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Book Review

Mark J. Loewenstein
University of Colorado Law School

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Book Review

A. FLEISCHER, JR., G. HAZARD, JR., AND M. KLIPPER, BOARD GAMES (1988) ($19.95, Little Brown and Company, Boston, Massachusetts 02108).

MARK J. LOEWENSTEIN*

State corporate law statutes uniformly entrust the management of the business and affairs of a corporation to the board of directors of that corporation.[1] But the exercise of that authority is subject to some degree of judicial review at the behest of disgruntled shareholders challenging the directors' action (or inaction) through the mechanism of a derivative suit. Early case law established judicial willingness to review the behavior of corporate directors, and established "fiduciary" duties on the part of directors to act with due care and loyalty to the corporation. A violation by a director of his or her fiduciary duties might give rise to liability.

The availability of the derivative action to redress shareholder dissatisfaction with directors has led to a large and developing jurisprudence exploring the minimum level of conduct for directors. While some cases alleging lack of due care have suggested that directors might be liable for their simple negligence,[2] more recent cases make clear that the standard is gross negligence.[3] On the loyalty side, the courts have been less forgiving; if a director benefitted personally from a corporate action he authorized as a director, he may be held accountable to the corporation unless he can prove that the questioned transaction was indeed "entirely fair" to the corporation.[4]

From this body of case law, the authors of *Board Games* discuss, in some detail, director action in a half dozen or so recent cases

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* Associate Professor and Associate Dean, University of Colorado School of Law at Boulder. J.D., 1974, and B.A., 1969, University of Illinois.

1. *E.g.*, REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (1984) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation.").

2. Litwin v. Allen, 25 N.Y.S.2d 667 (S. Ct. 1940).

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

4. Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

involving corporate takeovers.[5] For the most part, these were highly-publicized cases and resulted in judicial opinions of some significance. The authors focus on the role played by target boards in responding to takeovers—both negotiated and hostile takeovers—and conclude that the takeover phenomenon has increased the power and influence of directors. They dispute the received wisdom, from Berle and Means' classic book *The Modern Corporation and Private Property*, that corporate control resides in the professional managers of a corporation. Rather, "control," in their view, "is now a troika: management, which controls operations; stockholders, who exercise continuous pressure through their rights of ownership; and market-sensitive directors, who continually reevaluate company health. This represents a major shift in the balance of power within the corporation in favor of the board."[6]

While a shift of control may be occurring (although I doubt it), the cases that the authors chose do not bear this out. Indeed, were one to generalize, one might say that those cases demonstrate the awesome influence that professional management exercises over corporate boards, and the judicial dissatisfaction with that state of affairs. All of the chosen cases involved a judicial test of management-initiated, board-approved action. The issue in each case, more or less, was whether the process of board approval (or rubber stamp, a cynic might say) met some abstract judicial notion of due deliberation and director disinterestedness. An examination of a few of the chosen cases and a few that were not discussed, demonstrates the fallacy of the authors' conclusion.

Smith v. Van Gorkom,[7] a 1985 Delaware Supreme Court decision, makes its first appearance in the book's prologue and is referred to frequently thereafter. It is a case that epitomizes the dominance of management in the corporate hierarchy: Trans Union Corporation's chief executive officer (Jerome Van Gorkom), on his own initiative

5. *Prologue*: Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); *Chapter 2*: Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch.), aff'd, 500 A.2d 1346 (Del. 1985); *Chapter 3*: Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); *Chapter 4*: Gelco Corp. v. Coniston Partners, 652 F. Supp. 829 (D. Minn. 1986), *aff'd*, 811 F.2d 414 (8th Cir. 1987); GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016 (S.D.N.Y. 1985); *Chapter 5*: MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (1986); *Chapter 6*: Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986).

6. A. FLEISCHER, G. HAZARD & M. KLIPPER, BOARD GAMES 193 (1988).

7. 488 A.2d 858 (Del. 1985).

and without prior board approval, approached Jay Pritzker, a social acquaintance, and negotiated a sale of Trans Union to a Pritzker-controlled entity for $55 per share. Pritzker and Van Gorkom concluded their discussions on a Thursday and Pritzker insisted that the Trans Union Board act within three days. That proved to be more time than Van Gorkom needed. He convened a board meeting for Saturday noon. Saturday morning was reserved so that he could break the news to senior management of the company, as only two of them were previously aware of the deal.

At first, events proceeded pretty much as Van Gorkom and Pritzker had planned. The Trans Union Board met, gave perfunctory consideration to the merger proposal and, two hours after the convening, approved the $690 million deal that would transform the company from a publicly-held entity to part of the Pritzker empire. The board had no prior notice that they were convened to consider the sale of the company, no documentation to review, no written summary of the terms, and, of greatest importance, nothing to support the adequacy of the price being offered.

Thereafter, events did not proceed according to script. Several members of senior management sought to upset the deal, purportedly because they felt the price was inadequate. That revolt led to further negotiations, some amendments to the agreement, approaches by potential purchasers, and litigation. All of this was for naught. The shareholders approved the deal, and the transaction was consummated.

But the story did not end there. The final chapter was written by the Delaware Supreme Court four years later, when it held that the Trans Union directors breached their fiduciary duty of care in approving the merger agreement. In a lengthy opinion, the Court reviewed what the directors did and did not do, the former being a much shorter list than the latter. In brief, the directors approved the price with an inadequate basis for doing so. The record suggested that the company could have been sold for more money, and the Court said the directors would be liable for the difference.[8]

To the authors of *Board Games*, this case marks somewhat of a turning point in corporate law, implying that the cavalier attitude of the Trans Union Board would not have given rise to liability in earlier years. This is a questionable conclusion. While it is true that there are few reported cases holding directors liable for breach of

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8. *Id.* at 893.

the duty of due care, there are few exonerating them on the merits. These cases just do not get tried very often.[9] The law was fairly clear that directors could be liable for failing to give adequate attention to their duties.[10] What was unclear was whether directors would be liable for their simple negligence, or whether their misfeasance had to be more serious. On this score, *Smith v. Van Gorkom* was welcome news to the nation's corporate directors: the standard, at least in Delaware, is gross negligence.[11]

More importantly, the Trans Union directors were not held liable for exercising poor judgment, which would indeed have been a significant precedent, but for not adequately informing themselves before making such a momentous decision. Thus, *Smith* tells directors that they needn't fear second-guessing by the courts, so long as they adequately document their actions. The same judgment, with the right paper (like a copy of the agreement), likely would have avoided judicial scrutiny.

The lasting practical effect of *Smith* may be, at best, that directors more carefully document the reasons that they proceeded as they did. Corporate counsel are likely to integrate the teachings of *Smith* in their standard advice for corporate board meetings to remove any doubt that the board action was properly approved.[12] One cannot conclude from *Smith* that directors will exercise greater control over senior management or more independence from it. The real question following *Smith* is whether the courts will cut through this formalism when director action is challenged and the board can demonstrate the due deliberation called for by *Smith*.

Whatever significance one might have attributed to *Smith*, and its effect on the balance of power within a corporation, is undercut by the dramatic turn that state statutory law has taken since *Smith*, and because of it. Many states, led by Delaware, have amended their corporate codes to limit director liability for breach of the duty of due care. A Delaware corporation may now provide in its charter that directors are not liable for monetary damages for failing to exercise due care.[13] This may be the real legacy of *Smith*: to the

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9. *See* R. CLARK, CORPORATE LAW 126 (1986).

10. Francis v. United Jersey Bank, 432 A.2d 814 (N.J. 1981).

11. *Van Gorkom*, 488 A.2d at 873.

12. *See, e.g.*, Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1 (1985).

13. DEL. CODE ANN. tit. 8, § 102(b)(7) (1986). Other states have followed suit, e.g., COLO. REV. STAT. § 7-3-101 (Supp. 1988).

extent that some murky precedents in corporate law suggested that directors might be liable for their simple negligence, charter provisions can now make it clear that directors will not be liable for even their gross negligence. That, in turn, strengthens the hand of management vis-à-vis the board, for with an important threat of liability removed, the board has even less incentive to stand up to management.

Smith v. Van Gorkom is unusual in that the directors were challenged for approving a takeover of the company; in the typical case, the directors are sued for thwarting a tender offer. *Unocal Corp. v. Mesa Petroleum Co.*,[14] another case highlighted in the book, arose from such a suit. Mesa made a tender offer for Unocal and sued to enjoin a defensive tactic that Unocal adopted to defeat Mesa's unwanted bid. Unocal's maneuver consisted of a tender offer for its own shares, structured to exclude Mesa, and with the practical effect of precluding Mesa from buying the Unocal shares tendered to Mesa. The Delaware Supreme Court ruled in favor of Unocal, and in so doing made clear that targets of hostile takeover bids can, at least under some circumstances, adopt measures designed to defeat those bids, even if those measures call for discrimination among its shareholders.

But the authors do not cite *Unocal* because of its broad holding; rather, they are attracted to the court's language that places new restrictions on the target board of directors. The Court said that before defending against a tender offer, the board must determine that the bid poses a threat to the company. If they so find, any defensive action they adopt must be "reasonable in relation to the threat posed." Presumably, *Unocal* shows the key role the board plays in the tender offer arena: it must make judgments concerning the effect of a tender offer on the company and must be able to justify its response.

But the analysis of *Unocal* in *Board Games* illustrates somewhat more than this. The authors show the profound influence of Unocal's chairman, Fred L. Hartley, on developing Unocal's strategy. Whether purposeful or not, the impression that comes across in this chapter is that Hartley regarded Unocal as his company, and by god, no upstart like Boone Pickens (Mesa's chairman) was going to take it over. Indeed, this impression—the dominance of a company's chief executive—comes across in every chapter. The Delaware Supreme Court decision in *Unocal* does not change that dominance very much;

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14. 493 A.2d 946 (Del. 1985).

it only makes clear what the board must do if it is going to agree with the strategy devised by management.

Subsequent decisions bear this out. In numerous Delaware cases the courts have consistently agreed with the board's decision that a hostile tender offer posed a threat to the company. As to the reasonableness of the response, the Delaware courts have differed with board decisions, finding that the response was unreasonable in relation to the threat posed in several cases. Each one of these cases may be cited as an example of board capitulation to the whims of management. One post-*Board Games* case, *Robert M. Bass Group, Inc. v. Evans*,[15] involving a struggle for control of MacMillan, Inc., illustrates the point particularly well.

In late-1987, at about the time the Bass Group was acquiring a significant stake in MacMillan, management of the large publishing concern was already worried about a possible hostile takeover of the company. It had in place some antitakeover devices and was planning some others, including a complicated restructuring plan. Before that plan could be implemented, however, Bass proposed a cash buy-out of MacMillan at $64 per share and indicated a willingness to negotiate a higher price.

Bass's offer to negotiate was largely ignored by the company and shortly thereafter a "Special Committee" of the board, that had been formed just a week earlier, approved the restructuring plan that management had been developing for several months. The Special Committee's investment banker (which had been chosen by management of the company), valued the plan as worth $64.15 per share to the MacMillan shareholders. Bass responded with an offer to purchase all of the shares at $73 per share or to fund a restructuring nearly identical to the one approved by the Special Committee, except that the shareholders would receive more cash and management of the company would be treated like all other shareholders, thereby foregoing the special treatment that the restructuring plan provided. Both of these offers were rejected by the Special Committee.

Happily, the court's decision set aside the restructuring plan approved by the Special Committee. But the case really stands for further proof of the influence of management over the board. The management-proposed restructuring was, in a word, outrageous. It had the effect of dividing MacMillan into two independent companies, one holding the publishing assets, and the other the non-publishing

15. 552 A.2d 1227 (Del. Ch. 1988).

assets, including information services, instruction, retail merchandising, and a home learning and reference material division. Management, consisting of four individuals, would end up owning thirty-nine percent of the latter company (Information), and obtain a significant voting stake in the publishing company (Publishing).

This miracle of high finance was possible, in part, because in the months immediately preceding the restructuring, management had been given over 400,000 shares of the company and options to purchase an additional 200,000 shares. It was possible because the Special Committee, consisting of directors "independent" of the company, did not negotiate on behalf of the shareholders over the terms of the restructuring. It was possible because no one negotiated with the Bass Group. In short, it was possible because the management of MacMillan, led by its forceful chief executive Edward P. Evans, was determined that its control of the company would not be lost to outsiders, for what else can explain the board's willingness to shift ownership of a substantial portion of MacMillan's assets from the shareholders to management in the face of a much more lucrative offer from the Bass Group?

Instances of true board independence from management are rare. The much publicized auction of RJR Nabisco, Inc. in late 1988, where management's leveraged buy-out proposal was rejected by the board in favor of a lower third party offer, was remarkable because of its rarity. The popular press reports on the affair suggested that personality conflicts between RJR's flamboyant president, F. Ross Johnson, and the chair of a special committee of the RJR board, Charles Hugel, played a role in the outcome of the contest. Hugel, apparently, was so put off by Johnson's tactics that he refused to give management the usual advantage it enjoys in these contests.[16]

The captains of modern day industry, like Johnson, Hartley, Evans, Pickens, and the others discussed in *Board Games*, often have only nominal supervision from their respective boards of directors. The panacea for this state of affairs has long been supposed to be the emergence, as a force in America's board rooms, of a cadre of independent directors—that is, individuals not otherwise employed by, or beholden to, the company they serve and, therefore, not subject to the domination and influence of the company's chief executive officer. In numbers, at least, the independent directors

16. Saporito, *How Ross Johnson Blew the Buyout*, Fortune, Apr. 24, 1989, at 296.

have arrived, as most large companies have boards with a majority of independent directors. But being independent of management, and being able to exercise judgment independent of management's, are apparently not the same thing. This is the message of *Board Games*.