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FUNDAMENTAL CORPORATE CHANGES: CAUSES, EFFECTS, AND LEGAL RESPONSES

INTRODUCTION—THE BIGGEST DEAL EVER

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Twenty-five billion dollars buys a lot of Oreos, Winstons, and Milk-Bone dog biscuits. In early December 1988, Kohlberg, Kravis, Roberts & Co. (KKR), a firm specializing in leveraged buyouts, won the contest for ownership and control of RJR Nabisco, Inc., a victory that resulted in the largest corporate control transaction in the United States to date. When the LBO was completed in 1989, the nineteenth-largest industrial company in the United States had increased its indebtedness from \$5 billion to \$20.1 billion. RJR Nabisco's former public shareholders received, in addition to cash, a package of preferred stock and notes convertible into common stock, but immediate control of the company, and its equity, passed to KKR in exchange for a \$1.5 billion equity investment. KKR itself provided an estimated 1% of this equity investment, or \$15 million, and a pool of funds that KKR gathered from institutional investors provided the remainder.

The RJR Nabisco transaction illustrates the significance of the issues that the authors in this symposium address. Beyond the transaction's magnitude, its structure and origins demonstrate the increasing obsolescence of long-held assumptions about the finance and governance of large corporations in the United States. For example, many have assumed that the structure of very large companies inevitably involves a

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division between ownership interests, held by public shareholders, and management, composed of individual managers who typically invest little of their own wealth in company shares. In addition, many have believed that very large corporations are immune to the risk of a takeover simply because of the massive amounts of money required, even if a good number of a corporation's shareholders might avidly accept an offer to sell their shares at a premium over market price. Indeed, many have thought that even large corporations with a predominance of institutional shareholders enjoy such immunity.¹ Many large corporations with solid earnings have long been able to finance most of their needs for additional capital out of retained earnings and thus to operate independently of other equity capital sources like public trading markets. Moreover, such corporations have used little long-term debt to finance operations. As a result of the interrelationship among these factors, certain large corporations have seemed to resemble non-ownership institutions (like universities, perhaps) more than smaller public corporations in which equity owners' interests and claims seem more immediate.

The soundness of these long-held assumptions has been challenged by a series of recent transactions, culminating in the LBO for RJR Nabisco. This Introduction will develop the history of the RJR Nabisco acquisition and examine its impact, along with the impact of similar transactions, on these assumptions.

On October 19, 1988, F. Ross Johnson, the president and chief executive officer of RJR Nabisco, took the outside directors of his company's board out to dinner in Atlanta on the night before a board meeting. Mr. Johnson told the outside directors that he was considering leading an LBO for the company because the price of its stock had, despite his two-year effort to increase the stock's value by restructuring the company, continued to lag.² The directors were stunned but did not object to Mr. Johnson's proposal: "We came to the conclusion that shareholders would be best served by a short-term gain," one of the directors recalled later.³ At the time of Mr. Johnson's proposal, RJR Nabisco was trading around \$55 per share,⁴ and thus the stock market's implicit price tag on the entire company was around \$13 billion.

1. See generally L. LOWENSTEIN, *WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER* 57-63 (1988) (describing the institutionalization of stock markets and its consequences).

2. Helyar & Burrough, *Nobody's Tool: RJR Nabisco Board Asserts Independence in Buy-Out Decisions*, *Wall St. J.*, Nov. 9, 1988, at A1, col. 1, col. 1.

3. *Id.* (quoting outside director).

4. Sterngold, *Managers' Huge Stake in a Private Nabisco*, *N.Y. Times*, Nov. 14, 1988, at D1, col. 3, D5, col. 2.

Although Mr. Johnson's formal proposal did not emerge until a few weeks later, RJR Nabisco promptly issued a press release announcing that members of its senior management, in association with Shearson Lehman Hutton, would offer \$17 billion,⁵ or \$75 per share, to buy out RJR Nabisco's shareholders. This announcement promptly led to a steep drop in the price of the company's outstanding bonds.⁶ As a senior bond trader at Drexel Burnham Lambert (which will shortly enter the story in a major role) said, "Bondholders suffer from those sorts of transactions It is clear that the industrial bond market cannot benefit from this deal."⁷ Indeed, institutional holders of RJR Nabisco bonds eventually sued, alleging that, among other things, the company neglected to disclose that discussions about a prospective LBO had already occurred when the holders bought their bonds in spring 1988.⁸

On October 25, 6 days after the RJR Nabisco directors' dinner with Mr. Johnson, KKR announced a competing offer at \$90 per share for a total of \$20.3 billion, subject to the approval of RJR Nabisco's board.⁹ KKR is the leading LBO specialist in the United States. As a result of its prior transactions—all coupling large amounts of debt (principally from bank loans and high-yield debt securities) with small pools of equity collected from institutions—KKR has become an enormous industrial holding company with nearly as much annual revenue as the General Electric Company.¹⁰ Formed only in 1976, KKR nevertheless has many firsts to its credit. In 1979, it arranged the first LBO of a large company listed on the New York Stock Exchange¹¹ and, in 1984, the first billion dollar

5. Sterngold, *Shearson Risks, Rewards on RJR Nabisco*, N.Y. Times, Oct. 22, 1988, at 33, col. 3, col. 3; Sterngold, *Buyout Specialist Bids \$20.3 Billion for RJR Nabisco*, N.Y. Times, Oct. 25, 1988, at A1, col. 6, col. 6 [hereinafter *Buyout Specialist Bids \$20.3 Billion for RJR Nabisco*].

6. Gilpin, *Bid for RJR Nabisco Jolts Bonds*, N.Y. Times, Oct. 21, 1988, at D11, col. 1, col. 1.

7. *Id.* (quoting senior bond trader).

8. Wallace, *Nabisco Sued over Bond Drop*, N.Y. Times, Nov. 18, 1988, at D3, col. 4, col. 4.

As it happens, KKR had discussed a buyout with Mr. Johnson in September 1987, thirteen months before Johnson's own proposal surfaced. Sterngold, *The Nabisco Battle's Key Moment*, N.Y. Times, Dec. 2, 1988, at D15, col. 1, col. 2; cf. *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,703 (Del. Ch. Jan. 31, 1989) (KKR was purportedly earlier rebuffed in an effort to entice management to join in an LBO). In a court filing, Mr. Johnson acknowledged that six months prior to his announced buyout proposal, a large shareholder approached him with an offer to buy the company. Durham (N.C.) Morning Herald, Jan. 22, 1989, at B1, col. 3, col. 3. The shareholder, C.D. Spangler, Jr., owned less than 1% of RJR Nabisco's stock through family-held corporations. *Id.* at B1, col. 1. Mr. Spangler, the president of the University of North Carolina, is also a director of Jefferson Pilot Corp., an insurance company that is suing RJR Nabisco over the devaluation of RJR Nabisco bonds it purchased prior to the LBO. *Id.* at B1, cols. 3-4.

9. *Buyout Specialist Bids \$20.3 Billion for RJR Nabisco*, *supra* note 5, at A1, col. 6.

10. *Id.*

11. *Id.* at D6, col. 6.

buyout.¹² In 1985, KKR began the \$6.4 billion LBO of Beatrice Companies, a transaction of record size at the time.¹³ KKR reportedly has about \$5 billion available to invest as equity in such transactions, in addition to its own capital.¹⁴ In fact, KKR generally invests in only 1% of the equity in its deals from its own capital.

Such large LBOs have become more feasible since banks have developed the practice, when committing themselves to a large loan, of selling smaller pieces of the loan to other financial institutions. Indeed, about 9% of all U.S. bank loans made to corporate borrowers in 1987 were connected to LBOs.¹⁵ In addition, expansion of the market for high-yield debt securities (a.k.a. "junk bonds") enhanced the potential for large LBO transactions. For example, KKR financed its offer for RJR Nabisco in part through the issuance of junk bonds to be sold by Merrill Lynch & Co. and Drexel Burnham Lambert. Many have credited the latter firm with developing the market for high-yield debt securities;¹⁶ Drexel Burnham, however, was also the subject of a January 1989 federal information that alleged various violations of the federal securities laws, none involving the RJR Nabisco transaction.¹⁷

KKR, Mr. Johnson, and Shearson Lehman discussed the possibility of a joint or combined bid, but they reached no agreement. Neither KKR nor Shearson was willing to surrender control in any joint deal or to share control on an equal basis.¹⁸ Although KKR and Shearson reportedly later reached an agreement in principle for a joint bid, the agreement collapsed when the firms' investment banks failed to agree on which bank would manage the debt securities offerings necessary to finance the bid.¹⁹ In any event, as a consequence of the participants' failure to make a joint bid, the KKR proposal came to the directors of RJR Nabisco without incumbent management's endorsement or participa-

12. *Id.*

13. *Id.* The Beatrice transaction produced an antitrust obstacle to the RJR Nabisco deal, which was eventually resolved. Through Beatrice, KKR controlled brands that competed with RJR Nabisco brands. KKR announced at the end of January that it had reached an agreement with the staff of the Federal Trade Commission to sell either RJR or Beatrice brands to eliminate overlaps, specifically those in Chinese foods, soy sauce, packaged nuts, and ketchup. Smith & Waldman, *Buy-Out of RJR Proceeds as Financing Is Expanded, Antitrust Pact Is Reached*, Wall St. J., Jan. 31, 1989, at A3, col. 2, cols. 2-3.

14. *Buyout Specialist Bids \$20.3 Billion for RJR Nabisco*, *supra* note 5, at D6, col. 6.

15. Bartlett, *A Corporate Milestone*, N.Y. Times, Oct. 26, 1988, at A1, col. 4, D6, col. 5.

16. *See, e.g., C. BRUCK, THE PREDATORS' BALL 344-50 (1988).*

17. *See Cohen, Criminal Charges Filed Against Drexel Indicate Alleged Wrongdoing by Milken*, Wall St. J., Jan. 25, 1989, at A4, col. 2.

18. Sterngold, *Joint Deal for Nabisco Is Rejected*, N.Y. Times, Oct. 27, 1988, at D1, col. 6, col. 6.

19. Burrough & Helyar, *RJR May Get A Third Offer, Topping Others*, Wall St. J., Nov. 7, 1988, at A3, col. 1, col. 2.

tion.²⁰ This circumstance—that the KKR bid appeared to be at least semi-hostile—troubled some investors in KKR's equity pool. The head of one potential investor, a state pension fund, characterized the KKR offer as "a hostile friendly deal."²¹ In fact, two of the investors in the KKR equity pool were pension funds of companies that, like RJR Nabisco, have headquarters in Atlanta.²² Nevertheless, on November 2, Charles Hugel, an outside director serving as chairman of RJR Nabisco, said that the board was "interested in receiving proposals . . . from all credible parties wishing to present such proposals."²³

On November 4, a third group announced that it was considering making an offer. Led by Forstmann, Little & Company, another LBO specialist, and Goldman, Sachs & Company, a large investment bank, the group also included three consumer goods companies.²⁴ This group's announcement provoked controversy on two different scores. First, senior partners in Forstmann, Little had failed to reach terms on a bid during earlier discussions with Mr. Johnson's management group but, according to the management group, had promised not to bid for RJR Nabisco on their own.²⁵ Second, a special committee of RJR Nabisco directors, set up to evaluate all offers, had told KKR and Mr. Johnson's group that it wanted no "pre-selling" of the corporation's assets before the committee determined whether to support a buyout.²⁶ The inclusion of the consumer products companies in the Forstmann, Little group, however, suggested that pre-selling might be occurring.²⁷ This issue fell away when the Forstmann, Little group announced, less than two weeks later, that it had decided not to submit a bid.²⁸

The deal that Mr. Johnson and a small number of other senior executives had made with their financial partners also provoked controversy in early November. This deal promised to give the small management group 8.5% of RJR Nabisco's equity, a stake that could rise to 19.5% if the company met specified financial goals.²⁹ In addition, the deal gave

20. Sterngold, *supra* note 18, at D1, col. 6.

21. Wallace, *Several Giant Pension Funds Investing in Offer for Nabisco*, N.Y. Times, Oct. 31, 1988, at A1, col. 5, D5, col. 1.

22. *Id.* at A1, col. 5 (Coca-Cola Company and Georgia-Pacific Corporation).

23. *RJR Nabisco Stock Surges*, N.Y. Times, Nov. 3, 1988, at D4, col. 4, col. 4.

24. Sterngold, *Nabisco Officials Weigh Suit to Block a Bid*, N.Y. Times, Nov. 7, 1988, at D1, col. 3, col. 3.

25. *Id.* at D1, col. 4.

26. *Id.* at D14, col. 4. "Pre-sold" assets are those committed to purchasers before a putative seller acquires the entity that owns the assets.

27. *Id.*

28. Sterngold, *Forstmann Declines to Bid on RJR Nabisco*, N.Y. Times, Nov. 17, 1988, at D1, col. 3.

29. Sterngold, *supra* note 4, at D5, col. 3.

the group veto power over board decisions in the post-buyout company and promised group members a combined annual compensation of at least \$18 million, plus at least \$20 million in bonuses.³⁰ In an SEC filing, RJR Nabisco disclosed that Mr. Johnson and nineteen other senior executives would receive "golden parachutes" (or severance payments contingent on a sale of the company) worth \$52.5 million.³¹ After a newspaper disclosed the terms of this deal, Mr. Johnson wrote to RJR Nabisco's chairman, Mr. Hugel, stating that he had asked his lawyers to "analyze ways in which this stock could be distributed to our employees."³² In this same letter, Mr. Johnson argued that his group's compensation and equity-share percentages were typical for management buyout agreements.³³ Reportedly, however, one potential financial partner in Mr. Johnson's group, Salomon Brothers, refused to agree to these terms.³⁴

On November 8, RJR Nabisco's special committee promulgated five pages of formal guidelines for the disposition of the company and its assets. These guidelines contemplated a single round of bidding, to conclude on November 18.³⁵ The committee was eager to structure the transaction to leave RJR Nabisco's shareholders a substantial equity stake in the post-buyout company.³⁶ The committee also announced that it would favor only a bidder that could do something for RJR Nabisco's shareholders beyond what the company itself could do—like providing a large initial cash payment rather than simply selling off food interests.³⁷

KKR's success in obtaining sufficient information from RJR Nabisco's managers aided its preparation of a bid. A few days prior to the November 18 deadline, Nabisco's chief told KKR that he wanted to provide more information than other managers had furnished about the subsidiary's operations. KKR's head lawyer subsequently sent the special committee a letter on behalf of KKR complaining that some of RJR Nabisco's managers were apparently withholding information.³⁸ The committee promised to remedy the problem.³⁹ Some of the committee's own financial advisors similarly complained that at the initial stages even they had not received adequate information to evaluate bids.⁴⁰

30. Sterngold, *supra* note 24, at D14, col. 4.

31. Sterngold, *RJR Nabisco Discloses Guidelines for Its Buyout*, N.Y. Times, Nov. 9, 1988, at D6, col. 3, cols. 3-4.

32. Sterngold, *supra* note 4, at D5, col. 4.

33. *Id.*

34. *Id.*

35. Sterngold, *supra* note 31, at D6, col. 3, cols. 3-4.

36. *Id.* at D6, col. 4.

37. *Id.*

38. Sterngold, *supra* note 8, at D15, cols. 2-3.

39. *Id.*

40. *Id.* at D15, col. 3.

On November 18, both the management group and KKR submitted bids. The board's special committee, however, extended the bidding deadline by ten days—to November 29—permitting a third bidding group, led by First Boston Corporation, to develop a firm offer.⁴¹ On November 18, the highest bid was the management group's bid at \$100 per share, for a total of \$22.7 billion.⁴² KKR's bid was lower at \$21.3 billion.⁴³ The First Boston deal, which would have yielded a price of between \$23.8 and \$26.8 billion, contemplated an installment sale of RJR Nabisco's food businesses to the investment group by the end of 1988, to achieve tax savings.⁴⁴ Since Congress had in 1988 repealed the tax provisions that favored installment sales (effective January 1, 1989), closing this aspect of the First Boston deal by the end of 1988 was crucial. Further, the installment sale would result in a \$13 billion installment note, which the investment group, as the note's holder, would need to "monetize" (turn into cash). To date, no one had achieved such a feat with a note of comparable size.⁴⁵

Finally, on November 30, after much confusion on November 29, KKR claimed victory. Its winning bid offered cash and securities worth \$109 for each of RJR Nabisco's 227 million common shares and \$108 for each of the company's 1.3 million outstanding preferred shares, totaling \$24.88 billion.⁴⁶ Although the management group claimed that its bid had a higher total value, \$25.42 billion (or \$112 per share), RJR Nabisco issued a statement that its advisors assessed the two offers as "substantially equivalent."⁴⁷ The committee of outside directors recommended acceptance of the KKR offer, and the full board (apparently without Mr. Johnson's participation) voted in favor of the committee's recommendation.⁴⁸ The First Boston group dropped out of the bidding as a result of uncertainties about the bank financing for its bid.⁴⁹

The management group subsequently complained that the bidding process had been unfair. The process had become somewhat confused around midnight, November 30, when the management group learned that the board committee was working out a deal with KKR. At the 5

41. Sterngold, *Tax Hurdles Seen on Bid to RJR Nabisco*, N.Y. Times, Nov. 22, 1988, at D1, col. 6, col. 6.

42. *Id.*

43. Sterngold, *supra* note 28, at D15, col. 1.

44. *Id.* at D1, col. 6, D8, cols. 3-4.

45. *Id.* at D8, col. 4.

46. Sterngold, *RJR Nabisco Suitor Claims \$24.88 Billion Victory*, N.Y. Times, Dec. 1, 1988, at A1, col. 2, col. 2, D8, col. 1.

47. *Id.* at D8, col. 1.

48. *Id.*

49. *Id.* at D8, col. 2.

p.m. bidding deadline on November 23, KKR had submitted a bid of \$106 per share, topping the management group's bid of \$101 per share.⁵⁰ Early in the morning of November 30, the management group offered a new bid of \$108 per share and demanded that it be considered.⁵¹ By midday on November 30, the board committee told both groups that they had a few minutes to formulate a final proposal.⁵² KKR then raised its bid to \$108 per share, and the management group raised its bid to \$112 per share. The committee invited KKR to raise its bid further, which it did, to \$109 per share.⁵³ KKR then gave the committee's advisors a signed merger agreement and stated that they had half an hour to sign on.⁵⁴ In forty minutes, the committee's advisors came back with the chairman's signature.⁵⁵

Despite the definiteness of the amounts given above, each proposal consisted of a complex mixture of cash and securities, so that differing valuations of each proposal were inevitable. The management group offered per share \$84 in cash, preferred stock valued at \$24, and stock in the post-buyout company valued at \$4 (and which would total 15% of RJR Nabisco's equity).⁵⁶ KKR offered \$81 in cash per share, preferred stock valued at \$18 with dividends to be paid with additional shares of preferred stock, plus convertible debentures that it valued at \$10.⁵⁷ After four years, the debentures would be convertible to 25% of the post-buyout company's equity.⁵⁸

The committee ultimately recommended the KKR proposal on the basis of nonfinancial factors. KKR promised to sell neither the tobacco operations nor much of the food business, whereas the management group had planned to sell all the food operations.⁵⁹ KKR also promised to try to maintain employees' benefits, even if it sold particular business operations.⁶⁰ Under KKR's proposal, moreover, current shareholders would ultimately receive more equity in the post-buyout company.

Three weeks after KKR's victory, the firm's head, Henry Kravis, flew to Tokyo. The financing of KKR's bid called for \$13.75 billion to be

50. *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,704 (Del. Ch. Jan. 31, 1989).

51. *Id.* at 91,706.

52. *See id.*

53. *Id.* at 91,707.

54. *See id.*

55. Sterngold, *supra* note 46, at D8, col. 4.

56. *In re RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,706.

57. *Id.* at 91,706-07.

58. *Id.* at 91,705.

59. *See id.* at 91,708.

60. Helyar & Burrough, *How Underdog KKR Won RJR Nabisco Without Highest Bid*, Wall St. J., Dec. 2, 1988, at A1, col. 6, A11, col. 6.

raised from banks, and Mr. Kravis asked Japanese banks to provide \$5.5 billion; some observers saw these banks' participation as crucial to the deal.⁶¹ In Tokyo, Mr. Kravis also spoke with potential Japanese customers interested in purchasing junk bonds that were expected to form part of the deal.⁶² In addition to Japanese financiers' assistance, the original deal also required \$5 billion in short-term loans, or "bridge financing," with \$3.5 billion coming from Drexel Burnham Lambert and \$1.5 billion from Merrill Lynch.⁶³ KKR's plan called for refinancing these bridge loans within a year from the proceeds of the sale of \$2 billion in zero-coupon high-yield bonds and \$3 billion in interest-paying high-yield bonds.⁶⁴

KKR's efforts to recruit banks succeeded. By January 17, 1989, the firm reported that its bank syndicate had received commitments for \$14 billion,⁶⁵ an indication that banks had even oversubscribed. Although analysts were optimistic that KKR could also place the necessary junk bonds, they noted that junk debt financing of other large deals would require the market to absorb \$12 billion of such debt in early 1989, possibly leading to a rise in junk bond interest rates. In mid-January, Drexel increased the amount of its planned junk bond sale from \$3.5 billion to \$4 billion.⁶⁶ By January 31, however, KKR's need for a bridge loan was eliminated: Drexel had decided that it would be able to sell \$5 billion rather than \$3 billion in short-term notes, to be refinanced in the spring with a sale of long-term junk bonds.⁶⁷ One novel feature of Drexel's note sales, perhaps responsible in part for their success, was KKR's payment of cash fees (analogous to "points" paid to a mortgage lender), along with equity stakes in RJR Nabisco, to note buyers. KKR funded these novel cash fees partially from RJR Nabisco's assets, and Drexel funded the rest.⁶⁸

61. Cowan, *Banks to Get Steep Fees in Nabisco Deal*, N.Y. Times, Dec. 20, 1988, at D5, col. 4.

62. Sanger, *Kohlberg, Kravis Seeks Japan's Help on Nabisco*, N.Y. Times, Dec. 22, 1988, at D2, col. 5, col. 5.

63. Cowan, *Efforts Begin to Rebuild Nabisco's Morale*, N.Y. Times, Dec. 3, 1988, at 35, col. 3, 37, col. 4.

64. *Id.*

65. Smith, *RJR Buy-Out by KKR Clears Hurdle as \$14 Billion of Bank Loans Are Set*, Wall St. J., Jan. 18, 1989, at A3, col. 1, col. 1.

66. *Id.* at A3, col. 2.

67. Smith & Waldman, *supra* note 13, at A3, col. 2.

68. Although such fees are not unusual in private placements of bonds, fees for buying junior notes were novel to this transaction. See Smith, *How Drexel Overcame Big Hurdles in Selling Junk Issue for KKR*, Wall St. J., Mar. 3, 1989, at A1, col. 7, A7, col. 3. Like the commitment fees paid to bank lenders, see *infra* text accompanying note 75, the junior note buyers' fee percentage scaled upward with the amount of debt purchased. *Id.*

As a result of its magnitude, KKR's buyout of RJR Nabisco will naturally generate large fees for the financial institutions involved in the LBO and related transactions. KKR will receive a \$75 million fee for arranging the transaction, a 1.5% management fee for the use of its buyout funds, and 20% of any profit that each pool of funds garners from a successful LBO.⁶⁹ Although the \$75 million fee is the largest that KKR has received to date for a single transaction, the amount only slightly exceeds fees that KKR has received for considerably smaller transactions in the past.⁷⁰ As of the end of January, Drexel was to receive \$201.9 million and Merrill Lynch \$84.4 million for arranging the requisite junk bond financing.⁷¹ Each investment bank also expected \$25 million in advisory fees.⁷² RJR Nabisco disclosed that it would pay \$14 million to each of the two investment firms—Dillon Read & Company and Lazard Freres & Company—that advised the board.⁷³ The law firms involved in the transaction have also earned record-setting fees.⁷⁴ Finally, banks that agree to help finance LBOs typically receive commitment fees in a percentage of the loan amount, a percentage that increases with the amount of the loan. The smallest loan amount for the RJR Nabisco transaction (\$100 million) carried a fee of 1.5%, and the largest lenders were reportedly to receive as much as 3.25% in fees.⁷⁵

Numbers aside,⁷⁶ the most remarkable aspect of this transaction is that the management-sponsored deal lost, even after the management group made a bid economically equivalent (and perhaps superior) to

69. Smith, *KKR to Receive \$75 Million Fee in RJR Buy-Out*, Wall St. J., Feb. 1, 1989, at A6, col. 1, col. 1.

70. *Id.* For example, in 1986, KKR received a fee of \$45 million for the \$6.2 billion management buyout of Beatrice Companies. *Id.*; see also Williams, *King of the Buyouts Kohlberg Kravis Helps Alter Corporate U.S.*, Wall St. J., Apr. 11, 1986, at A1, col. 4.

71. Smith & Waldman, *supra* note 13, at A12, col. 2.

72. *Id.*

73. Sterngold, *Talking Deals: A Feeding Frenzy on Nabisco Fees*, N.Y. Times, Nov. 10, 1988, at D2, col. 1, col. 1.

74. Law firms involved in the RJR deal will receive more than \$60 million in fees. Sontag, *\$60 Million in Fees*, Nat'l L.J., Dec. 19, 1988, at 2, col. 1. The transaction used the services of 200 lawyers from at least 10 law firms, who represented bidders, investors, and sundry banks, and reportedly billed at premium rates for furnishing round-the-clock service in a high-pressure atmosphere. *Id.* Transactions in the wake of the LBO, like the formal tender offer to RJR Nabisco shareholders and asset sales, along with litigation, will also require lawyers' services. *Id.*; see also *For Further Details*, See *Carton No. 587*, Wall St. J., Mar. 15, 1989, at B1, col. 1, col. 1 (reporting that over the Christmas holiday, KKR employed 150 attorneys from Latham & Watkins, Los Angeles, to compile 680 cartons of documents in response to an FTC request for information, which required a DC-9 jet for shipping data to Washington).

75. Cowan, *supra* note 61, at D5, col. 4.

76. Economists predicted that completing the transaction, which entailed the transfer to KKR of \$18.9 billion from banks as well as KKR's purchase of 74% of RJR Nabisco's shares, would cause a "blip" in U.S. money supply statistics. Anders, *RJR Finale Will Send Money Coursing*, Wall St. J., Feb. 9, 1989, at C1, col. 3.

KKR's.⁷⁷ Such an outcome stands out because management groups initiating buyout proposals typically defeat outsiders' competing proposals.⁷⁸ Why is this? And why did the RJR Nabisco contest turn out differently?

Several factors explain management groups' frequent success over competing bidders. If a management group initiates a buyout transaction, it enjoys advantages that flow to any initial bidder: such a bidder chooses the time for the transaction and structures an initial proposal to which other prospective bidders must respond. Moreover, events often move quickly, limiting the likelihood that other prospective bidders will make competing proposals at all. Management groups also enjoy unique advantages. As the RJR Nabisco experience demonstrates, these groups have unlimited access to nonpublic information on their company, whereas outside bidders have circumscribed access to such information at best, and often face serious initial difficulty in getting any access.⁷⁹ Uncertainty thus might cause outside bidders to systematically discount the top price they are willing to pay for a target, and corporate management can exacerbate such uncertainty by sharply limiting the outside bidder's access to nonpublic information.

Senior management's often considerable rapport with the corporation's directors also provides an advantage for management groups. If control of the corporation is to shift, all things being equal, even outside directors would prefer a victory by a management-backed group. Current managers seem more likely than total "outsiders" to be familiar with corporate operations and sympathetic to the interests of nonmanagement employees and others with long-standing interests in the corporation's stability.

Several factors explain why the contest for RJR Nabisco turned out differently for the management group. Although management's first offer—\$75 per share—represented a 36% premium over the then-current RJR Nabisco market price, it soon appeared unduly low. Within four days, KKR had offered \$90 per share, and soon thereafter RJR Nabisco's directors gained access to studies setting the value of the company, if its component businesses were sold separately, at prices in excess

77. *Cf. In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,713 (Del. Ch. Jan. 31, 1989) (holding that directors' preference for KKR proposal was not "so beyond the bounds of reasonable judgment as to raise an inference of bad faith").

78. Cowan, *Losers Get Some Spoils in Fight for RJR Nabisco*, N.Y. Times, Dec. 2, 1988, at D14, col. 5, col. 5.

79. See *supra* notes 38-40 and accompanying text.

of \$90 per share.⁸⁰ KKR's ability to make a *credible* bid at \$90, given RJR Nabisco's size, meant that it could raise sufficient financing for a \$20.4 billion deal. The management group, however, might have underestimated its likely competitors' ability to raise serious money⁸¹ on short notice. The management group's posture became even more controversial when a newspaper article revealed the generosity of Shearson Lehman's financial arrangements, potentially producing \$100 million in profits for each management participant.⁸² As other bidders joined the fray, moreover, the contest became lengthier and pricier. In the end, KKR's proposal, compared with the final management-backed proposal, was more generous to RJR Nabisco's shareholders, eventually giving them 25% of the company's equity. In addition to shareholder benefits, the KKR deal was kinder to the company's nonmanagement employees. Whereas the management group announced plans to sell off all of RJR Nabisco's food businesses, KKR stated that it planned to retain most of the food businesses and all of the tobacco operations. Further, unlike the management group, KKR explicitly agreed to guarantee nonmanagement employees' fringe benefits through 1991, notwithstanding any sale of business operations.⁸³

Another factor that perhaps contributed to the demise of management's offer was the involvement of F. Ross Johnson himself, a person unpopular in many circles in Winston-Salem, North Carolina. Three years prior to the buyout, the R.J. Reynolds Tobacco Company had merged with Nabisco.⁸⁴ Mr. Johnson, who came from Nabisco, decided that the company should move its headquarters from Winston-Salem to Atlanta, describing Winston-Salem as unduly "bucolic" for a cosmopolitan enterprise like RJR Nabisco.⁸⁵ In Winston-Salem, however, successive generations of people had worked in Reynolds's tobacco operations and, because of the company's generous stock purchase program for its employees, individual residents and local institutions of that "bucolic" place owned about \$2.5 billion worth of RJR Nabisco stock at the time

80. Sterngold, *Nabisco Battle Redefines Directors' Role*, N.Y. Times, Dec. 5, 1988, at A1, col. 2, D5, cols. 1-2.

81. Lawyers and support staffs working on such large transactions seem to have problems handling the numbers involved. The lawyer for one RJR Nabisco bidder reported: "As we kept typing letters, the last three zeros occasionally dropped out . . . [p]eople were not used to typing billions." Sontag, *LBOs Put New Focus on the Bar*, Nat'l L.J., Dec. 19, 1988, at 1, col. 4, 20, col. 3 (quoting First Boston's attorney).

82. Sterngold, *supra* note 80, at D5, col. 2.

83. *Id.* at D5, col. 6.

84. Sterngold, *supra* note 4, at D5, col. 1.

85. See All Things Considered: Winston-Salem (NPR broadcast, Dec. 12, 1988) (tape on file with author).

of the buyout.⁸⁶ Winston-Salem families had handed down the stock for generations, like heirlooms or homesteads, exhibiting an unusually emotional, personalized tie to the company.⁸⁷ Winston-Salem, moreover, has been a quintessential "company town" for over one hundred years; in 1988, 15,000 of its residents still worked for RJR Nabisco. Even after KKR's assurances reduced local fears of job losses, employee-stockholders resented the large tax obligations they would incur when they sold their shares. Although Mr. Johnson initiated the events leading to the sale that made many employee-stockholders wealthy, they continued to speak of him in highly unfavorable terms.⁸⁸ As one tobacco worker, interviewed by National Public Radio, said of Mr. Johnson's era of management: "it's not a home town crowd any more."⁸⁹ Many Winston-Salem residents remain ambivalent at best about the LBO. The irreparable change to long-settled local practices, coupled with the widespread perception that the initial management bid was an attempt to buy the company on the cheap,⁹⁰ outweighed (or at least accompanied) residents' satisfaction with their enhanced individual wealth.⁹¹

Indeed, Delaware's chancery court⁹² eventually considered the possibility that RJR Nabisco's directors endorsed the KKR proposal in order to repudiate Mr. Johnson publicly. Actions brought on behalf of RJR Nabisco's shareholders challenged the directors' decision to accept the KKR proposal, after receiving substantially equivalent bids, rather than again asking the contestants if they wished to increase their bids.⁹³ The plaintiffs alleged, among other things, that the directors' special committee chose KKR in order to repudiate Mr. Johnson and thereby publicly disassociate themselves from the harsh criticism evoked by the management proposal.⁹⁴ The court denied the plaintiffs' motion for a

86. *Id.*

87. *Id.*

88. *Id.* (one employee described Johnson's initial bid as an attempt to "steal the company").

89. *Id.*

90. During the buyout contest, the following song, created by a local radio station's morning disc jockeys and sung to the tune of *Santa Claus Is Coming to Town*, proved popular:

You better watch out,
 You better pay heed,
 We're all going to be the victims of greed,
 F. Ross Johnson's not coming to town.

Id.

91. In the same vein, a local journalist observed: "We have seen the future and didn't even get its license number." *The RJR Shuffle*, *The Independent* (Durham, N.C.), Dec. 16, 1988, at 3, col. 2, col. 3.

92. Despite strong ties to North Carolina, RJR Nabisco is a Delaware corporation.

93. See *In re RJR Nabisco, Inc. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,700 (Del. Ch. Jan. 31, 1989).

94. *Id.* at 91,702, 91,710-13.

preliminary injunction. In light of evidence that the committee members and directors acted in good faith, the court held that the plaintiffs would be unlikely to establish that the special committee's action showed an improper motivation that worked in KKR's favor.⁹⁵ The court observed, however, that the alleged motivations, if established, would disqualify the directors' decision from protection under the business judgment rule. In that case, the directors would have pursued the transaction for a reason unrelated to the corporation's best interests, even though the directors themselves did not benefit financially from opposing the corporation's interests. As the court noted, "[g]reed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge or, as it is here alleged, shame or pride."⁹⁶

One action that had a substantial effect on the transaction's outcome was the directors' decision to disclose Mr. Johnson's proposal to the public on October 20.⁹⁷ Early disclosure enhanced the likelihood that competing bids would be made; indeed, KKR announced its first offer five days after RJR Nabisco issued a press release announcing that the management group would offer \$75 per share.⁹⁸ Delaware law probably did not *require* disclosure at that point: Delaware courts have rejected shareholders' challenges to LBOs that were not publicly announced until after the directors and the acquiring entities had signed merger agreements.⁹⁹ For example, in *In re Fort Howard Corp. Shareholders Litigation*, the Court of Chancery denied plaintiffs' motion for a preliminary injunction to prohibit the closing of a public tender offer that was the first move in a two-step LBO of Fort Howard.¹⁰⁰ A special committee of Fort Howard's directors had signed a merger agreement with the financial partner in the LBO without conducting an auction of any sort, public or private.¹⁰¹ The merger agreement, however, contained provisions permitting the committee, during a period of thirty business days following the deal's public announcement, to negotiate with or provide information to any other potential acquirer.¹⁰² One distinction between the Fort Howard and RJR Nabisco LBOs is the relative magnitude of the two transactions: the Fort Howard LBO carried a price of \$3.7 billion,¹⁰³ not an

95. *Id.* at 91,703, 91,710-14.

96. *Id.* at 91,711.

97. See Helyar, *RJR Nabisco Buy-Out Would Fit the Pattern of a Restless Chief*, Wall St. J., Oct. 21, 1988, at A1, col. 6, col. 6.

98. See *Buyout Specialist Bids \$20.3 Billion for RJR Nabisco*, *supra* note 5, at A1, col. 6.

99. See, e.g., *In re Fort Howard Corp. Shareholders Litig.*, No. 9991, slip op. (Del. Ch., Aug. 8, 1988) (Westlaw, 1988 WL 83147).

100. *Id.*, slip op. at 52.

101. *Id.*, slip op. at 21.

102. See *id.*, slip op. at 19.

103. *Id.*, slip op. at 3.

insubstantial amount by most measures, but one dwarfed by the \$25 billion price of the RJR Nabisco LBO. Even though the Delaware cases to date do not require directors to conduct an auction in response to a proposal for such a large transaction, the determination whether to pursue the auction route seems well within the range of decisions protected by the business judgment rule.

Thus, the special committees' disclosure of the management bid, the price disparity between initial bids, and, arguably, Mr. Johnson's local unpopularity led to the unusual result of a management group losing an auction for a company, even when that group's bid was substantially equivalent to the competitor's bid.

Another startling fact about the RJR Nabisco transaction, along with others like it, is the enormous discrepancy between the company's value as realized in the LBO and its value as reflected in the price of shares traded on the New York Stock Exchange prior to the announcement of management's buyout proposal. How can one best explain this discrepancy in value? Given RJR Nabisco's size, no one factor is likely to suffice. Some observers took management's proposal as an admission that the merger three years earlier between RJR, a tobacco company, and Nabisco, a food company, had failed to produce its expected return for shareholders.¹⁰⁴ To be sure, the operational relationships between manufacturing and selling tobacco, on the one hand, and food products, on the other, are not obvious. However, in light of KKR's apparent willingness to retain all of the company's tobacco operations and most of its food businesses, one would be mistaken to attribute much of the incremental value realized by this transaction to an expected disaggregation of mismatched operations.¹⁰⁵ Likewise, in evaluating competing LBO proposals, RJR Nabisco's directors were appalled at the extent and cost of incumbent management's perquisites, including lodgings in Palm Springs, California, and a large fleet of jets referred to internally as the "RJR Air Force."¹⁰⁶ However excessive these expenditures might appear, the opportunity to eliminate them does not add up to a \$12 billion premium.

Other types of savings may provide a stronger explanation. KKR disclosed internal RJR Nabisco projections, obtained during the contest,

104. See, e.g., Sterngold, *supra* note 4, at D5, col. 1 ("In effect, Mr. Johnson was admitting that the merger . . . failed to produce the expected return for shareholders.").

105. Another possibility is that the stock of a company with a track record of unsuccessful acquisitions trades at a discount from the company's asset value, in part because investors believe that the company's management will continue to use its earnings or other funds to make unsuccessful investments. An LBO can "capture" this discount. For a full explication of this argument, see Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 635 (1989).

106. Helyar & Burrough, *supra* note 60, at A11, col. 1.

that coupled predictions of increased profit over the next ten years with projections of an initial increase in capital spending, from \$1.1 billion in 1988 to \$1.7 billion in 1989, followed by a decline in capital spending to \$735 million in 1998.¹⁰⁷ Prior to the LBO contest, moreover, the company's Nabisco operation lagged behind competitors in modernizing its facilities and reformulating its cookie and cracker products to replace lard and tropical oils with unsaturated fats.¹⁰⁸ On the tobacco front, the profit margin from RJR's cigarette operations fell in fourth quarter of 1988, while competitor Phillip Morris's profit margin rose.¹⁰⁹ And RJR's best-known new product in recent years, the expensively developed "smokeless cigarette" called Premier, was a failure.¹¹⁰ Premier cost 25% to 30% more than ordinary cigarettes, but consumers in test markets disliked its taste and the feel of its part-aluminum holder.¹¹¹ On February 28, 1989, RJR Nabisco announced the termination of Premier's market testing and indicated that it had no immediate plans of reintroducing Premier or anything like it.¹¹² The Premier venture was not cheap; KKR reportedly told its bankers that, prior to the LBO, RJR Nabisco's management had planned capital expenditures of \$80 million on Premier in 1989¹¹³ and had budgeted an operating loss on Premier of \$100 million.¹¹⁴

Like many companies that have restructured through buyouts or leveraged recapitalizations, RJR Nabisco had a strong cash flow (that is, cash revenues and inflows in excess of the cash outflows needed to operate its present businesses). KKR has disclosed that RJR has a projected 1989 cash flow of \$4.5 billion, a financial condition that, if it continues, can easily service and retire debt from the LBO.¹¹⁵ Another common

107. Smith, *Investment Bankers Should Get at Least \$386.3 Million in RJR Nabisco Buy-Out*, Wall St. J., Dec. 8, 1988, at A4, col. 2, col. 4.

108. Waldman, *KKR Girds for Tricky Turns in Buy-Out*, Wall St. J., Feb. 1, 1989, at A6, col. 1, col. 1. In March 1989, Nabisco Brands, Inc., announced that, although it had no target date for removing saturated fats from its products, it would attempt to do so as quickly as possible. *Unit Says Many Products Are Free of Tropical Oils*, Wall St. J., Mar. 6, 1989, at B5, col. 5. Nabisco reported that only four to six of its products still contained tropical oils, while about 60 still contained lard. *Id.*

109. *Unit Says Many Products Are Free of Tropical Oils*, Wall St. J., Mar. 6., 1989, at B5, col. 5.

110. Waldman, *supra* note 108, at A6, col. 4.

111. Waldman & Morris, *RJR Nabisco Abandons "Smokeless" Cigarette*, Wall St. J., Mar. 1, 1989, at B1, col. 3, col. 5.

112. *Id.* at B1, col. 3.

113. *Id.* at B1, col. 4. The \$80 million capital spending on Premier that RJR Nabisco planned for 1989 amounted to 4.7% of total capital spending planned for that year (\$1.7 billion). See *supra* text accompanying note 107.

114. Waldman & Morris, *supra* note 111, at B1, col. 4.

115. White, *KKR Tells Its Partners RJR Is a Bargain but Gives Them Few Numbers to Prove It*, Wall St. J., Dec. 5, 1988, at A4, col. 2, col. 3.

explanation for the premiums paid for companies like RJR Nabisco is improvement in the corporation's brand management—selling more Oreos, Winstons, Milk-Bones, and other products through better marketing.¹¹⁶ Finally, after a buyout, the relationship between a company's senior managers and their financial partner in a transaction (e.g., KKR) will differ from the prior relationship between senior management and the company's public shareholders. Share ownership and managerial control are no longer divided, and management becomes subject to more focused and immediate financial accountability.¹¹⁷

Like many other restructuring transactions, the RJR Nabisco transaction is striking because of the identity of some of its participants and the sources of its funding. KKR itself is an entity of relatively recent origin, almost as recent a development as the market for junk debt securities.¹¹⁸ Large amounts of capital have become available for debt financing, largely outside established markets for public offerings of debt and equity securities. It is telling that the Federal Reserve Board, and not the Securities and Exchange Commission, is the federal regulatory body most closely watched in the policy debate over LBOs.¹¹⁹

The articles in this symposium address a range of issues at the center of the legal response to fundamental corporate changes. Three of the articles examine various concepts of financial value and devices to enhance value in the context of such fundamental changes. As the RJR Nabisco transaction illustrates, explanations of value and sources of value in such transactions can be elusive. Though we know that KKR paid \$25 billion for the company, including a \$12 billion premium over the stock market's prior "valuation" of RJR Nabisco, could we ever discover the company's "true" value? And what, if anything, does "true value" mean? Perhaps when substance appears so ineffable, the law appropriately focuses on process—on the quality of the decisionmaking that governs pricing rather than prices themselves. In *Fairness Opinions*:

116. See *The Year of the Brand*, THE ECONOMIST, Dec. 24, 1988, at 95. Especially in the food industry, which has in recent years become more product-competitive than price-competitive, capturing strong brands assures shelf space in retail food stores and thus market share. See *Cheese Whizz*, THE ECONOMIST, Oct. 22, 1988, at 74, 75.

117. See Waldman, *New RJR Chief Faces a Daunting Challenge at Debt-Heavy Firm*, Wall St. J., Mar. 14, 1989, at A1, col. 6.

118. See generally Loomis, *Buyout Kings*, FORTUNE, July 4, 1988, at 52 (discussing KKR's origins and operations).

119. See *Man of the New Year*, THE ECONOMIST, Jan. 7, 1989, at 13, 14 ("For the Fed, the S&Ls and the LBOs make an ironic couple of concerns."). But see Ricks, *SEC Staff Weighs Stronger Requirements For Disclosure by Buy-Out Participants*, Wall St. J., Dec. 22, 1988, at A4, col. 2 (SEC Chairman to testify that staff is considering extending the disclosure required in any takeover involving management participants to make disclosure equivalent to that required in going-private transactions).

How Fair Are They And What Can Be Done About It?, Professor Lucian Bebchuk and Mr. Marcel Kahan describe the central role of investment bankers' fairness opinions in corporate control transactions.¹²⁰ Directors commonly rely on such opinions when approving transactions that they support or denouncing ones that they oppose (like hostile takeover bids). Professor Bebchuk and Mr. Kahan demonstrate, however, that fairness is difficult to measure and that a definition of "fairness" or "adequacy" is unavoidably problematic.¹²¹ Moreover, the fee structure for compensating investment banks that write fairness opinions—especially the use of consummation-contingent fees—and investment banks' desire to enhance future business, combined with the fact that management decides which investment banks to hire, cause banks to "write the fairness opinions that managers wish to see."¹²² In this respect, the RJR Nabisco transaction was unusual, because "management" was not monolithic or single-minded; the outside directors' interests were clearly differentiated from those of Mr. Johnson and his bidding group.

Professor Bebchuk and Mr. Kahan argue that courts should be alert to these problems when adjudicating cases that involve directors' reliance on fairness opinions. These authors advocate deliberate judicial attention to whether an investment bank, in preparing its opinion, used a definition of fairness appropriate to the transaction at issue.¹²³ They recommend that courts discount opinions written by banks compensated through contingent fee arrangements.¹²⁴ They further suggest that courts, in evaluating the reasonableness of directors' reliance on a fairness opinion, consider whether the bank informed directors of a range of fair prices and whether the bank's assumptions were reasonable.¹²⁵ In Delaware, at least, these criteria seem susceptible of easy incorporation into courts' assessments of whether directors acted within "the bounds of reasonable judgment"¹²⁶ after informing themselves "of all material information reasonably available to them."¹²⁷

The operative definition of "fairness" also plays an important and problematic role in the context of an appraisal remedy, which requires courts to determine the value of dissenting shares following a merger or

120. Bebchuk & Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 DUKE L.J. 27.

121. *Id.* at 30-36.

122. *Id.* at 42.

123. *Id.* at 46-47.

124. *Id.* at 49.

125. *Id.* at 47-48.

126. *In re* RJR Nabisco, Inc. Shareholders Litig., [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,713 (Del. Ch. Jan. 31, 1989).

127. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

other control transaction. In *Rejecting the Minority Discount*, the note writer critically assesses the setting of valuation standards in judicial practice, focusing in particular on some courts' practice of reducing the pro rata value of shares held by a minority shareholder who lacks power to control a corporation's policy and operations.¹²⁸ To be sure, many of the explanations for the massive premium that KKR paid to RJR Nabisco shareholders turn on KKR's ultimate control of the company's business policy and assets. These explanations, however, may simply not apply to judicial interpretation of statutory provisions governing appraisal. The Note argues that judges have difficulty in appropriately quantifying minority discounts and, more generally, justifying the use of such a discount in any coherent fashion. In the absence of such a justification, the minority discount is untenable.

The operative definition of "value" is often the price that a buyer has paid for an asset. In contested corporate control transactions, the appropriate role of a target's directors has long been the subject of litigation and more theoretical disputes. Should the directors do nothing? Should they attempt to cause the bidder to pay more than it would otherwise? May they act to defeat a bid? These questions currently arise in the debate over the adoption and use of "poison pills," which are securities or rights to purchase securities designed to deter hostile bids. In *Poison Pills and Litigation Uncertainty*, Professor Charles M. Yablon examines the role of poison pills in facilitating settlements between bidders and managers of target companies; such settlements convert transactions that commence as hostile tender offers into negotiated acquisitions.¹²⁹ Professor Yablon explains that both a bidder's and a target's management have incentives to settle prior to final judicial resolution of their disputes in order to remove their respective risks of downside loss.¹³⁰ Litigation of such disputes presently focuses on whether target directors have an obligation to redeem the securities constituting a poison pill. A pill, in effect, extends the time over which any given takeover contest will run, arguably enhancing the likelihood that higher offers will emerge. In Delaware, where the bulk of such litigation takes place, Professor Yablon discerns not increased certainty in judicial decisions, but, if anything, a movement toward greater judicial discretion and uncertainty.¹³¹ Delaware's applicable legal standards are "loose" criteria like "reasonableness" and "proportionality,"¹³² which courts apply in fact-specific ways

128. Note, *Rejecting the Minority Discount*, 1989 DUKE L.J. 258.

129. Yablon, *Poison Pills and Litigation Uncertainty*, 1989 DUKE L.J. 54.

130. *Id.* at 66-68.

131. *Id.* at 76-77.

132. *Id.* at 73.

without isolating specific dispositive factors. Even cases that clarify the law in one respect confuse it in another, engendering factual inquiries about new issues in subsequent cases. Professor Yablon argues that the resultant uncertainty is, on balance, both inevitable and desirable. In particular, he argues that motion practice before a judge or chancellor provides an appropriate forum for the decision whether a pill should be redeemed and the auction for a company thereby terminated.¹³³

Poison pills are not, of course, the only area of development in Delaware law at the moment. The applicable standard for directors' decisions to end an auction is also uncertain. In shareholder litigation challenging such a decision in the context of the RJR Nabisco transaction, the chancery court acknowledged that the precise nature of the directors' duty in the auction context is unresolved.¹³⁴ One might view that duty as an extension or application of the directors' general duty to act in good faith, with loyalty, and with due care.¹³⁵ An alternative view is that the directors' duty in the auction setting, distinct from their general duty to act in good faith and with due care, amounts to a duty to conduct a fair or effective auction.¹³⁶ Under the first view, a court examines whether the directors acted with due care and in a good faith effort to achieve an appropriate objective.¹³⁷ Under the alternative view, which operates like a form of strict liability, the court examines whether, after the fact and without regard to the board's good faith, the auction was fair or, perhaps, effective.¹³⁸ In its May 1989 opinion in *Mills Acquisition Co. v. Macmillan, Inc.*, the Delaware Supreme Court characterized these apparent di-

133. *Id.* at 87-88.

134. See *In re RJR Nabisco Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,714-15 (Del. Ch. Jan. 31, 1989). The chancery court attributed its uncertainty on this point to the limitations of the Supreme Court's bench ruling in a case about management's auction-related decisions, see *Mills Acquisition Co. v. Macmillan, Inc.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,072, at 91,025 (Del. Ch. Nov. 2, 1988) (in auction for sale of corporate enterprise, there must be "the most scrupulous adherence to ordinary principles of fairness"), *rev'd*, [Current Transfer Binder] *id.* ¶ 94,401, at 92,602 (Del. May 3, 1989). *In re RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,715.

135. See *id.*; accord *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 781-84 (Del. Ch. 1988) (auction does not require "level playing field" if directors act with care and in good faith pursuit of shareholders' interests).

136. See *In re RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,714; accord *In re Holly Farms Corp. Shareholders Litig.*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,181, at 91,644 (Del. Ch. Dec. 30, 1988) ("Even if the Board thought it was acting in good faith, the sale process itself was so substantially flawed that the Board's actions, considering all the facts and circumstances, were not likely to have maximized the value of the corporation for its shareholders and, therefore, its actions cannot be viewed as being rational.")

137. See *In re RJR Nabisco*, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 91,714-15.

138. See *id.* at 91,714. Even if an "effective" auction is required, the court held that boards need not conduct perfect auctions to escape liability. *Id.* at 91,715.

vergences as “more a matter of semantics than substance.”¹³⁹ The court held in *Mills* that directors’ decisions incident to conducting and concluding an auction should have as their “primary objective, and essential purpose, . . . the enhancement of the bidding process for the benefit of the stockholders.”¹⁴⁰ Directors who treat bidders unequally must establish that they had a rational basis for the action, founded in the shareholders’ interests,¹⁴¹ and that their actions were reasonable in relation to the end sought.¹⁴² The facts reviewed in the *Mills* opinion illustrated a flawed bidding process in which a management-sponsored bidding group received tactical advantages not available to other bidders (including disclosure of another party’s bid). The Supreme Court held that the directors had failed to exercise their “active and direct duty of oversight,” a failure that significantly contributed to the mismanagement of the auction.¹⁴³

In recent years, Delaware law on directors’ fiduciary obligation to a corporation and its shareholders has evolved to subject directors to affirmative duties, which directors can breach even if they act disinterestedly. To this extent, directors as fiduciaries resemble other types of fiduciaries, like trustees and guardians, whose positions are conventionally held to impart affirmative obligations. In *Smith v. Van Gorkom*, a 1985 case involving a proposed LBO, the Delaware Supreme Court interpreted the directors’ duty of care to require that “directors inform[] themselves as to all information that was reasonably available to them,” including the basis on which an acquisition price was computed.¹⁴⁴ Later in 1985, the Delaware Supreme Court held in *Unocal Corp. v. Mesa Petroleum Co.* that directors confronted with a takeover bid had an obligation to determine whether the bid was in the best interests of the corporation and its shareholders.¹⁴⁵ Directors also have a related obligation to protect the corporation and its shareholders “from perceived harm whether a threat originates from third parties or other shareholders.”¹⁴⁶ Indeed, the *Unocal* court observed that directors have a duty to “ensure that the minority stockholders receive equal value for their shares,” at least when an offeror proposes a transaction that compels an exchange of

139. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,401, at 92,602 (Del. May 3, 1989).

140. *Id.* at 92,601.

141. *Id.*

142. *Id.* at 92,602.

143. *Id.* at 92,597

144. 488 A.2d 858, 877 (Del. 1985).

145. 493 A.2d 946, 954 (Del. 1985). For a discussion of the potential significance of *Unocal*, see Gilson & Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989).

146. *Id.* at 955.

some shares for junk debt.¹⁴⁷ Under *Unocal*, the directors' duty to protect requires that protective means be "reasonable" or proportional to the threat.¹⁴⁸ In *Mills*, the Delaware Supreme Court expressly made this standard applicable to directors' decisions during an auction.¹⁴⁹ Finally, as Professor Yablon's article explores at length, directors in particular circumstances may come under an affirmative duty to redeem a poison pill.

This judicial invigoration of the directors' role is relatively recent. In 1968, a leading academic wrote that he was "very skeptical of the proposition that directors of industrial corporations run any substantial risk of liability for ordinary negligence," uncomplicated by self-dealing.¹⁵⁰ To be sure, it is awkward at best to characterize the more recently enunciated duties as an obligation not to be negligent,¹⁵¹ and only slightly less awkward to treat them as particular manifestations of the directors' obligation to act with due care. Both formulations—"avoid negligence" and "use due care"—address how directors discharge their duties, and not the affirmative content of those duties.

Consider, in contrast, the legal position of a trustee. In addition to a duty of loyalty, which requires a trustee to administer a trust solely in the beneficiary's interest,¹⁵² and a duty to use skill and care in doing so,¹⁵³ the trustee has many affirmative duties. For example, the trustee must, using reasonable skill and care, preserve the trust property.¹⁵⁴ If the trust has two or more beneficiaries, the trustee must deal impartially with all of them.¹⁵⁵ Moreover, if the trustee can reasonably perform her duties personally, she may not delegate them.¹⁵⁶ Directors, of course, are not entirely like trustees in their legal obligations,¹⁵⁷ but the recent developments in Delaware law give directors *affirmative* duties like those applicable to trustees. In the midst of such evolution, it can be difficult to distinguish between legal developments and legal uncertainty.

147. *Id.* at 957.

148. *Id.* at 955.

149. [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) at 92,601-02.

150. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 *YALE L.J.* 1078, 1101 (1968).

151. *But see* *Smith v. Van Gorkoin*, 488 A.2d 858, 873 (Del. 1985) (holding that "concept of gross negligence" is applicable test to determine whether directors' business judgment was informed).

152. RESTATEMENT (SECOND) OF TRUSTS § 170(1) (1959).

153. *Id.* § 174.

154. *Id.* § 176.

155. *Id.* § 183.

156. *Id.* § 171.

157. *See, e.g.,* DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 *DUKE L.J.* 879, 908-09, 909 n.136; Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 *BUS. LAW.* 35 (1966).

Two of the symposium articles focus on the impact of corporate restructurings on nonshareholders. In any restructuring, present equityholders receive a bonus financed by substantial borrowing. As the RJR Nabisco transaction illustrates, this additional borrowing reduces the market value of the corporation's preexisting debt securities. In *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, Professor William W. Bratton, Jr., analyzes the differing legal conceptions of the relationship between debtholders and corporate issuers.¹⁵⁸ Professor Bratton notes debtholders' curious failure to bargain for greater contractual protection against the financial consequences of restructuring. In the mid-1970s, new unsecured public debt of large industrial corporations ceased to contain covenants restricting issuers' ability to incur additional debt and distribute assets to equityholders. This situation raises the important question of what limits the law may appropriately impose on issuers' behavior that harms creditors who could have protected themselves by contract.

Though the bulk of RJR Nabisco's bonds contained no restrictions addressed to the risk of a restructuring, the company had during the past three years issued almost \$500 million in Swiss-franc-denominated bonds that gave holders the right to redeem the bonds at initial face value in the event of a corporate reorganization.¹⁵⁹ Two underwriters of the Swiss franc bonds, citing stringent capital preservation norms in Swiss fiduciary law, threatened to force redemption unless KKR agreed to a satisfactory settlement with the bondholders.¹⁶⁰ Professor Bratton's article provides a number of explanations for U.S. investors' willingness—startling in retrospect—to buy debt securities without comparable restrictions. His article also justifies a *limited* regulatory role for the law (albeit one capable of expansion). Professor Bratton rejects arguments that an issuer owes a fiduciary obligation to debtholders, calling these arguments “overwrought”;¹⁶¹ self-protection in the market diminishes the urgency of the bondholders' predicament.

Restructuring, nonetheless, both embodies and provokes profound change. Long-held assumptions about management's preferences for stability and asset growth funded by retained earnings have become inaccurate, destabilizing the relationships premised on them. More generally,

158. Bratton, *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92.

159. Winkler, *Two Underwriters Demand RJR Call Swiss Franc Bonds*, Wall St. J., Feb. 7, 1989, at C1, col. 5.

160. *Id.* at C19, col. 5. In March, a Swiss court issued a temporary order to block completion of the LBO. White, *Swiss Court Seeks to Halt Takeover of RJR Nabisco*, Wall St. J., Mar. 23, 1989, at A19, col. 3.

161. Bratton, *supra* note 158, at 151.

as Professor Bratton observes, the "restructuring movement presupposes diminished relational solidarity."¹⁶² In this view, F. Ross Johnson might not be a villain, but his obvious pursuit of a self-serving agenda defeated others' expectations, expectations that were real although not captured in explicit contract terms. The question of the appropriate legal response to claims that such expectations have been disappointed is a difficult one. Is a public-law response appropriate? If so, on behalf of what categories of claimants, and on what terms? Should the law leave parties to anticipate and allocate the risks associated with corporate restructuring and to establish appropriate contracts?

In *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, Professor Jonathan R. Macey assesses the impact of fundamental corporate changes on a range of non-shareholder constituencies and demonstrates the overall desirability of private contract solutions.¹⁶³ Professor Macey explains that corporate restructurings provide occasions for shareholders' opportunistic behavior, that is, for shareholders to benefit from a firm's income stream at the expense of other claimants.¹⁶⁴ Many such claimants make firm-specific capital investments, including human capital investments, that leave them vulnerable to exploitation. In Professor Macey's judgment, a corporation is best viewed as a web of contractual relationships among producers of factors necessary for a corporation's financing and operation, not as an object of claims based on property rights.¹⁶⁵ Courts should ascertain the contracts that link a corporation's constituents, acknowledge that the firm's residual claimants are equity shareholders, and police expropriation of firm-specific capital investments.¹⁶⁶ Further, Professor Macey expresses great skepticism toward arguments founded on "implicit" contracts among these constituents.

In the period described by Professor Bratton's article, an era of unforeseen change in the circumstances defining parties' expectations, the content of parties' "implicit contracts" might be difficult to determine. Professor Macey's article explains why persons and organizations within the web of a firm's contractual relationships, as well as "outsiders," might find explicit-contract-based solutions most appropriate.¹⁶⁷ The article specifically condemns public-law solutions—like plant-closing laws requiring advance notice to rank-and-file workers—that operate indis-

162. *Id.* at 171.

163. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173.

164. *Id.* at 188-89.

165. *Id.* at 179-80.

166. *Id.* at 180.

167. *Id.* at 182-88, 199-200.

criminally and might actually inflict injury on their intended beneficiaries.¹⁶⁸

In the United States, the institutional context of fundamental corporate change includes significant federal regulation of securities transactions. An important example is the regulation of tender offers through the Williams Act.¹⁶⁹ One might think of federal regulation in this area as furnishing background rules that limit tactics that parties might otherwise deploy in control transactions for publicly held companies. In *The Rise and Fall of Street Sweep Takeovers*, Professor Dale A. Oesterle deals with the short-lived but provocative phenomenon of street sweeps,¹⁷⁰ large-scale acquisition efforts mounted on national stock exchanges or through privately negotiated transactions. Buyers can acquire shares quickly through a street sweep, avoiding the publicity and delay that accompany a general offer to buy out shareholders. Professor Oesterle's article evaluates and rejects the claim that street sweeps are inherently exploitive; the article even explains how investors might be best served by regulation that revitalizes rather than inhibits street sweeps.¹⁷¹ Professor Oesterle points out that the SEC has given the operative term in the Williams Act, "tender offer," a broad and imprecise interpretation, thereby chilling some types of street sweeps.¹⁷² In addition, the combined effects of state takeover legislation and poison pills have proved even more effective deterrents to street sweeps.¹⁷³ The article evaluates and critiques a variety of current proposals for regulation of sweeps, noting that the phenomenon to be regulated has itself nearly died out. Professor Oesterle argues that street sweeps are potentially less coercive to shareholders than tender offers; he explains, however, that when a potential offeror accomplishes a sweep, shareholders must bargain at an informational disadvantage.¹⁷⁴ Accordingly, he suggests that state statutory regulations and poison pills that affect sweeps can best be justified as devices that compel a prospective bidder to disclose its intentions and bargain with target shareholders as a group.¹⁷⁵

Financially speaking, we have sailed to Byzantium.¹⁷⁶ Startling

168. *Id.* at 191-97.

169. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982 & Supp. IV 1986).

170. Oesterle, *The Rise and Fall of Street Sweep Takeovers*, 1989 DUKE L.J. 202.

171. *Id.* at 245-57.

172. *Id.* at 216-33.

173. *Id.* at 233-41.

174. *Id.* at 243-44.

175. *Id.* at 244-45.

176. Yeats, to be sure, was writing in an entirely different context, see W. YEATS, *Sailing to Byzantium*, in COLLECTED POEMS OF W.B. YEATS 217 (2d ed. 1952), but the first line of the poem ("[t]hat is no country for old men," *id.*) seems highly descriptive of today's fast-track corporate finance.

changes in financial practices have occurred in a relatively short period of time, and the consequences of those changes are not confined to the denizens of financial institutions. In particular, the availability of large amounts of debt financing, on terms attractive to present or prospective corporate managers, has resulted in a dramatic restructuring of many major firms. In many respects, the law's response to these developments has a tentative quality. It is yet to be seen whether a financial Byzantium will prove stable and desirable in the long run.