Quasi-Rationality in Action*, *supra* note 91, *passim*.

solutions. It discusses the benefits and shortcomings of each mechanism. The potential solutions discussed below are all worthy of greater discussions, however, as recently noted by Professor Langevoort: "Those familiar with corporate law will know that none of these is much of a check on value-destruction."[222]

A. Acquirer Shareholder Voting Rights

Several scholars have argued for shareholder voting rights for acquirer shareholders in certain acquisitions, such as transactions over a certain size.[223] To a certain extent, arguments for shareholder voting rights are reflected in the MBCA, which, unlike Delaware, provides for shareholder voting in acquisitions where more than 20% of the outstanding shares of the acquirer will be issued in the transaction.[224] Nothing in the model act, however, envisions a shareholder vote in transactions where the acquirer is using cash or a combination of cash and less than 20% of its outstanding shares.[225]

In his comprehensive assessment of the tender offer's role in corporate governance, Professor Coffee suggested the adoption of a rule that would require a tender offer acquirer to obtain approval of its tender offer from the acquirer's own shareholders.[226] The proposal was based on the contemporary empire-building literature, which argued that "managements seek to maximize growth even when it is contrary to the shareholders' best interests."[227] Professor Coffee explained that requiring ac-

222. Langevoort, *Behavioral Economics of M&A*, *supra* note 26.

223. *See, e.g.*, Black & Kraakman, *supra* note 22; Coffee, *Regulating*, *supra* note 12, at 1281–82; Hamermesh, *supra* note 24, at 911.

224. *See supra* note 132 and accompanying text.

225. *See* Hamermesh, *supra* note 24, at 911.

226. *See* Coffee, *Regulating*, *supra* note 12, at 1269–72. While Professor Dent raised several objections to the shareholder voting proposal put forth by Professor Coffee, he acknowledged that it would be an improvement to the lack of protection under corporate law for bidder shareholders. *See* Dent, *supra* note 21, at 793–94.

227. Coffee, *Regulating*, *supra* note 12, at 1157. Professor Coffee set forth several of the reasons that scholars have identified as leading to such empire-building:

quirer shareholder approval would discourage inefficient empire-building and acquirer overpayment, while preserving the market for corporate control.[228] Similarly, Professors Black and Reinier Kraakman have argued for a corporate governance regime requiring stockholder approval for major transactions, stating, "[f]or other similarly fundamental transactions that are now outside the voting requirements under Delaware law, we would encourage the courts or the legislature to extend shareholder voting rights."[229]

While greater shareholder voting rights may be of some value, there are a number of arguments militating against it. Shareholder voting is costly and uncertain, but may not necessarily result in shareholders making an informed decision, particularly given historic shareholder apathy problems.[230] Individual shareholders of public corporations do not have a rational incentive to inform themselves of whether a management action is actually in their best interest.[231] Shareholders suffer from severe collective action problems, and normally no individual shareholder has sufficient incentive to invest optimally in researching the issue.[232]

Professor Coffee also recognized the potential problems with the shareholder voting mechanism, particularly in the takeover context. He noted that such voting could (1) permit easy attacks against the acquirer by the target of a takeover that could derail the takeover battle by contesting the adequacy of the acquirer's disclosures; (2) result in the need for costly and repeated disclosure in the event an acquirer finds it necessary to raise its bid in the face of an alternative rival for the target;

> (1) greater size tends to correspond with higher compensation for management; (2) increased size implies greater security from a takeover or other control contest; (3) enhanced prestige and psychic income are associated with increased size and national visibility; (4) greater size often translates into oligopolistic market power; or, finally, (5) expansion offers opportunities for advancement to the executive staff of the bidding firm.

Id. at 1167–68.

228. *See id.* at 1269. In his article explaining the overpayment hypothesis, Professor Black agreed that Professor Coffee's suggestion was an option worth exploring. *See* Black, *supra* note 12, at 652.

229. Black & Kraakman, *supra* note 22.

230. *See* Langevoort, *Behavioral Economics of M&A*, *supra* note 26, at 75–76. Others have also argued that "voting rights protection is not a panacea." Hechler, *supra* note 21, at 382.

231. *See* Robert A. Prentice, *Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred*, 66 OHIO ST. L.J. 1155, 1218–20 (2005).

232. *Id.* at 1220.

and (3) cause a chilling effect on takeovers since acquirers could face potential shareholder suits claiming that acquirer's proxy statement failed to disclose material information.[233]

A practical challenge to expanded shareholder voting as a viable solution to the acquirer overpayment problem is that the possibility of legislative reform is rather low.[234] As described in Part II.A above, there is a long history of depriving acquirer shareholders of the right to vote. Given the management/director-centered ethos of corporate law in the United States, and particularly in Delaware, it is highly unlikely that expanded shareholder voting will be politically feasible.[235]

In addition to the legal and practical challenges to acquirer shareholder voting, there is also little research addressing whether shareholder votes are effective in monitoring board-acquisition policy.[236] While there are numerous articles relating to whether shareholder votes are effective monitors in general, there are few studies of acquirer shareholder voting in acquisitions, perhaps due to the limited situations in which acquirers must obtain shareholder approval.

One of the few studies of acquiring-firm shareholder approval finds that merger proxy votes may provide only some monitoring of management even though approval rates for votes on acquisitions are higher than other types of shareholder votes.[237] The study found that the shareholders of every acquirer firm in the sample approved the acquisition with an average approval of 95% of votes from votes cast.[238] One reason for this is that shareholders who disapprove of the acquisition are the most likely to sell their shares prior to the date of the vote, and another reason is that there might be a coordination problem where the remaining disapproving shareholders view casting negative votes as futile.[239] The authors note that there are

233. *See* Coffee, *Regulating*, *supra* note 12, at 1270.

234. *See* Hechler, *supra* note 21, at 382–83.

235. *See* Dent, *supra* note 21, at 786–87.

236. *See* Hechler, *supra* note 21, at 383 n.190.

237. *See* Timothy R. Burch et al., *Is Acquiring-Firm Shareholder Approval in Stock-for-Stock Mergers Perfunctory?*, FIN. MGMT., Winter 2004, at 45, 51.

238. Another study, which examines the holdings of institutional investors and their returns around merger announcements, has found that although the votes are still overwhelmingly for the merger, shareholders only invested in the acquirer are generally four times more likely to vote against a merger as a cross-owner. *See* Gregor Matvos & Michael Ostrovsky, *Cross-Ownership, Returns, and Voting in Mergers*, 89 J. FIN. ECON. 391, 399 (2008).

239. *See* Burch et al., *supra* note 237. With respect to institutional investors, a recent study suggests that on average they value both voting and cash-

quorum requirements so that voter turnout must exceed 50%, and thus in certain circumstances (such as when the vote is based off of voting rights) failure to vote acts as a "no" vote.[240] The authors find that a total of seven mergers in their sample of 209 were "close" votes either due to the vote itself or due to the total votes cast, and argue that this shows that boards have reason to be careful of shareholder votes.[241] The approval rate is then shown to be linked to several factors including: managerial ownership, institutional ownership, mixed consideration instead of purely stock, announcement return, the change in return on assets, return on assets, and whether the votes are out of votes cast or voting rights.[242] Because of these factors' effect on approval rates, they argue that managers choose mergers that are likely to be approved based on these factors and do not present mergers unlikely to be passed by shareholders.[243]

Overall, while there is some support for the argument that acquirer shareholders' voting rights may to some extent monitor the agency costs, thus far the evidence is too limited to be conclusive. In addition, I am not aware of any studies that show whether voting addresses the behavioral biases leading to acquirer overpayment. What is clear at this point is that much more inquiry into the value of voting rights for acquirer shareholders is necessary.

B. INDEPENDENT DIRECTOR CONTROL

One potential solution to the acquirer overpayment problem is for the law to require greater independent director control over acquisitions so as to provide increased monitoring of management and to lessen the risk of management overconfidence in acquisitions.[244] Given the level of authority given to board members in authorizing acquisitions, some scholars argue that boards will undertake these activities better if they have directors that are independent of the acquirer's manage-

flow rights. The study shows that institutional buying before the record dates increases voting turnout but negatively relates to shareholder support of the merger. *See* Jennifer E. Bethel et al., *The Market for Shareholder Voting Rights Around Mergers and Acquisitions: Evidence from Institutional Daily Trading and Voting*, 15 J. CORP. FIN. 129, 131 (2009).

240. *See* Burch et al., *supra* note 237, at 53.

241. *Id.*

242. *Id.* at 59–60.

243. *Id.* at 65.

244. *See* Fanto, *Braking the Merger Momentum*, *supra* note 23, at 335, 343.

ment.[245] Independent directors now constitute a majority of boards in public companies.[246] In fact, since the passage of Sarbanes-Oxley and related SEC and stock exchange rules, a typical corporate board is composed of a supermajority of independent directors.[247]

In the M&A context, the Delaware courts have continued to encourage the use of independent directors in the context of corporate decisions.[248] The Delaware courts rely on independent directors to control agency costs that arise in acquisitions in which management has potential conflicts of interest, such as negotiations with a controlling stockholder in a going-private transaction or a management-proposed leveraged buyout.[249]

Undoubtedly, increased board independence may be of some value in controlling some of the agency costs and behav-

245. For an overview of discussions about the value of independent directors, see CORPORATE GOVERNANCE: LAW, THEORY AND POLICY 289–354 (Thomas W. Joo, ed., 2d ed. 2010).

246. *See* Lisa M. Fairfax, *The Uneasy Case for the Inside Director*, 96 IOWA L. REV. 127, 135–37 (2010).

247. *See id.* at 136–37. Federal law and the stock exchanges have extensively mandated decision-making by independent directors. *See* 15 U.S.C. § 78j-1(m)(3) (2006) (mandating that "[e]ach member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent"); NASDAQ, *supra* note 18, R. 5605(a)(2) (defining an "Independent Director" as "a person other than an Executive Officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director"); NYSE, *supra* note 18, § 303A.05(a) ("Listed companies must have a compensation committee composed entirely of independent directors.").

248. A number of Delaware cases encourage the use of independent directors in corporate decision making. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) (holding that the existence of a majority of independent directors on the board "materially enhance[s]" the proof needed to satisfy the burden of "good faith and reasonable investigation" upon judicial review of a board's rejection of a tender offer); *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 942–46 (Del. Ch. 2003) (rejecting the dismissal recommendation of a special litigation committee based on lack of evidence that committee members were sufficiently independent); *see also* Fairfax, *supra* note 246, at 140–43 (arguing that courts and regulators are reluctant to judge the conduct of corporate officers and that they view independent directors as a more appropriate monitor of corporate officer conduct, especially conflict of interest transactions).

249. *See In re* CNX Gas Corp. S'holders Litig., C.A. No. 5377-VCL, 2010 WL 2291842, at *1 (Del. Ch. May 25, 2010) (proposing a unified standard for acquisition transactions involving controlling shareholders in which "the business judgment rule applies when a freeze-out is conditioned on *both* the affirmative recommendation of a special committee *and* the approval of a majority of the unaffiliated stockholders").

ioral biases in acquisition transactions. Several studies have shown that independent directors are more likely to function effectively in specific situations, such as with respect to CEO turnover or some executive compensation decisions.[250] Empirical studies are thus far inconclusive on whether independent directors do much to improve firm performance.[251]

In addition, corporate boards are often "subject to capture as a result of management ties, cognitive biases, and social norms that undermine directors' ability to exercise independent

250. *See*, John W. Byrd & Kent A. Hickman, *Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids*, 32 J. FIN. ECON. 195, 219 (1992); Vidhi Chhaochharia & Yaniv Grinstein, *CEO Compensation and Board Structure*, 64 J. FIN. 231, 232 (2009); James F. Cotter et al., *Do Independent Directors Enhance Target Shareholder Wealth During Tender Offers?*, 43 J. FIN. ECON. 195, 214 (1997); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 456–57 (1988). For a survey of empirical research indicating the value of independent directors, see Lucian A. Bebchuk & Michael S. Weisbach, *The State of Corporate Governance Research*, 23 REV. FIN. STUD. 939, 943–45 (2010). Professor Fairfax, in an excellent new article on the value of independent directors, asserts that with respect to discrete tasks empirical evidence "fails to demonstrate a strong correlation between independent directors and improved corporate performance in particular areas." *See* Fairfax, *supra* note 246, at 175.

251. *See*, STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 198–200 (2008); Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 233–34 (2002); Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 921 (1999); Benjamin E. Hermalin & Michael S. Weisbach, *Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature*, FRBNY ECON. POL'Y REV., Apr. 2003, at 8; Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1530–32 (2005). In a thought-provoking article, Professor Gordon provides an explanation for the lack of conclusive evidence on the value of independent directors:

> The strongest explanation is the diminishing marginal returns hypothesis: most of the empirical evidence assesses incremental changes in board independence in firms where there is already substantial independence and after the cultural entrenchment of norms of independent director behavior. But . . . the most important effects of the move to independent directors, particularly over the long term, are systematic rather than firm specific and thus are unlikely to show up in cross-sectional studies. One systematic effect, the lock-in of shareholder value as virtually the exclusive corporate objective, could have benefits for early adopters, but other effects, such as the facilitation of accurate financial disclosure and corporate law compliance, have principally external effects.

Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1505 (2007) (citation omitted).

judgment."[252] As noted by Professor Lisa M. Fairfax in a recent article questioning the value of independent directors, (1) independent directors' reputations are not harmed when they favor the interests of friends and business associates, (2) favoring social relationships enhances a director's reputation in business circles, and (3) "social ties can have a profound impact on a [director's] ability to behave objectively."[253] Moreover, "psychology research has offered many reasons to be skeptical of director independence as a cure for bias, most having to do with the mix of reciprocity demands, low-powered incentives and informational deficiencies that can produce excessive deference to managerial preference."[254]

More specifically with respect to acquisition decisions, there is little empirical research to show that independent directors are able to control overpayment by acquirers. The phenomenon of overpayment has continued to persist despite the great rise in the independence of corporate directors.[255] It is not clear that independent board members will necessarily solve the behavioral biases and agency costs identified in acquisition transactions.

There are several reasons why independent directors alone may not counteract the acquirer overpayment problem. Independent directors are often dependent on management for the inputs and information needed in order to make decisions.[256] These informational asymmetries, coupled with the outsider status of independent directors, make it difficult for them to address potential self-interest or biases of management in acquisition decisions. Independent directors may also lack the

252. Jill E. Fisch, *The Overstated Promise of Corporate Governance*, 77 U. CHI. L. REV. 923, 928 (2010); *see also* JONATHAN R. MACEY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 57–61 (2008) (discussing the problem of board capture).

253. Fairfax, *supra* note 246, at 149–59; *see also* Byoung-Hyoun Hwang & Seoyoung Kim, *It Pays to Have Friends*, 93 J. FIN. ECON. 138, 139, 154 (2009) (finding that "socially dependent" independent directors do worse as monitors of CEOs than socially independent directors).

254. Langevoort, *Behavioral Economics of M&A*, *supra* note 26, at 75; *see also* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 800 (2001) (contending that "too much true independence in the boardroom has unintended consequences").

255. For a history of the rise of independent directors in U.S. public companies, see generally Fairfax, *supra* note 246, *passim*, and Gordon, *supra* note 251, *passim*.

256. *See* Fairfax, *supra* note 246, at 161.

knowledge or skills to understand and combat the causes of the acquirer overpayment problem.[257] Scholars have argued that "even if directors received accurate and adequate information, they may lack the ability to understand that information, and thus they may also lack the ability to detect deficiencies with respect to that information."[258] Directors' knowledge deficiencies may mean that they will be unable to challenge managements' overly optimistic valuation of an acquisition target. Furthermore, as discussed in Part II above, the law provides little incentive for independent directors to invest significant time and resources to effectively monitor management with respect to acquisition decisions. The lack of a shareholder role in acquisition decisions and the somewhat meager disclosure requirements with respect to many acquisitions, coupled with the low risk of significant liability for independent directors, potentially reduces their effectiveness with respect to acquisition decisions.

C. LITIGATION & THE POTENTIAL FOR INCREASED JUDICIAL SCRUTINY

Several scholars have suggested judicial responses to the acquirer overpayment problem. In a 1986 article, Professor George Dent proposed that courts should enjoin, as corporate waste or breach of fiduciary duty, acquisition transaction bids that cause a material decline in the acquirer's stock price.[259] In an article addressing "mega-mergers"[260] and the behavioral problems that distort the process involved in such transactions, Professor Fanto proposed that courts adopt a standard whereby a board would

> 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,

257. *Id.* at 164–65.

258. *Id.* at 165.

259. Dent, *supra* note 21, at 794–97.

260. Professor Fanto's argument is limited to transactions "in which enormous companies, generally of comparable size, combine in a strategic 'merger of equals,' usually through a stock-for-stock exchange." Fanto, *Braking the Merger Momentum*, *supra* note 23, at 252. More specifically, a mega-merger is defined as "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." *Id.* at 334.

> most particularly not engaging in the mega transaction and remaining an independent firm.[261]

Professor Hamermesh also has suggested exploring judicial review in friendly stock-for-stock mergers, asserting that given the specter of managerial agency costs in such transactions, such transactions may be deserving of more judicial inquiry.[262]

Despite compelling arguments for at least considering a higher standard of review of acquirer board actions in some acquisition transactions, it is unclear whether litigation would adequately address the acquirer overpayment problem. Litigation is an ineffective check on the managerial agency costs that arise with respect to acquirers for two reasons: first, the specter of litigation agency costs,[263] and second, the reluctance of the courts to second-guess the business decisions of directors.[264]

Numerous scholars have noted the problematic issue of litigation agency costs.[265] Frequently, the announcement of an acquisition transaction triggers shareholder litigation, although the vast majority of these suits are brought on behalf of target

261. *Id.* at 263.

262. Hamermesh, *supra* note 24, at 909.

263. *See* Thompson & Thomas, *supra* note 121, at 135; *see also* Brian J.M. Quinn, *Shareholder Lawsuits, Status Quo Bias, and Adoption of the Exclusive Forum Provision*, U.C. DAVIS L. REV. (forthcoming 2011) (manuscript at 12), *available at* http://ssrn.com/abstract=1699464 (stating that shareholders have little incentive to monitor attorneys—the real parties in interest in shareholder litigation—that act as agents of shareholders).

264. Fairfax, *supra* note 246, at 140–43.

265. There is a robust discussion of agency cost problems associated with shareholder lawsuits. *See, e.g.*, John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 679–80 (1986); John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5, 8–9, 10 n.28 (1985); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 535–37 (1991); James D. Cox & Randall S. Thomas, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 COLUM. L. REV. 1587, 1593–95 (2006); Mark J. Loewenstein, *Shareholder Derivative Litigation and Corporate Governance*, 24 DEL. J. CORP. L. 1, 3 (1999); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiff's Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 3–4 (1991); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation*, 7 J.L. ECON. & ORG. 55, 57 (1991); Thompson & Thomas, *supra* note 121, at 138; Elliott J. Weiss & Lawrence J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797, 1799 (2004); Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2054–55 (1995).

shareholders.[266] There are important incentives for plaintiffs, or more accurately plaintiffs' lawyers, to bring lawsuits in change-of-control transactions or in transactions involving controlling shareholders whether or not it appears that the board violated their fiduciary duties to the corporation.[267] Scholars have argued that in shareholder suits that are representative litigation, "the plaintiff class's attorneys have much more to gain financially from a quick settlement of these suits than the named plaintiff, and these incentives can lead these lawyers to sell out the shareholders that they claim to represent."[268] Moreover, excessive litigation can result in losses to society, to the involved firms, and to shareholders since the cost of settling shareholder suits are borne by shareholders of the firm.[269]

Despite these potential issues, there are some robust studies show that shareholder litigation can address managerial agency costs, at least to an extent. To date, these studies have focused on litigation brought by shareholders of targets.[270] Thus, it is an open question whether greater judicial scrutiny could address either the agency costs or behavioral biases of acquirers. Without conclusive evidence of the value of shareholder litigation for shareholders of acquirers, it is difficult to argue for a solution that could increase legal uncertainty and

266. *See* Krishnan et al., *supra* note 170 (manuscript at 1). The large incidence of transaction-related shareholder litigation has been covered in the financial press. *See, e.g.*, Dionne Searcey & Ashby Jones, *First, the Merger; Then the Lawsuit*, WALL ST. J., Jan. 10, 2011, at C1.

267. Weiss & White, *supra* note 265, at 1804. In the recent past, Delaware courts have increasingly acted to police litigation agency costs. *See* John Armour, et al., *Delaware's Balancing Act*, 87 IND. L.J. (forthcoming 2012) (manuscript at 4), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1677400; Quinn, *supra* note 263 (manuscript at 8); Faith Stevelman, *Regulatory Competition, Choice of Forum, and Delaware's Stake in Corporate Law*, 34 DEL. J. CORP. L. 57, 137 (2009); *see also* John Armour, et al., *Is Delaware Losing Its Cases?* 4 (Eur. Corp. Governance Inst. Law Working Paper No. 151/2010, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1578404 (discussing factors that influence choices plaintiffs' lawyers make about venue selection). For an extensive analysis of transaction-related settlements, see generally Weiss & White, *supra* note 265, *passim*.

268. Thompson & Thomas, *supra* note 122, at 135 n.3. Professors Thompson & Thomas argue that potential agency costs can arise in shareholder suits which are representative litigation in which a self-selected shareholder and her attorney pursue claims on behalf of all shareholders and have interests that may differ from other shareholders. *Id.* at 135. Such costs are exacerbated given the potential financial gain by attorneys with quick settlement. *Id.*

269. *See id.* at 159.

270. *See id.* at 167.

cause excessive deal risk, neither of which helps the preservation of long-term value, and exacerbate litigation agency costs.

In addition to the costs of litigation, similar to the shareholder voting proposal, there is little indication that there would be any judicial support for abandoning what is a strongly held view among judges. As demonstrated by the discussion of In re *Dow Chemical* above, Delaware judges are wedded, perhaps more than ever, to the business judgment rule.[271] Courts have long recognized that "after-the-fact litigation is a most imperfect device to evaluate corporate business decisions. The circumstances surrounding a corporate decision are not easily reconstructed in a courtroom years later, since business imperatives often call for quick decisions, inevitably based on less than perfect information."[272]

Some scholars have also argued in favor of the deference afforded to directors by the business judgment rule. There is little reason to undermine the business judgment rule so that judges would be placed in the role of second-guessing acquisition decisions. "The costs of litigation are too high, and the business acumen of judges too meager, to make it likely that the benefits of greater judicial scrutiny will outweigh the costs."[273]

It is also not clear that an ex-post, case-dependent solution like litigation would directly address the overpayment problem. Litigation may result in costs even to properly priced acquisitions. In other words, litigation does not necessarily discriminate between good and bad deals, but can impose significant costs on all transactions. Furthermore, it is not clear that ex-ante agents making acquisition decisions would necessarily internalize the costs of ex-post litigation. Litigation only assists those shareholders who actually move forward with the decision to litigate and, if they can overcome the significant hurdles

271. *See In re* Dow Chem. Co. Derivative Litig., No. 4349-CC, 2010 WL 66769, at *10 (Del. Ch. Jan. 11, 2010).

272. Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982). The business judgment rule has been articulated in judicial decisions for over 170 years. FRANKLIN A. GEVURTZ, CORPORATION LAW 286 (2d ed. 2010).

273. Black, *supra* note 12, at 651; *see also* Langevoort, *Behavioral Economics of M&A*, *supra* note 26, at 76 ("Deference to the business judgment rule has many familiar justifications, even if we accept that psychological biases may exacerbate the problem of value-destroying transactions. The business judgment rule is a rule of abstention that stems from, among other things, judges' lack of confidence in their own second-guessing skills—perhaps even a sense of their own hindsight bias. The rule further stems from the fact that judicial review is labor and resource-intensive if offered by the courts." (citation omitted)).

of litigation, actually succeed in imposing liability on boards. Litigation is therefore not a broad-based solution to the overpayment problem.

Overall, greater judicial scrutiny appears to be an unsatisfactory solution. Given the Delaware courts' strict adherence to the tenets of the business judgment rule, it seems unlikely that the courts would exercise greater scrutiny in acquirer board decisions. Moreover, litigation is in itself an incomplete remedy that would only assist certain acquirer shareholders and has other shortcomings due to litigation agency costs.

IV. PROPOSAL FOR REFORM: A SHAREHOLDERS' PUT OPTION

The shareholders' put option, coupled with increased disclosure, seeks to provide a transaction-oriented solution to address the agency costs and behavioral biases that play a role in the acquirer overpayment problem. The solution helps to address the problem of acquirer overpayment without suffering from many of the problems faced by currently proposed solutions. The shareholders' put option mechanism would be an effective way for shareholders to directly address the overpayment problem.

Section A begins by describing the key elements of the shareholders' put option. Section B identifies the advantages of the shareholders' put option. Section C analyzes the incentives for voluntary adoption of the shareholders' put option, as well as whether this solution should be mandatory. Section D then examines in detail the mechanics of the proposal, along with securities laws issues raised by the shareholders' put option. Part IV concludes by addressing potential concerns with the solution.

A. DESIGNING THE SHAREHOLDERS' PUT OPTION

This Article proposes that in *fundamental* acquisition transactions,[274] the acquirer would sell an option to its shareholders, for up to 20% of the acquirer's outstanding stock, which would provide them with the right to sell their shares back to the acquirer following closing of the acquisition for cash at a fixed pre-acquisition announcement price. The option would be sold following announcement of the acquisition. The premium (sale price) for the option would be based on the trad-

274. *See infra* notes 331–33 and accompanying text for a discussion of transactions that would qualify as "fundamental."

ing price of the acquirer's securities immediately prior to the announcement of the acquisition transaction. Under the proposal, the exercise price (strike price) of the option is fixed at the pre-acquisition announcement price. The option would be exercisable following closing of the acquisition of the target entity. Each of these components is described in more detail below.

The goal of the shareholders' put option is not to launch an entire share buyback program for all of the acquirer's shares, but for the acquirer's management to internalize the cost of the acquisition ex-ante rather than to pass the costs to shareholders ex-post following closing of the transaction. Managers internalize the cost because they would need to use additional free cash of the company to redeem the shares if the shareholder exercise the put option. Of course, implicit is an assumption that managers are more sensitive to the use of company free cash than to a drop in share price.[275]

1. Fundamental Transactions

This Article suggests that a shareholders' put option should be afforded in transactions between publicly traded firms in *fundamental* transactions: i.e., transactions where the value of the target exceeds 25% or more of the assets or market capitalization of the acquirer.[276]

This Article contemplates the use of the shareholders' put option in fundamental transactions for several reasons. First, under current law acquirer shareholders are deprived of any participation in certain transactions—such as when the acquirer uses a combination of cash and less than 20% of the acquirer's outstanding stock—due to structure and without any regard to the size or potential impact of the transaction on the

275. *See infra* Part IV.B.3.

276. Several other jurisdictions also provide rights for acquirer shareholders in fundamental transactions. For example, Listing Rule 10 of the United Kingdom Financial Services Authority requires prior approval from shareholders of the acquirer of large transactions (Class 1 transactions), meaning a transaction that amounts to 25% or more of any of the acquirer's gross assets, profits, or gross capital, or in which the consideration is 25% or more of the market capitalization of the acquirer's common stock. *See* Friedlander, *supra* note 140, at 631 (citing FIN. SERVS. AUTH. HANDBOOK, LISTING R. 10.2.2 (2011) (U.K.), *available at* http://fsahandbook.info/FSA/html/handbook/LR/10/2; *id.* R. 10.5.1(2), *available at* http://fsahandbook.info/FSA/html/handbook/LR/10/5; Paul Davies, Shareholder Value, Company Law and Securities Markets Law: A British View 29 n.78 (Oct. 2000) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=250324).

acquirer.[277] Providing the put option in *fundamental* transactions, regardless of structure, would give acquirer shareholders the prospect of addressing overpayment problems in transactions that have proven to have the most potential for damaging the acquirer. Second, this Article contemplates limiting the put option to fundamental transactions because such transactions are the most damaging to acquirer shareholders and provide the greatest opportunity for behavioral biases and managerial benefits at the expense of shareholders. Third, the evidence of overpayment is most clear and significant in fundamental transactions. Given that clear evidence of acquirer overpayment in all acquisitions is inconclusive, limiting the put option to fundamental transactions would reach only those transactions for which clear empirical evidence of overpayment exists.[278]

2. The Scale of the Shareholders' Put Option

Under the proposal, the acquirer would, in connection with announcement of a fundamental acquisition, offer a right to shareholders, for up to 20% of the acquirer's outstanding stock, to put their shares to the acquirer. If the offer is oversubscribed, the option would be sold to participating shareholders on a pro-rata basis.[279] By limiting the shareholders' put option to up to 20% of the company's outstanding shares, the proposal can ensure that shareholders who do not believe that the acquisition transaction is value-enhancing can be bought out at a fair value without destroying the company's ability to move forward with the acquisition. In addition, limiting the put option to up to 20% of the outstanding stock avoids triggering any voting rights for the sale of the put under the stock exchange rules.[280] This is important in order to minimize the costs and complexities associated with the shareholders' put option.

277. *See supra* Part II.A.

278. *See supra* Part I.A.

279. Similarly, in an issuer tender offer, where a firm seeks to repurchase its own shares from its shareholders, if the tender offer by the issuer is for fewer than all of the outstanding shares of a class, and the number of shares tendered exceeds the number that the issuer is willing to purchase, the issuer must accept and pay for the shares as nearly as may be pro-rata, according to the number of shares tendered by each shareholder during the period that the offer remains open. *See* 17 C.F.R. § 240.13e-4(f)(3) (2011).

280. *See supra* Part II.A.

3. The Structure of the Shareholders' Put Option

a. The Premium (Sale Price) of the Shareholders' Put Option

As noted above, the option's sale price, or premium, would be calculated immediately prior to the announcement of the acquisition transactions. This premium would be paid at the time of the purchase of the shareholders' put option and, if the acquisition closes, would not be refundable to the shareholders even if the option is not exercised.[281] The acquirer would need to sell the option rather than simply grant the option to its shareholders as the option may have value even if it is out-of-the-money (i.e., it has no intrinsic value at that moment) because even just out-of-the-money options may be valuable due to uncertainty.[282]

To determine the price of the option, the put option would be valued at either the actual price of a put option with similar characteristics of the put option being priced, or as determined synthetically through generally accepted modeling of the option value.[283] In general, options are priced using several primary factors—the underlying stock price in relation to the strike price (intrinsic value), the length of time until the option expires (time value), and how much the price of the underlying stock fluctuates (volatility value).[284] Given that the option is priced immediately prior to the announcement of the acquisition, one would expect that the intrinsic value would be quite low.

The option would be fairly priced assuming that the acquisition does not fundamentally destroy the acquirer firm's value. If the option premium is determined before the market reacts to the announcement of the acquisition, then the option would be fairly priced at that point in time. That is, the acquirer could have purchased an option in the market and sold it to the shareholders for the same price.

The payoff from the shareholders' put option is inversely related to the stock price. If the acquisition transaction destroys the acquirer firm's value, then the option premium is

281. The proceeds from the sale of the put options should be placed in escrow so that, in the event that the acquirer determines not to close the acquisition, such proceeds can be returned to the shareholders who purchased the option.

282. *See infra* Part IV.A.4 and note 289 and accompanying text.

283. *See* BREALEY & MYERS, *supra* note 27, at 568–70.

284. *See id.* at 573.

"cheap." In other words, this option would now be "in-the-money" (i.e., the actual stock price of the acquirers is below the exercise price) since a transaction that destroys value depresses the traded share price of the acquirer. The put option, then, is more valued the more in-the-money it is. That is, the greater the drop in the acquirer's stock price following the announcement of the acquisition, the more likely that existing shareholders would purchase the option. If the option remains in-the-money at the time of the closing of the acquisition, there is a high likelihood that shareholders who purchased the option would exercise the option and force the acquirer's management to use free cash to purchase the shares put to the company. If, on the other hand, the deal enhances the acquirer firm's value, the premium is "expensive," and existing shareholders would not purchase the option.

b. The Maturity of the Shareholders' Put Option

For purposes of the put option, the maturity of the put will be a period after the closing of the acquisition of the target entity. The proposed shareholders' put option is a European-style option that is exercisable only following the date of the closing of the acquisition.[285] Thus, the option would only be exercisable if the acquirer in fact completes the purchase of the target entity.[286] Under the offer, the acquirer would agree to purchase, subject to closing of the acquisition transaction, the shares at an exercise price equal to the average trading price of the stock over a set period prior to the announcement of the acquisition transaction.[287] In order to address the potential issues of a shareholder stampede, the shareholders who agree to purchase

285. *See id.* at 558.

286. In the event that the put options are sold, but the acquirer determines not to move forward with the acquisition, the proceeds from the sale of the put would be returned to the shareholders who purchased the option.

287. The shareholders' put option uses the stock price as the proper exercise price for the purchase price of the shares, thus assuming an efficient market where the pre-offering price correctly reflects the value of the shares and the firm. For a general description of the concept of efficient markets and its regulatory implications, see generally William T. Allen, *Securities Markets as Social Products: The Pretty Efficient Capital Market Hypothesis*, 28 J. CORP. L. 551 (2003), and Christopher Paul Saari, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977). For a convincing argument as to why stock price is an informative measure of a firm's performance, see Gordon, *supra* note 251, at 1541–63. *But see* Stout, *supra* note 89, at 653–54 (2003) (surveying the weaknesses of the efficient capital market hypothesis).

the option would be unable to sell their shares until the closing of the acquisition transaction.

c. The Exercise Price of the Shareholders' Put Option

Under the proposal, the exercise price of the option is fixed based on a pre-acquisition announcement price. This Article proposes setting the exercise price of the shareholders' put option to be equal to the average trading price of the stock over the two week period prior to the announcement of the acquisition transaction. Thus, shareholders would only exercise the option if, after the closing of the acquisition, the actual stock price of the acquirer is below the exercise price.[288]

Formulating the correct strike price for the put option is a challenging endeavor. There are myriad ways that acquirer management might be able to manipulate the acquirer's share price pre-announcement in order to lower the shareholders' incentives to exercise the put and to lower the costs of the option. Management may want a share/strike price as low as possible on the announcement date, so they might precede the announcement with information that would depress the trading price of the acquirer's stock prior to the announcement of the acquisition transaction. Thus, the strike price of the option must be based on some representative pre-announcement period over which to average the stock price in order to set a non-manipulable strike price for the put options. This proposal uses the average trading price of the stock over a two week period partially to lessen the risk of management manipulation of the acquirer's pre-announcement stock price. Admittedly, management could try to depress the trading price in the two week period in advance of an acquisition announcement. This, however, is likely not a significant risk, as acquirers often use their own shares as acquisition consideration and depressing the share price could affect management's ability to undertake an acquisition.

4. An Example of the Shareholders' Put Option

While the structure described above may appear quite complicated, working through an example should expose how the shareholders' put option would provide a mechanism for the acquirer's management to internalize the costs of an acquisition. Assume A is the acquirer with a pre-transaction value of

288. *See* BREALEY & MYERS, *supra* note 27.

$1000. Suppose there are 100 outstanding shares. Thus, the share price of A is $10 per share prior to the announcement of the acquisition. T is the target with pre-transaction value of $400.

Under the proposed solution, A would sell an option to the holders of 20 of its shares entitling each holder of the option to sell to A one share at a price of $10 immediately following the acquisition of target T. Given that the option is priced at the value of A's stock immediately prior to announcement of the acquisition, the sale price of the option would likely be a nominal price reflecting the time and volatility value of the option from announcement to closing of the acquisition. For purposes of the example, assume such price is $0.10 per share. Thus, A would receive a maximum of $2 (20 shares multiplied by $0.10) from shareholders if 20% of the outstanding shares determine to purchase the option.

The option gives shareholders who believe that the purchase of T will diminish A's value the opportunity to sell a portion of their shares to the company for a higher price than that available in the open market immediately following the closing of the acquisition. Suppose the transaction is priced "just right." In this case, A determines to pay $400 for target T. The value of A would remain unchanged as it exchanges just right valued assets. That is, A would give to shareholders of T $400 in cash and/or stock and receive an asset valued at $400. Accordingly, the ex-post value of the firm will still be $1000, and the share price will be $1000/100 or $10. If A in fact obtains a "good deal" in the transaction (i.e., the acquisition is value-enhancing), the post transaction value of the firm will be greater than $1000. Thus, the value of the put option will be zero ex-post. That is, the share price of A will continue to be at least $10 and there would be no incentives for shareholders to purchase the option or exercise the put.[289]

289. This example also demonstrates why the options would need to be sold, as even out-of-the-money options may have value due to uncertainty. *See id.* at 570. Going back to our example: suppose that the target was acquired at the "just right" price. In this case, the value of the surviving firm is $1000. However, suppose that between the time that the merger is announced when the options are sold and the time that the transaction closes when the option is exercisable, there is some external event that lowers the value of the firm that has nothing to do with the value of A (e.g., an innovation renders some of A's products obsolete). In this case, the put option would be exercised. That is, even if the transaction is fairly priced, as long as there is some probability of a decline in price that results in the put option being "in the money" then the

Now assume that A is overbidding for the target T, offering $500 even though the ex-transaction value of T is $400. If shareholders perceive the deal as value-destroying, they would determine to purchase the option, thus providing the firm with $2. Assume further that the transaction goes through. Then, the resulting firm would have a post transaction value of $902 or ($1000-$100+$2). In this case, the value per share would decline to $902/100 or $9.02 per share. The strike price of the put option is $10. In this scenario, the shareholders of A who hold put options would exercise the put, which would require a transfer of the free cash flow resources of A to the shareholders who exercised the put. Therefore, the directors would immediately face the cost of the reduction in A's share value as a result of the overbidding.

B. Advantages of the Shareholders' Put Option

Previously, scholars have argued that the role of the board of directors in monitoring management actions in acquisitions should be reexamined in light of acquirer overpayment problems.[290] To date, due in part to a lack of legal liability, there are few significant incentives for acquirer boards to be heavily involved in acquisition decisions and to meaningfully question management and their incentives. The shareholders' put option is in part intended to provide incentives for, or pressures on, the board of the acquirer to engage more deeply with the decision to acquire a target entity. The shareholders' put option may provide well-motivated independent directors an avenue through which they can "play a more active role in project assessment and selection to counterbalance CEO overconfidence."[291]

A limited shareholders' put option may be an optimal way to address the managerial agency costs and behavioral biases that arise in acquisition transactions. The put option proposal provides a number of benefits. Some of the benefits of the shareholders' put option as a solution to the acquirer overpayment problem arise from the complexity involved in determining the correct sale price and exercise price for the option. This complexity could both enrich the decision-making process and the disclosure made by acquirers to their shareholders. Moreover, the offer of the shareholders' put option would demonstrate

option is valuable. Thus, the firm needs to sell the put option at the pre-transaction price.

290. *See* Black, *supra* note 12, at 651.

291. *See* Malmendier & Tate, *supra* note 7, at 42.

to the firm's shareholders the board's confidence in the acquirer's acquisition plan. If the acquirer's shareholders then purchase the put option and later exercise it in a value-destroying transaction, then the acquirer's management would be forced to utilize some of the company's free cash. Exercise of the shareholders' put option would also directly affect the costs of the transaction for the acquirer's managers, making it significantly more costly to acquire a target company in a transaction where the acquirer's shareholders have exercised their put option.

1. Benefits for Board Process

One of the benefits of the put option is the impact that it would have on the involvement and decision-making processes of acquirer boards in acquisition decisions. The put option in essence provides a market-oriented incentive for acquirer boards to meaningfully consider the decision to acquire a target entity and properly value the consideration being used in such acquisitions.[292] Additionally, the shareholders' put option can serve as a commitment device by boards that want to signal to the market that they are "good boards" who have undertaken a rigorous process to enter into value-enhancing transactions.

In terms of process, given the voluntary nature of this proposal, acquirers boards of directors would first need to engage with the question of whether to sell a put option to their shareholders at the time that they are engaging in the acquisition decision. Acquirers who decide to sell the put option to their shareholders then would need to undertake a process to determine the sale price of the option in connection with entering into a formal agreement to acquire a target company. This process would likely involve the board of directors in a deeper discussion about the value of the consideration being paid in the acquisition, the probabilities of the expected gains to be made from the acquisition transaction, and the expected investor reaction to the acquisition transaction.

Ideally, the board would engage with outside experts in order to make any such determination. Boards often turn to outside experts to make important decisions, and courts have long

292. In cases where acquirer shareholders already have the ability to vote on the transaction, requiring acquirers to provide the proposed put option to their shareholders would not substitute for traditional external regulation but would offer an important supplement to the existing regulatory toolkit for constraining management from engaging in value-destroying acquisitions.

encouraged boards to do so.[293] Furthermore, the use of experts to advise the board on the put option may also be an ideal way to implement suggestion by other scholars on using experts to address behavioral biases in large mergers.[294]

2. Disclosure Benefits

The sale of the shareholders' put option could also provide useful disclosure.[295] In selling the shareholders' put option, a board of directors would likely need to explain the pricing mechanism used for valuing the option as well as the underlying assumptions used by the board in such pricing. The need to provide this disclosure would provide an incentive for boards to become more deeply involved in the acquisition decision. This disclosure could be useful for shareholders in determining the value of the acquisition decision based on the acquirer's disclosure regarding the volatility value of the option.

Given the disclosure that would be required in offering the acquirer's shareholders a put option, the board would have greater opportunity to question management about the decision to acquire another entity, and the methods by which management determined the best price. The tactical decisions necessary to determine the scope of the shareholders' put option would necessarily require greater time commitment and involvement of the acquirer's board. Rather than solely relying on presentations by potentially interested management and advisers to the board of the potential value and synergies of the transaction, the board would have to evaluate such value and synergies in detail in order to articulate more specifically to its shareholders how the proposed transaction is intended to increase shareholder value. The need to explain the value of the

293. *See* Fanto, *Quasi-Rationality in Action*, *supra* note 91, at 1382–84.

294. *See id.* at 1398. Professor Fanto suggests a disclosure-based rule that requires investment bankers who advise on acquisition decisions provide fairness opinions that "consider the potential negative consequences and costs arising from the transaction and to quantify the likely negative results of the merger" and explain "the rationality of the deal from both the acquirer's and target's perspective as opposed to their current limited focus on the fairness of the exchange ratio" for the target's shareholders. *Id.*; *see also* Joan MacLeod Heminway, *A More Critical Use of Fairness Opinions as a Practical Approach to the Behavioral Economics of Mergers and Acquisitions*, 12 TRANSACTIONS: TENN. J. BUS. L. 81, 89–91 (2011) (noting that the opinions of auditors "carry great weight" with boards because auditors are subject to externally imposed restrictions).

295. For further discussion of disclosure obligations related to the sale of the shareholders' put option, see *infra* Part IV.D.

transaction to shareholders encourages the board to be more demanding of management regarding the data and assumptions used to evaluate the value of the acquisition, and to perhaps even rely on experts who do not necessarily have an interest in the closing of the acquisition.[296] In addition, the disclosure given to shareholders to explain the put option, would necessarily need to expose the risks related to the acquisition, including integration risks and potential management incentives associated with the transaction.

3. Management's Internalization of Costs

Currently, when shareholders learn of an acquisition that is believed to be value-destroying, shareholders quickly proceed to sell their shares.[297] Thus, the stock price of the acquirer generally declines following the announcement of the deal. This pre-acquisition flight does not necessarily discipline management because it is not clear that it forces management to internalize the costs of a bad deal. All the flight does is drive stock prices down which based on most long-term compensation schemes may not ever affect management.[298] Accordingly, shareholders suffer losses when a value-destroying acquisition is announced since they suffer a blow from the drop in the stock price.

Unlike under current conditions, the shareholders' put option places the burden of a value-destroying acquisition on management. As described in Part IV.A above, in the case that a transaction is believed to be value-destroying by the market, the price of the acquirer's shares will decline. Thus, under the proposal, the option would be of value to shareholders who will likely rush to buy what they would perceive to be a cheap price. While under the proposal, a shareholder would be paying for the price of the option, the price they would pay for the option will be lower than the losses they generally would suffer if they sold in the open market. In all likelihood, if the acquirer's management determines to move forward with a value-destroying transaction, management would be forced to redeem shares using free cash flow in the process.[299]

296. *See* Fanto, *Braking the Merger Momentum*, *supra* note 23, at 336–37.

297. *See* Jensen, *supra* note 11, at 328–29.

298. *See* Grinstein & Hribar, *supra* note 76, at 119, 122–23; Jensen, *supra* note 11, at 323–29.

299. *See* Jensen, *supra* note 11, at 323 ("Free cash flow is cash flow in excess of that required to fund all projects that have positive net present val-

The benefit of using the shareholders' put option is that it directly reflects and translates the value of the transaction, through its impact on the acquirer's share price, and on management's use of free cash flow. Economic theory establishes that when management retains a large part of the firm's earnings, management tends to use it to make unprofitable investments.[300] Scholars have long argued that "managers have incentives to cause their firms to grow beyond the optimal size. Growth increases managers' power by increasing the resources under their control. It is also associated with increases in managers' compensation . . . ."[301] The shareholders' put option would place a pressure on the incentives of managers to grow the firm through value-destroying acquisitions. If the option is exercised, management would need to use a portion of the firm's free cash to redeem the shares put by the acquirer's shareholders. As described by Jensen, such "[p]ayouts to shareholders reduce the resources under managers' control, thereby reducing managers' power, and making it more likely they will incur the monitoring of the capital markets which occurs when the firm must obtain new capital."[302]

C. Adoption of the Shareholders' Put Option

The shareholders' put option can be seen as a market mechanism that can effectively constrain managerial discretion and inefficiency. In essence, the shareholders' put would provide for a mechanism for shareholders and boards to minimize managerial agency costs and behavioral biases. The put option would provide important incentives for both directors and shareholders within the current corporate governance framework. Moreover, it is in line with economic theory that establishes that when management retains a large part of the firm's earnings, they tend to use it to make unprofitable investments.[303]

One of the main challenges of the put option is whether acquirers would in fact ever wish to sell put options to their own

ues . . . . The problem is how to motivate managers to disgorge the cash rather than investing it at below the cost of capital or wasting it on organization inefficiencies.").

300. *See* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 903–04 (2005).

301. Jensen, *supra* note 11, at 323.

302. *Id.* (citation omitted).

303. *Id.* at 327.

shareholders in connection with an acquisition. This Article's shareholders' put option is in fact designed to provide a mechanism for the acquirer's management to internalize the costs of an acquisition and could intensify the risks of a more expensive acquisition as a result of the exercise of the put. Yet, there may be at least two important reasons for adoption of the shareholders' put option: (1) it enables the board and management to signal the value of an acquisition and to differentiate their good deals from bad deals, and (2) it provides shareholder pressure to offer the put option in connection with an acquisition. This Section briefly discusses each of these reasons. It also addresses whether making the shareholders' put option mandatory is an attractive solution.

1. Adoption of the Shareholders' Put Option by Acquirer Boards

While some boards and management may resist the put option, adoption of the shareholders' put option may occur by boards of directors as a precommitment device to assure shareholders that they are concerned about preserving shareholder value in acquisition decisions, or by acquirers that wish to signal the value of an acquisition and the value of their own management performance.

Scholars have long recognized that

> [p]recommitment strategies . . . abound in business life. When a corporation's board of directors authorizes the inclusion of a negative pledge clause in a bond indenture, the board disables the corporation from issuing certain types of secured debt. When the board and/or shareholders adopt a mandatory indemnification amendment to the bylaws, they precommit the corporation to a policy of indemnifying officers and directors under circumstances in which the statute does not mandate such indemnification. And so on.[304]

Given the extensive knowledge about the potential for agency costs and behavioral biases with respect to acquisitions, boards of directors could adopt a policy to provide the shareholders' put option mechanism in fundamental transactions in order to restrict over time the chances for undertaking value-destroying acquisitions. Furthermore, as monitors of management, boards may adopt the shareholders' put option to lower monitoring mistakes in fundamental acquisitions.

The put option could also serve as a device by which management signals with respect to a particular acquisition that

304. Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1, 2–3 (2003).

they expect the acquirer's value to rise as a result of the closing of the acquisition.[305] It can be a credible way for good managers to differentiate their deals from value-destroying acquisitions and to induce investor confidence in the acquisition decision.[306]

Several studies have addressed signals by companies in connection with repurchases of stock. Indeed, some scholars have argued that management of public companies have used issuer put options in the past in part to signal optimism to the market about their firm.[307] Public announcement of open market repurchase (OMR) programs by issuers often result in at least a short-term spike in the firm's stock price.[308] The use of OMRs has led to arguments by legal and financial scholars that managers often use such repurchase programs to create a false signaling (i.e., to exploit the short-term spike in price without any intention to complete the repurchase).[309] Some scholars have argued that the use of OMRs also allows for greater managerial opportunism.[310]

The shareholders' put option does not suffer from this same false signaling and managerial opportunism concern. Under the proposal in this Article, management would be required to

305. Public announcement of open market repurchase (OMR) programs by issuers often result in at least a short-term spike in the firm's stock price. *See* Michael Simkovic, *The Effect of Mandatory Disclosure on Open-Market Repurchases*, 6 BERKELEY BUS. L.J. 96, 99 (2009).

306. Professor George S. Geis has made a similar argument in support of internal poison pills to protect minority shareholders. George S. Geis, *Internal Poison Pills*, 84 N.Y.U. L. REV. 1169, 1218 (2009).

307. *See* Scott Gibson et al., The Information Content of Put Warrant Issues 12 (Feb. 2006) (unpublished manuscript), *available at* http://www.bauer.uh.edu/povel/documents/puts.pdf; Stanley Bojidarov Gyoshev, Synthetic Repurchase Programs through Put Derivatives: Theory and Evidence 21 (June 2001) (unpublished Ph.D. thesis, Drexel University), *available at* http://idea.library.drexel.edu/bitstream/1860/45/10/gyoshev_thesis.pdf.

308. *See* Simkovic, *supra* note 305.

309. *See, e.g.*, Jesse M. Fried, *Informed Trading and False Signaling with Open Market Repurchases*, 93 CALIF. L. REV. 1323, 1336–40, 1357 (2005); Elias Raad & H. K. Wu, *Insider Trading Effects on Stock Returns Around Open-Market Stock Repurchase Announcements: An Empirical Study*, 18 J. FIN. RES. 45, 46 (1995); De-Wai Chou & J. R. Philip Lin, *False Signals from Open-Market Repurchase Announcements: Evidence from Earnings Management and Analysts' Forecast Revisions* 1–3 (2004) (unpublished manuscript), *available at* http://ssrn.com/abstract=471122. The SEC has also expressed concern with this type of false signaling and adopted specific disclosure requirements with respect to repurchase programs. *See* Purchases of Certain Equity Securities by the Issuer and Others, Securities Act Release No. 33-8335, 68 Fed. Reg. 64952, 64961–63 (Nov. 17, 2003).

310. *See* Simkovic, *supra* note 305, at 107.

complete the purchase of the shares if the options are exercised following the closing of the acquisition. Moreover, if the shareholders' put option is exercised following an acquisition transaction, the market value of the acquirer would in fact decrease, which would presumably decrease the market value of management's stock holdings.

If the shareholders' put option provides an effective signal that the acquirer believes that it is receiving a deal in the acquisition and that its stock following the acquisition will increase in value, then it may be an attractive option for diligent boards and management who believe in the value of the acquisition. Boards at times adopt voluntary practices to try to preempt government regulation, or to prevent devaluing of the company by investors.[311] Moreover, voluntary rules can encourage long-term compliance.[312] An effective voluntary practice can become the norm as more and more corporations acknowledge and adopt it.[313] Corporations may also comply with the voluntary practice because of the fear that they will lose investors if they do not.[314] Compliance in the voluntary regime continually increases after the first year. This "peer pressure effect" is a market mechanism that occurs without mandatory legal rules.[315]

2. Shareholder Power and Responsibility vis-à-vis the Put Option

Given the increasing power of institutional investors, who seem willing to counter wealth-destroying acquisitions by acquirers, the shareholders' put option is certainly a possibility.[316] In addition to providing incentives for greater board involvement, the put option would greatly increase the opportunity of acquirer shareholders to have a say in the transaction. The market pricing and shareholder participation in this process will offer a de-facto referendum on the decision to undertake an

311. *See* Anita Indira Anand, *An Analysis of Enabling vs. Mandatory Corporate Governance: Structures Post-Sarbanes-Oxley*, 31 DEL. J. CORP. L. 229, 235 (2006).

312. *Id.* at 240–41.

313. *Id.* at 240.

314. *Id.*

315. *Id.*

316. *See, e.g.*, Alon Brav et al., *Hedge Fund Activism, Corporate Governance and Firm Performance*, 63 J. FIN. 1729, 1741 (2008) ("[H]edge funds may attempt to play an activist role in a pending merger or acquisition generally by asking for a better price . . . or by trying to stop the pending acquisition.").

acquisition. If shareholders purchase and exercise the put, it would be clear that acquirer shareholders believe that the transaction is value-destroying.

The rise of institutional investors may strengthen the power of the shareholders' put option. Under the traditional Berle Means model of the corporation, a collective action problem existed in public corporations since no single shareholder had sufficient incentives to bear the cost of acquiring the information necessary to exercise her rights, such as voting rights.[317] Unlike the traditional Berle Means corporation, the shares of many public companies today are owned by institutional investors that have the incentives, means, and power to access and act on information. "Increased concentration of shareholding makes shareholder activism more rational, making it easier for shareholders to surmount the classic collective action problem that forms the basis for much of corporate law, namely, the problem facing dispersed shareholders in disciplining management."[318] Given their large ownership stake, institutional investors have a strong economic interest in monitoring management's decisions through the shareholders' put option.

3. Should the Shareholders' Put Option Be Mandatory?

This Article proposes voluntary adoption of the shareholders' put option, but one question that arises is whether the shareholders' put option should be mandated through legislation. There are a myriad of ways that the shareholders' put option could be implemented through legislation, for example, through state corporate law or through changes to the listing requirements of the stock exchanges. While mandatory rules have much to recommend, they may also have unforeseen costs. This Article offers some of the preliminary costs and benefits of a mandatory versus voluntary adoption of the shareholders' put option. Actual legal reform would require much more careful inquiry.

An important argument in support of mandatory rules is that shareholders are unable to control management from making decisions adverse to shareholder interests and therefore need mandatory rules for protection.[319] One could argue that

317. *See* BERLE & MEANS, *supra* note 10.

318. Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 452 (1991).

319. *See* Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1556 (1989); Jonathan R. Macey, *Corporate Law and*

the shareholders' put option should be mandatory given evidence that not only do large-scale acquisitions involving public companies destroy value for shareholders of the acquirer, but that there is some evidence that they destroy overall value. Thus, a mandatory provision could be justified as a way to reduce the waste produced by the agency costs and behavioral biases leading to acquirer overpayment.

Another rationale for mandatory rules is that it prevents companies from operating under different sets of rules that would inevitably cause uncertainty.[320] Mandatory rules standardize transactions and reduce information costs for investors.[321] Mandating the shareholders' put option could effectively allow investors to share control over acquisition decisions with the acquirer's management without taking away management's overall control of the firm and acquisition decisions.

There are, however, potential problems with a mandatory provision. A mandatory rule could prevent good managers from customizing the shareholders' put option in ways that could benefit shareholders.[322] For example, if shareholders' overwhelmingly support a well thought out and thoroughly explained acquisition decision where management in fact disclosed its pricing rationale, a mandatory rule would prevent the company and its investors from customizing the investors' role in the acquisition decision to meet investor concerns.[323]

A mandatory rule could also impede the shareholder's put option mechanism from advancing through the development of innovative corporate governance structures.[324] Scholars have argued that innovation will be more prevalent under a legal system that allows for enabling rules than a system in which mandatory rules dominate.[325] It is worth noting that a corporate board of directors will reach agreement quicker and at a cheaper price than a legislative body.[326] In addition, the board gener-

Corporate Governance: A Contractual Perspective, 18 J. CORP. L. 185, 187 (1993).

320. *See* Macey, *supra* note 319, at 190.

321. *See* John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1678 (1989).

322. *Id.* at 1677–78.

323. *Id.*

324. *See* Macey, *supra* note 319, at 189.

325. *See id.* at 194.

326. *See id.*

ally "has greater expertise about corporate affairs, and enjoys better access to the necessary information."[327]

A voluntary/enabling structure could also be less costly both for acquirers and their shareholders, and for regulators. Adopting a mandatory regime imposes "policy design costs, implementation costs, and enforcement costs (including the costs of monitoring the market for abuses)" on the regulator.[328] In a voluntary structure, the corporation's compliance costs are reduced.[329] Likewise, costs associated with enforcement and market surveillance are less.[330]

D. Regulation of the Shareholders' Put Option: Registration, Disclosure, and Market Manipulation

Those knowledgeable in federal securities laws may ask, (1) how would the sale of the shareholders' put option work under federal securities laws and (2) is it possible to sell the shareholders' put option at the same time that the issuer (i.e. the acquirer) is engaged in an acquisition transaction?

One of the powers of a corporation is the authority to buy its own stock.[331] Except for unusual circumstances, such as in the case of an insolvent company, corporate law norms clearly permit firms to purchase their own shares.[332] Indeed, share re-

327. *Id.*

328. *See* Anand, *supra* note 311, at 242.

329. *Id.* at 243 (discussing direct and indirect compliance costs). Briefly, direct costs include fees that must be filed prior to or following a transaction whereas indirect costs include internal management costs.

330. *See id.* at 244 (stating that "where there is no requirement for implementing governance practices and no corresponding remedy for failure to implement governance practices per se, enforcement costs, including investigation costs, must be less than if the requirement and accompanying remedy existed").

331. Publicly traded firms in the US often engage in share repurchases. *See generally* HOWARD SILVERBLATT & DAVE GUARINO, STANDARD AND POORS, S&P 500: BUYBACKS AND TREASURY SHARES—THE OVERLOOKED AND HIDDEN ASSETS (2007). In the 18 months preceding June 30, 2007, companies in the S&P 500 stock index repurchased more than $700 billion of their own stock. *Id.* at 13.

332. Share repurchases are subject to the state of incorporations' legal restrictions on the corporations' power to distribute money to shareholders with respect to their shares. *See* O'KELLEY & THOMPSON, *supra* note 164, at 599. Under legal capital statutes, such as that found in the DGCL, corporations may make distributions to shareholders only out of "surplus," usually defined as net assets of the corporation in excess of capital. *See* DGCL Sections 154 (definition of surplus) and 170 (payment of dividends). In general, such statutory restrictions "do not result in substantial litigation." O'KELLEY & THOMPSON, *supra* note 164, at 598.

purchases are a commonly used method through which public companies return cash to their investors. Share repurchases have several goals, including reducing agency costs by returning excess cash to shareholders or signaling positive information about the company to the market.[333]

The mechanics of the shareholders' put option would work similarly to a share repurchase program undertaken via an issuer put option.[334] Issuer put options have been used by large public companies in order to manage their repurchase programs.[335] In 1991, an SEC "no action" letter permitted firms to sell puts on their own stock in connection with an authorized share repurchase program.[336] The SEC stated that it would not bring enforcement action against put issuers for manipulation of stock prices under the Securities Acts of 1933 and 1934, subject to certain conditions such as the puts being out-of-the-money (i.e. the strike price of the put must be below the market price of the issuer's stock) at the time of issuance and the transaction adhering to the trading-volume limits under Rule 10b-18 of the 1934 Securities Exchange Act.[337] Similar to such issuer put option, the proposed shareholders' put option could raise several issues under the Securities Act of 1933 and the Securities Exchange Act of 1934. This Section shows how these issues can be addressed.

333. Of course, share repurchases can also be used to prop up sagging stock prices, or to consolidate voting control for management.

334. *See* Bruce K. Dallas & Vincent T. Cannon, *Issuer Share Repurchases: Derivative Strategies*, *in* NUTS AND BOLTS OF FINANCIAL PRODUCTS 15–16 (PLI Corp. Law & Practice, Course Handbook Series No. 13974, 2008).

335. *See* Dirk Jenter et al., *Security Issue Timing: What Do Managers Know, and When Do They Know It?* 1 (Simon Sch. Working Paper No. FR 06-12; MIT Sloan Research Paper No. 4654-07; Rock Center for Corporate Governance Working Paper No. 25, July 1, 2007), *available at* http://ssrn.com/abstract=945471. Issuers have generally used private transactions with major investment banks as counterparties in order to sell put options. *See id.* at 3. However, there is no reason that the sale of put options could not be done through public transactions. *See* Chi. Bd. Options Exch., *Corporate Stock Repurchase Programs* & *Listed Options*, 2001 CBOE INVESTOR SERIES 4 [hereinafter CBOE Investor Series Paper #2], *available at* http://www.cboe.com/institutional/pdf/corporaterepurchase_11-2001.pdf.

336. The SEC no-action letter was requested by the Chicago Board Options Exchange. Chi. Bd. Options Exch., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 335, at *1 (Feb. 22, 1991) [hereinafter CBOE, SEC No-Action Letter].

337. *Id.* at *17–18.

1. Registration

With respect to the registration requirement under § 5 of the Securities Act, the proposed shareholders' put option could overcome any questions regarding registration if the firm utilizes a standardized put issued by the Option Clearing Corporation as described in the 1991 SEC no-action letter on issuer put options.[338] Utilizing a standardized put would then avoid the transaction costs associated with registration of the security.

2. Disclosure & Rule 10b-5

The shareholders' put option would also be subject to Section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, which generally makes it unlawful, in connection with the purchase or sale of any security, for a person to (1) make any untrue statement of a material fact or (2) omit to state a material fact necessary to prevent the statements made from being misleading.[339] Therefore, a company undertaking a stock repurchase program generally has disclosure obligations under SEC Rule 10b-5, including if such purchases are done through the sale of put options.[340]

The shareholders' put option would likely trigger disclosure requirements for public companies.[341] Given that the shareholders' put option is a European-style option (i.e. exercisable only on the date of closing of the acquisition), the acquirer would need to disclose material non-public information only at the time of writing the put and the closing of the put.[342] Moreover,

338. *See id.* at *11 (seeking confirmation from the SEC that "the writing of a standardized put -- a security issued by The Options bearing Corporation [sic], registered under the Securities Act, representing a right to sell the underlying stock back to the writer of the put -- by an issuer in an ordinary, open-market transaction unrelated to any effort by the issuer to offer or sell, or to solicit offers to buy, its own stock would not involve a 'sale', 'offer', or 'offer to sell' within the meaning of Section 2(3) and, thus, would not implicate Section 5 of the Securities Act."); *see also* CBOE Investor Series Paper #2, *supra* note 335, at 8 ("A company is not required to register listed put options that it may write on its own stock under the Securities Act of 1933.").

339. *See* Employment of Manipulative and Deceptive Devices, 17 C.F.R. § 240.10b-5 (2009); CBOE Investor Series Paper #2, *supra* note 335, at 7; CBOE, SEC No-Action Letter, *supra* note 336, at *14.

340. 17 C.F.R. § 240.10b-5; *see also* CBOE Investor Series Paper #2, *supra* note 335, at 7.

341. In addition to disclosure concerns arising out of Rule 10b-5, both NASDAQ and the New York Stock Exchange require disclosure of material information. *See* Dallas, *supra* note 334, at 25.

342. *See* CBOE Investor Series Paper #2, *supra* note 335, at 8.

given that the shareholders' put option would affect an on-going material transaction, the acquirer would likely need to disclose the sale of the put and its connection with the acquisition.

3. Anti-Manipulation Rules, the 10b-18 Safe Harbor, and Regulation M

a. Anti-Manipulation Rules

Public company stock repurchases of their outstanding shares, including the repurchase of shares through a put option, must also comply with the anti-manipulation rules under the Exchange Act. Under Section 9(a)(2) of the Exchange Act, it is illegal for an individual or corporation to conduct a series of transactions within a security to induce others to buy or sell the security.[343] A repurchase program would violate 9(a)(2) if it were conducted with the intent of driving up the stock price and making it appear as if there were heavy demand for the stock. In general, however, when it seeks to repurchase its stock, a company could take advantage of the "voluntary, non-exclusive 'safe-harbor'" under SEC Rule 10b-18.[344]

b. Rule 10b-18

The safe-harbor provisions of SEC Rule 10b-18 would likely not be available for the shareholders' put option. First, under the SEC's 1991 No-Action Letter, it appears that the rule 10b-18 safe harbor is unavailable for issuer put options generally. Indeed the CBOE has recommended that in selling a put option to its shareholders, a company "must take care, in consultation with its counsel, to avoid writing puts or buying calls in such volumes, at such times, or with exercise prices and expiration dates that, considered together under the company's circumstances, could expose it to charges of market manipulation."[345] Second, Rule 10b-18 includes a specific "merger exclusion" which provides that the rule's safe-harbor is not available commencing with the first public announcement of a merger or similar transaction, other than transactions consisting solely of

343. CBOE, SEC No-Action Letter, *supra* note 336, at *19.

344. *See* Dallas, *supra* note 334, at 21.

345. CBOE Investor Series Paper #2, *supra* note 335, at 9 n.16; *see also* Dallas, *supra* note 334, at 21 (stating that while the safe harbor under Rule 10b-18 does not extend to companies engaged in derivative transactions, companies "often seek to comply, at least by analogy, with one or more of the Rule's conditions on the manner, timing, price, and volume of share repurchases as a matter of best practice").

cash as acquisition consideration.[346] The exclusion applies regardless of the method being used to effect the acquisition. Nevertheless, Rule 10b-18 does not prohibit share repurchases by companies that have announced an acquisition transaction.[347]

c. Regulation M

The sale of the shareholders' put option would also be subject to Regulation M which generally restricts repurchases during a distribution of securities.[348] "Regulation M is designed to prevent any person with a financial interest in a distribution of securities from manipulating the market price of such securities, misleading potential investors as to the 'true' state of the public market for the securities being distributed."[349] Under the 1991 SEC No-Action letter, a company may sell a put option during a distribution so long as the expiration date of such put occurs after the termination of the distribution.[350] Thus it does not appear that the shareholders' put option which would be exercisable following closing of an acquisition would violate Regulation M.

4. Issuer-Tender Offers and the Shareholders' Put Option

While the writing of the shareholders' put would generally not be considered an issuer tender offer,[351] in order to achieve

346. *See* SIMPSON THACHER, A PRIMER ON SHARE REPURCHASES IN CONNECTION WITH MERGERS AND ACQUISITIONS 1 (2005), *available at* http://www.stblaw.com/content/publications/pub502.pdf.

347. *See id.* In its adopting release addressing the merger exclusion, the SEC noted that the merger exclusion did not unduly restrict issuer repurchase activity because issuers will retain the "flexibility to purchase outside the safe harbor" without creating any presumption of market manipulation. 68 Fed. Reg. 64,956, 64,955 & n.30 (Nov. 17, 2003).

348. *See* SIMPSON THACHER, *supra* note 346, at 3. An acquisition transaction, regardless of the structure, in which all or part of the deal consideration consists of the acquirer's securities would typically be considered a "distribution" of securities. *Id.*

349. Dallas, *supra* note 334, at 24; *see also* Anti-Manipulation Rules Concerning Securities Offerings, Securities Act Release No. 33-7375, Exchange Act Release No. 34-38067, 62 Fed. Reg. 520, at 525 (Jan. 3, 1997) (adopting release for Regulation M).

350. *See* CBOE, SEC No-Action Letter, *supra* note 336, at *11–13; CBOE Investor Series Paper #2, *supra* note 335, at 9.

351. The 1991 SEC No-Action Letter grants an exemption from SEC Rule 13e-4 for issuer-written standardized puts that comply with the restrictions set forth in the no-action letter, including that the issuer write only "out-of-the-money" standardized put options on a national securities exchange and comply with the volume limitation of Rule 10b-18. For the purpose of the daily trading volume limitation of SEC Rule 10b-18, the no-action letter states that

the goals of the proposal in the Article, the sale of the put option would ideally follow the rigorous disclosure requirements of issuer self-tender offers.[352] The SEC's rules with respect to issuer self-tender offers are intended to prevent fraudulent, deceptive or manipulative acts in connection with the offer. Thus, the disclosure and dissemination requirements for issuer tender offers are extensive.[353] For example, the issuer must send a summary term sheet and all of the other information required by Schedule Tender Offer (excluding exhibits) or a fair and adequate summary of the information plus a transmittal letter to each stockholder.[354] In addition, the disclosure required in an issuer tender offer is subject to the antifraud provisions of Section 14(e) of the Exchange Act, which prohibits material misstatements and omissions, and fraudulent, deceptive, or manipulative acts or practices in connection with any tender offer.[355] This is not to suggest that more disclosure is always beneficial. Disclosure undoubtedly has costs, and unlimited disclosure is neither desirable nor achievable. Despite its shortcomings, disclosure is critical for effective corporate governance, including an effective market for corporate control.[356]

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an issuer is deemed to have purchased the shares underlying standardized put options only at the time the standardized put options are written. CBOE, SEC No-Action Letter, *supra* note 336, at *11–13.

352. For publicly traded entities, issuer self-tender offers are governed by Section 13(e) of the Securities Exchange Act of 1934. Rule 13e-4 promulgated under the Exchange Act defines an issuer tender offer as "a tender offer for, or a request or invitation for tenders of, any class of equity security, made by the issuer of such class of equity security or by an affiliate of such issuer." Exchange Act Rule, 17 C.F.R. § 240.13e-4 (2008). A tender offer is commonly considered to be a public offer made to the shareholders of an issuer to purchase all or part of a class of securities of the issuer. *See* BAINBRIDGE, MERGERS, *supra* note 126, at 170.

353. *See* MAYNARD, *supra* note 17, at 400. For a summary of the criticism lodged against the disclosure requirements of the Williams Act, see BAINBRIDGE, MERGERS, *supra* note 126, at 173–76.

354. BAINBRIDGE, MERGERS, *supra* note 126, at 173–76.

355. Securities Exchange Act of 1934, 15 U.S.C. § 78n(e) (2006); *see also* Schreiber v. Burlington N., Inc., 472 U.S. 1, 12 (1985) (holding that there can be no manipulative conduct without misrepresentation or nondisclosure).

356. The market for corporate control is often defined as the role that equity markets play in the transfer of ownership and control of companies from one group of managers and investors to another group of managers and investors. Thus, the market for corporate control can play an important corporate governance role by countering opportunistic behavior by inefficient management. *See* Coffee, *Regulating*, *supra* note 12, at 1152–55.

E. Potential Concerns with the Shareholders' Put Option

The shareholders' put option is designed to address the acquirer overpayment problem by providing a mechanism through which shareholders can make acquirer management internalize the costs of a bad deal. The approach proposed in this Article offers important advantages over the approaches previously advocated. This proposal is a more reliable inducement than ex-post litigation for acquirer boards to curb value-destroying transactions. It is also a more direct and market-oriented solution than a shareholder vote for addressing the costs of acquisitions.

Nevertheless, there are a number of important issues that would need to be considered in connection with this proposal. Set forth below are some of the primary objections likely to be raised with respect to the shareholders' put option, and responses to such objections.

1. Increased Transaction Costs

One of the drawbacks of the shareholders' put option is the risk that it may increase the transaction costs associated with acquisitions. The shareholders' put option can raise several transaction costs. There may be transaction costs associated with increasing board involvement in the acquisition process, including the potential costs associated with the board's determination to sell the put option. There also may be transaction costs associated with the actual sale of the option, including increased disclosure required by the sale of the put option. These costs include the costs of the preparation and dissemination of the necessary disclosure and sale documents.

Potentially the most significant costs are those affecting the acquisition transaction itself. It is likely that the proposed put option would need to be addressed in acquisition agreements. For example, the acquirer could insist that its obligation to close the acquisition transaction be conditioned on the absence of the purchase or potential exercise of the put by a particular percentage of the acquirer's shareholders. Acquirer boards would need a fiduciary out under the agreement in order to exercise their on-going fiduciary duties if the put is purchased and likely to be exercised en masse. This may result in sellers asking for additional provisions in order to address their concern for deal certainty.[357] Sellers may also insist on including reverse termination fee provisions that address the risk that the acquirer would walk away from the acquisition in the event of the exercise of the put option.[358]

Despite the potential for increased transaction costs, it is not clear that such costs would outweigh the potential benefits, both to acquirer shareholders and to the acquirer company going forward, of reducing acquirer overpayment. Boards may be willing to adopt the shareholders' put option solution, despite its costs, if they find that the solution both assists them in signaling to the market the value of their acquisition decisions and in curbing management biases. Boards may also be willing to incur these costs if they find that the proposal provides a mechanism through which they can lessen the risks of management self-interest in pursuing large-scale acquisitions. In addition, while the shareholders' put option could increase the transaction costs associated with large-scale acquisitions, the potential for acquirers to incur these costs could also place significant pressure to curb value-destroying transactions.

2. The Risk of Shareholder Litigation

Anytime a proposal provides expanded rights to shareholders it also raises the possibility of increased litigation. For example the additional disclosure related to the shareholders' put option could result in shareholders having the opportunity to sue management and the board for false or misleading information related to the sale of the put. However, litigation may be a tolerable risk if such risks are offset by the benefits gained from deterring value-destroying acquisitions.

While increased litigation risk may be deemed problematic, the concern may be somewhat overstated. Firms continually engage in disclosure despite the risk of disclosure-based litigation. The risk of suits are heightened only if the company in fact puts out false or misleading information. Moreover, the threat of litigation may not necessarily be an entirely negative consequence of the shareholders' put option. As discussed above, one of the goals of the proposal is to increase board engagement in acquisition decisions so as to avoid value-destroying acquisitions. Under the current regime, the general lack of shareholder say in acquisition decisions together with

357. *See* Afra Afsharipour, *Transforming the Allocation of Deal Risk Through Reverse Termination Fees*, 63 VAND. L. REV. 1161, 1173 (2010).

358. For a discussion of reverse termination fee provisions, see generally *id.*

the minimal threat of fiduciary-duty litigation has resulted in many boards passively acquiescing to management interests in acquisition decisions. The shareholders' put option and the threat of litigation may help provide incentives for the board and management to undertake serious inquiry into the value of the acquisition transaction and could help lessen the agency costs and behavioral biases of the acquirer's management.

3. The Risk of Short-Termism

Another possible objection is that the shareholders' put option could increase the risks of short-termism. Given that the exercise of the shareholders' put option is dependent on movement in the stock price of the acquirer between the announcement and closing of an acquisition transaction, the proposal could pressure management "to pursue policies that raise share price in the short term but fail to help the company, and even harm it, in the long term."[359] In fact, excessive shareholder focus on stock prices and significant presence of transient shareholders has been "associated with an increased likelihood of . . . overbidding and value reducing acquisitions."[360] A focus on stock prices and the reaction of markets to a particular acquisition transaction could lead management to attempt to affect the stock price of the acquirer in such a way as to make the exercise of the option unattractive.

While the general concern regarding short-termism is well-founded, one must balance the risk of short-termism with the risk and consequences of value-destroying acquisitions. The shareholders' put option does indeed rely on share prices as reflecting the market's perception of an acquisition transaction. Such reliance is, however, reasonable given the substantial evidence that acquirer shareholders in large public-public transactions suffer the harms of the conflicts of interests and biases of management. Studies suggest that the harms suffered by acquirers as a result of value-destroying acquisitions are not just short-term harms, but harms to the business in the long-term.

359. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1291 (2008); *see also* Lynne Dallas, *Short-termism, the Financial Crisis and Corporate Governance* 6 (University of San Diego Legal Studies Research Paper Series, Research Paper No. 11-052, 2011), *available at* http://ssrn.com/abstract=1794190 (describing short-termism as "the excessive focus of corporate managers . . . on short-term results . . . and a repudiation of concern for long-term value creation and the fundamental value of firms").

360. *See* Dallas, *supra* note 359, at 30.

The shareholders' put option in effect is a significant monitoring device to counter the incentives of managers to pursue short-term strategies that can lead to overpayment. Moreover, the shareholders' put option if exercised can also reduce the free cash under management's control so as to place some pressure on management's ability to manipulate short-term stock prices.

CONCLUSION

Acquisition transactions can make or break a company. While large public company acquisitions are often viewed with awe in the financial press, the empirical evidence suggests that these deals often destroy tremendous value for the acquiring firm. There is a market failure that results in public firms overbidding for other public firms. This failure arises due to asymmetric information between management and shareholders and due to powerful behavioral biases of the acquirer's management. Law has largely remained silent in the face of value destroying acquisitions. Instead, corporate law provides mechanisms and incentives that largely promote value destroying acquisitions.

This Article argues that there is a need to address the acquirer overpayment problem and the factors that lead to the problem. This Article's novel proposal—the use of a shareholders' put option—can be a powerful tool to counteract the agency costs and behavioral biases apparent in acquisitions. The shareholders' put option, while not flawless, would provide incentives for greater transactional scrutiny by the transaction participants (such as managers, directors and advisers), as well as incentives for greater shareholder participation in acquisitions. Indeed, this solution can help ultimately balance the extensive confidence placed by the law in the decisions of the acquirer's management.