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Roundtable Discussion: Corporate Governance

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Moderator

William J. Carney, Charles Howard Candler Professor of Law,
Emory University School of Law

Participants

Jack B. Jacobs, Vice Chancellor,
Delaware Court of Chancery

Richard Painter, Professor of Law,
University of Illinois College of Law

Robert Pritzker, President and Chief Executive Officer,
The Marmon Group, Inc.

Robert H. Sitkoff, Assistant Professor of Law,
Northwestern Unversity School of Law

ROUNDTABLE DISCUSSION: CORPORATE GOVERNANCE

Chicago-Kent College of Law
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JACK B. JACOBS, Vice Chancellor, Delaware Court of Chancery

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SMITH V. VAN GORKOM

WILLIAM CARNEY: We have a unique opportunity today, having Mr. Robert Pritzker here with us. He was a participant in one of the most famous cases in corporate law,[1] one that Dan Fischel has described as one of the worst decisions in the history of corporate law,[2] and I've quoted him with approval on that particular judgment.[3] But whatever you think of the quality of the judgment, the case is a

1. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). Voluminous work has been written about *Van Gorkom*. For an overview of scholarship concerning the case, see Symposium, *Van Gorkom and the Corporate Board: Problem, Solution, or Placebo?*, 96 NW. U. L. REV. 447 (2002).

2. Daniel R. Fischel, *The Business Judgement Rule and the* Trans Union *Case*, 40 BUS. LAW. 1437, 1455 (1985) (calling Van Gorkom "one of the worst decisions in the history of corporate law").

3. William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 GEO. WASH. L. REV. 898, 924 n.137 (1993).

very important one. It seemed to be fact intensive, in the sense that the Delaware Supreme Court seemed to pay a great deal of attention to the factual background of what Mr. Van Gorkom did and what the directors did. And Mr. Pritzker is in a position to provide us with some additional information that might be useful for the historical record about the development of that case. And I guess the first question is, exactly how did the $55 number come about, that wound up as the purchase price in this case?

ROBERT PRITZKER: It was a number that was selected by Jerry Van Gorkom. And as I understand it—and I wasn't there when they made the decision what price they wanted—it was on the advice of their internal people. Mr. Romans[, Chief Financial Officer of Trans Union,] and some others had wanted to have a management buyout. And I think he came up with a price somewhat similar to that. And then the Boston Consulting Group had made a study—it was something with Carpenter, I can't think of his first name, he later went with GE Capital—and he had been evaluating Trans Union for some time—four months, something like that. And he had a lot of input. The reason I say that is our due diligence was limited to one week, and it was limited to three officers of Trans Union: Van Gorkom, who was chairman and CEO, Chelberg, who was president, and Peterson, who was vice president and controller. We could speak to the three of them and we could speak to Carpenter from Boston Consulting Group, and that's all. It's a challenge to do due diligence on a big spread out corporation in one week with that array. So we did the best we could.

WILLIAM CARNEY: One week seems like an awfully short time in which to negotiate and to sell a company, and the supreme court was critical of that timetable.[4] Who initiated that timetable?

ROBERT PRITZKER: Van Gorkom, but I think he had a good reason. I don't agree with the supreme court on that point, either. His general logic was this: he was generating tax credits faster than he could use them, by a lot. So, he could buy a company that had use for tax credits, he could sell it to a company that had use for tax credits, or merge. His feeling was that he wouldn't get more than $55 per share in any event, and he didn't want his company kicked around and auctioned. So, I think the stock was selling—ultimately it was $37, I believe—

4. *Van Gorkom*, 488 A.2d at 875.

WILLIAM CARNEY: I think $37 or $38 was the range that the court referred to.[5]

ROBERT PRITZKER: Yes, one or the other. It had been selling below that, so the premium was pretty great. And, of course, the proof in the pudding that he was right was later, as you know. It was put out to bid in an auction and Salomon Brothers had a $5 million commission riding on it. And in four months they couldn't top the bid. So, apparently $55 was the right price to charge us. Now, from our point of view it didn't look like such a slam dunk. We had a huge loan against it, and for the first couple of years I thought we may have made a mistake. But ultimately it's worked out fine.

WILLIAM CARNEY: The court was critical of the lockup arrangement that your family had. I believe it turned out to be a million shares of stock at $38. The supreme court seemed to suggest that that might have been a deal killer. Was that your view of why they didn't come up with any other offers?

ROBERT PRITZKER: I don't quite see why it would be a deal killer, but I don't think that's the reason. I know this: there was a management buyout attempt, and it failed because the management got in a fight with each other. I can't think of his name—Jack Kruzenga from Union Tank Car—he's a very difficult individual—and he apparently reneged on the whole thing and they couldn't do it without him.[6] So that took care of the management buyout. Jack Welch from General Electric looked at it.[7] And it would be a natural for them, just a perfect fit. But for various reasons he turned it down. So you've got some pretty sophisticated people who looked at it. They had lots of people who took a look, but those two were almost deals. But I think history has proved that it was a good price.

WILLIAM CARNEY: The other question that has, I think, fascinated many people is the settlement of this case,[8] which, I believe, was for $23 million, and there was, I think, $10 million worth of directors' and officers' liability insurance, and your family contributed $11 million—

ROBERT PRITZKER: Thirteen.

5. *Id.* at 866 n.5 (stating that the high and low range for the common stock of Trans Union for 1980 through September 19 was $38¼–$29½).

6. For the Delaware Supreme Court's discussion of Mr. Kruzenga's involvement, see *Van Gorkom*, 488 A.2d at 897 n.1.

7. Jack Welch served as Chairman and CEO of General Electric from 1981–2001.

8. *See generally* Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom after* Van Gorkum, 41 BUS. LAW. 1 (1985).

WILLIAM CARNEY: Thirteen? Did you contribute the entire $13 million to the settlement?

ROBERT PRITZKER: Yes.

WILLIAM CARNEY: Could you tell us what motivated you to make that kind of a contribution?

ROBERT PRITZKER: Well, we didn't think the directors had done anything wrong. They were a very knowledgeable group; as I recall, four of them were CEOs of conglomerates that had been put together by buying companies. They surely knew what they were doing. There was an academic, Allen Wallis, who had been, I think, head of one of the business schools, either the U of C or Rochester.

WILLIAM CARNEY: Chicago?

ROBERT PRITZKER: Yes, Chicago. And then he ended up the president or provost or whatever of Rochester University. He was quite knowledgeable about this. And there was another director who was in the hospital during this entire transaction. In fact, I'm not sure I've ever met him, but he knew nothing about it. Now, let's start with him. For him to pay $1.3 million which he didn't have would have bankrupted him. It just didn't seem quite appropriate. One of the directors had passed away and his widow was the one who was supposed to come up with the $1.3 million. It just didn't seem fair. As a matter of fact, I think it was $13-and-a-half million, as I recall now. So we felt that we were the beneficiaries of the whole event. The directors didn't do anything wrong, why should they bear the responsibility? They had nothing to gain and everything to lose. Our feeling was that morally we owed it to them. So, our deal was we would pay 90 percent of that $1.35 million for each one, and they would pay 10 percent to charity. We felt they ought to have something, but not so gross a number. And, incidentally, Van Gorkom paid three or four of their charity contributions. He was about as high class as you could be. He asked for nothing, he didn't want any final settlement or bonus. He made one request of us, and that was that we give him some office space for the Chicago Public School Finance Authority. A very decent guy—stubborn as hell—but very honorable.

WILLIAM CARNEY: A question that has come up in that context is whether the directors had any rights to indemnification from Trans Union Corporation that would have passed over to you. You don't think that that was the case?

ROBERT PRITZKER: I know of none.

WILLIAM CARNEY: Okay. Anybody on the panel have any questions? This is our chance to get the last word on this case.

RICHARD PAINTER: It seems to me the court focused in most of its opinion on the procedural due care that went into the transaction on the part of the Trans Union directors, rather than the fairness of the price. Were there aspects of the procedure in the negotiations that in retrospect perhaps could have been handled in a way that would have provided more legal cover? The short time between when the board was notified and when the contract had to be signed was an issue the court was concerned about;[9] it was only a matter of forty-eight hours.[10] Indeed, I think the contract was signed at the Lyric Opera Ball.[11]

ROBERT PRITZKER: You know, my memory is not so hot because I wasn't there. I hate the opera. (Symphony is a different story, and swing bands altogether different.) The story that I've read was that that was where they happen to have finished the deal. I thought it's where it started. But Jay and Jerry Van Gorkom knew each other from skiing in Vail, and had skied together a lot. And we were kind of a natural because we could finance it. So he could ask us the question and get an answer.

A week is too short. Van Gorkom had some ghosts in his closet that bothered him. Personally, I'd have given more time, but not for the reason that the supreme court said. I thought he wasn't fair to his management, who felt that they had created a lot of this wealth, to just pull the rug out from under them with two hours' notice. And they rebelled. They all wrote the same letter, but the reason for some of them was that they wanted a management buyout, and for some they were offended that they weren't brought into the discussion. And I can sympathize with them. In fact, a lot of them have become my very good friends. One continued to work for us until he was about seventy-six, and then I got sore at him because he retired (semi)! Terrific guy. But it wouldn't have made any difference. And, a week is a short time, but some of these deals drag out for months and months and months—it'd be better if they were a week. There

9. *See Van Gorkom*, 488 A.2d at 875.

10. *See id.* at 867, 869 (stating that on September 19, 1980, Jay Pritzker insisted the Trans Union Board act on his merger proposal within three days; the contract was signed on September 20).

11. *See id.* at 869 (stating that Van Gorkom executed the merger agreement "during the evening of September 20 at a formal social event that he hosted for the opening of the Chicago Lyric Opera").

are operating reasons why faster is better. So, I have kind of mixed feelings. I hated it because the due diligence was so tough, and particularly not being able to meet the people. We didn't know whether we had a bunch of bums or some really good folks.

RICHARD PAINTER: The business concerns are different from the legal. Ultimately the transaction from your end was driven by business concerns. Obviously, from the legal perspective, taking all the time in the world—dotting your i's, crossing your t's, and so forth—usually gives you more legal protection, like getting a fairness opinion from Salomon Brothers on the deal or something like that.

ROBERT PRITZKER: Well, you know, I'm kind of a lawyer by genetics because my dad, my granddad, my uncles, my brothers, my nieces and nephews are all lawyers. And I'm an engineer. My dad and I used to have big discussions. He said, "Bob, you ought to go to law school because it teaches you how to think." And I said, "I think engineering school makes a stab at it occasionally." And then whenever there'd be some wacky case, and there sure have been, I'd turn to him and say, "Is this the logic that I was supposed to learn in law school and missed?" He became a believer, and he wound up mad at the legal system. But, sure, I think as an operating person; sometimes it's hard for us to figure out how the law is achieving what its goal is.

JACK JACOBS: Mr. Pritzker, at the time that decision came down in 1985, I was just another member of the Delaware Bar, and, as such, an outside observer of those events. All I know about the case is what I read in the supreme court opinion, which reversed the chancellor, who had found no liability on the part of the Trans Union board.[12] A key point that the supreme court made was that Mr. Van Gorkom had not obtained any valuation of the company.[13] All that had been developed, at least as far as the record showed, was a study by Trans Union's CFO of the price at which it would be feasible to acquire the company in a leveraged buyout.[14] That study was the basis for how the $55 price was arrived at.[15] My question to you is whether, in fact, a valuation of the company was ever made?

12. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), *rev'g sub nom.* Smith v. Pritzker, Del. Ch. C. A. No. 6342 (July 6, 1982) (Marvel, C.).

13. *Van Gorkom*, 488 A.2d at 876–77.

14. *Id.* at 877.

15. *Id.*

ROBERT PRITZKER: As I understand it, the Boston Consulting Group tried to make an evaluation.

JACK JACOBS: Was that before or after the deal was signed up, if you know?

ROBERT PRITZKER: Before. Considerably before.

JACK JACOBS: And was there a number that was arrived at?

ROBERT PRITZKER: It was told to me that it was $55 a share. Now, we went through individual pieces of it because I was interested and willing to pay $55. I was at the other end of the telescope. I wasn't privy to what they had told Van Gorkom.

JACK JACOBS: But as far as you remember, that was a valuation that had been made before the merger agreement was signed?

ROBERT PRITZKER: Well, I know that they had been working for four months on it. And since we only heard about it a week before I assume that—but I'm assuming something I don't know as a fact.

ROBERT SITKOFF: I don't think anyone wants me to say where I was or what I was doing when the opinion came out. Instead I'll just say that, like the Vice Chancellor, my knowledge of the case comes from reading the opinion, and the majority opinion rests on the premise that the one-week timeline came from your family, not from Van Gorkom.[16] According to the opinion, the $55 price, as the Vice Chancellor just suggested, was the result of splitting the difference between a pair of back-of-the-envelope feasibility studies.[17] The Boston Consulting Group analysis that you just mentioned was not discussed in Justice Horsey's opinion in the context that you just gave it, and so my guess is that it might not have been presented to the court in that way. So what you are telling us is that the statement of the facts in the opinion is wrong about both the source of the one-week deadline and the origin of the $55 price. Now, both of those facts were critical to the court's decision. So, my question is, do you have a view about the performance of the lawyers? What happened in the litigation that these facts, which might have changed the outcome, didn't come out?

ROBERT PRITZKER: Well, a couple of things: A week's notice was not our idea. It was their idea completely. Can you imagine how frustrated I was trying to evaluate something where you have one week, and you're only privy to three people? And these are hard

16. *Id.* at 875 (stating that Pritzker imposed the "urgent time constraints").

17. *Id.* at 865–66.

assets—a lot of them were, and some of it was pretty complicated. I wanted more than a week. A year I didn't need. Even maybe a month I didn't need. But a week? Although, with as little information as we had, a week was probably enough. The other part of your question was . . .?

ROBERT SITKOFF: Whether you had a comment about the management of the litigation or the performance of the lawyers since the source of the one-week timeline and the fact of the Boston Consulting Group valuation didn't make it into the majority opinion. You just said a few moments ago that there was a four-month study by Van Gorkom's people. But that didn't make it into the opinion either, at least not in the context that you just gave it.

ROBERT PRITZKER: You're asking me to give an opinion on whether a lawyer is a good lawyer or a bad lawyer. I know the other side had a good lawyer! Whether our side had a good lawyer I really don't know because I didn't handle that part of it.

JACK JACOBS: Could I ask one more question? One of the fascinating aspects of the opinion for those of us who are involved in corporate governance issues is that Mr. Van Gorkom did not tell his board or his senior management what he was doing during the time that he was negotiating with Jay Pritzker. The proposed deal was presented to the board essentially as a fait accompli, and that created the senior management rebellion that you were referring to. You might not know the answer to this question, but I'll ask it anyway: Why did he proceed in that manner? Was that his style? Was that the way public companies were run during that era? Or, is there some other explanation?

ROBERT PRITZKER: No, I think it would be contrary to the way they were run, is my impression. I think his feeling was he had these choices that I mentioned before. He felt that it would not be economic to buy something that could use the tax credits, so he really had to sell the company. And if he was going to sell the company, he reasoned he had several ways to sell it: one was the way he did sell it; one would be to have an open auction—hire Salomon Brothers to auction it or hire whatever he wanted. I think he felt that these were more destructive to the company than picking the price that he thought it would sell for in the end anyway, which, apparently, it turned out he was right. In retrospect, he was right. At the time it didn't seem that way.

JACK JACOBS: But he did not consult his board or his senior management before doing any of this, and my question is: Why?

ROBERT PRITZKER: I wouldn't have done it that way, if you're asking me.

WILLIAM CARNEY: You know, I seem to recall that Justice McNeilly's dissent alludes to some long-term studies that had been done by the Boston Consulting Group.[18] It seems to me there was some allusion to the fact that the board had rather carefully looked at its options, not in the week preceding the approval of this transaction but there had been sort of an ongoing conversation about what they could do. And perhaps Mr. Van Gorkom felt at that time that the message was fairly clear from his board implicitly if not explicitly. I guess we'll never know the answer to that, but at least I think there's that possibility that comes out of some of the things that the dissenting opinion says.

PUBLIC AND PRIVATE BOARDS OF DIRECTORS

WILLIAM CARNEY: I'd like to move on. Mr. Pritzker has the advantage of having sat on the boards of both public and private corporations, and has seen how boards work in both contexts. There's long been a debate about what the boards of public corporations do, and what kind of time horizons they have, and whether or not they're actually focused on maximizing the long-term value of the company for shareholders, and criticism that maybe they are myopic in responding to stock price movements. And perhaps you can give us your general impressions about what role stock prices and markets play in altering the behavior of directors of public companies versus directors of private companies. Is there a difference?

ROBERT PRITZKER: My observation is that there is a difference. Neither system is very good. But, you know, it's like democracy: it's a terrible system; it's just the best one we can think of. I think that's true of our legal system, too. But the trouble with the public companies is, I think, obvious. One is that they're so short-term.

18. Justice McNeilly's dissent discusses "a comprehensive study of Trans Union made by The Boston Consulting Group" that Van Gorkom presented to the Trans Union board in August 1980. According to Justice McNeilly, the study was "prepared over an 18 month period and consisted of a detailed analysis of all Trans Union subsidiaries, including competitiveness, profitability, cash throw-off, cash consumption, technical competence and future prospects for contribution to Trans Union's combined net income." *Id.* at 895 (McNeilly, J., dissenting).

You are dealing with a quarter at a time, and everybody focuses on the stock price and not the value of the company, which may or may not be the same. Why something should have three times the multiple of a company similar to it I've never understood. Sometimes it's in the name. It's got the right word in it: "dot-com" at the right moment meant everything. And you can find a lot of examples of that. I think public companies are driven by what the security analysts say. Security analysts are not interested in long-term activities, and that distorts the governance. That's one thing.

Secondly, there's a social problem on the board—and now I'm getting into the public company problem; I can give you the private company problem later. It seemed to me Roger Smith should have been allowed to leave General Motors about ten years before he was sort of sidelined.[19] You didn't have to be much of an expert to know that he didn't know what he was doing. At least that was my opinion. And yet it took a monumental revolution to do anything because generally the CEO is the one that appoints the board, and it's kind of impolite in American society to chip away at the existing management, and tough to do—tough to know enough to do it. And who are the board members? There are a few token something-or-others who have a difficult time leading a group, and then there are businessmen like the chairman, and they are less apt to do it. So, there's no system that we've got to coalesce around somebody else. And just socially—sociologists could have fun with this, as to how boards actually operate. Am I expressing . . . ?

WILLIAM CARNEY: I think you are. What you're saying is perfectly consistent, I think, with the famous book Myles Mace wrote around 1970 about the dynamics of boards of directors, that strong CEOs dominated the selection process and set the agenda for meetings, and that by and large these groups were so collegial there was almost never any challenge, at least in the board meetings.[20] If there were any challenge, it occurred outside the board meeting. As a result, Mace didn't think that boards exercised much independence.[21] And I think his work was somewhat at the base of a lot of the reforms that were attempted in the 1970s: requirements by stock exchanges that there be more outside directors on boards, and that they man

19. Roger Smith was CEO of General Motors from 1981–1990.
20. MYLES L. MACE, DIRECTORS: MYTH AND REALITY 69 (1971).
21. *Id.*

particular committees of the board—compensation committees and audit committees.

ROBERT PRITZKER: Let me give you an example: Compensation committees. I was on the board of a reasonably large public company, and at one point I was chairman of the compensation committee. And this was a regulated utility, but they also had a large piece that was unregulated. I thought the management was excellent. I would've hired them and probably paid them more than they were being paid. So, I had no particular complaint. They would have McKinsey & Company make a survey of like jobs and present it to us each year. And I finally went to the chairman one year, and I said, "Listen, it's wonderful that you give us what McKinsey has to say, but you tell them what to look for. You're the one paying their fee. This is not what I would call an 'independent analysis.' Why don't you give my committee the money and let us go out and hire somebody to do it, and give them the specifications." I said, "To be honest with you, I think you can get a raise in pay as a result, but it just seems to me fairer to the rate payers and to the shareholders if you did it that way." And he actually agreed with me. But when we put up to the board, it was turned down. And why? Because a lot of these guys were themselves CEOs, and they didn't think this was such a cool idea.

Now, private companies have a different problem, and that's the interplay of families. You've got siblings, one is CEO and one isn't. The one that isn't isn't happy. He may be more competent and he may be less competent. He may be incompetent. But he still wants what he wants, and the dynamics of families are very complicated.

JACK JACOBS: If I may, I would like to footnote a comment that [William Carney] made, and also ask a question for the panel. I think we have come a long way since the 1970 study that you referred to. It is true that we started in the '50s and '60s with the strong-CEO–passive-board model. But after *Van Gorkom*, we have observed significant changes from that model at this point for a variety of reasons. One of those reasons, in my opinion, is the Van Gorkom decision itself, which in the view of some is more of a symbol than a substantive change-agent. A second reason for the emergence of a more "proactive" board governance model can be attributed to the corporate governance reforms that have been referred to, including the recommendation to create audit committees and other types of formal structures. Third, and I think most important, is the activist institutional investor movement. All of these have been forces in the direction of creating more independent, proactive, boards. Despite that, however, boards and managements have, as you said, a very short-term emphasis on current stock price that, in turn, is causing a short-term emphasis on the way many public companies are being governed, and a corresponding de-emphasis on long-term planning. Many have argued this de-emphasis on long-term planning is not good for the economy. My question is, is there any way to reverse that practice, other than by overhauling the compensation structure of senior managements in public companies by making that structure less dependent on stock market price performance?

WILLIAM CARNEY: I'll jump in on that one. I make this comment in my law school class from time to time: I say that business schools did a terrible job of educating their students about the role of markets and stock market pricing and market efficiency for a very long time. Thus, it seems that all too few senior executives believe that market prices are really sending very important signals or that markets are very well informed. And I say that in the context of a lot of criticism that there's probably insufficient R&D [(research and development)] because R&D doesn't drop immediately to the bottom line, and you take a stock price hit. Except the empirical studies say otherwise: the empirical studies say that R&D does get valued to the extent that we can make any kind of an informed prediction that it will create value. There are studies out there that say, "Yes, the markets do appreciate a long-term perspective and they appropriately discount to present value the entire expected stream of future earnings."[22] There are, of course, information asymmetries from time to time, but there's no reason to believe they're systematic. And, therefore, I've always wondered about business executives. I'll give you another example: purchase versus pooling accounting.[23] In a rational world, purchase accounting lowers taxes (it also happens to lower stated earnings but it raises cash flows) where pooling accounting raises stated earnings and raises taxes. And yet for a very long time corporate executives have desperately sought pooling

22. Su Han Chan et al., *Corporate Research and Development Expenditures and Share Value*, 26 J. FIN. ECON. 255 (1990); John J. McConnell & Chris J. Muscarella, *Corporate Capital Expenditure Decisions and the Market Value of the Firm*, 14 J. FIN. ECON. 399 (1985); *see also* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 144–45 (1992).

23. For a discussion of accounting principles, including "purchase" and "pooling" forms of accounting, see Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics*, 22 DEL. J. CORP. L. 141 (1997).

accounting. Claire Hill has written about this in the past,[24] and very thoughtfully. But it seems to me that there is some evidence here of a terrible market failure in the market for managers who don't get it: taxes are bad, cash flow is good. How can this be?

ROBERT PRITZKER: Because stock prices are so important.

ROBERT SITKOFF: There was a related debate a few years ago regarding the accounting treatment of option-based executive compensation.[25] Putting to one side transaction costs—the costs of having analysts decipher idiosyncratic forms of reporting—the form in which these compensation packages are reported shouldn't matter in an efficient market. Anyway, Bill's earlier point raises a very important question: Why do we believe that a focus on the short-term stock price deflects us from seeking long-term value? Why can't the market discount to present value the benefit of investment in the future and adjust the current market price accordingly? Why is it if you announce, "We have a sound long-term strategy that in ten years will generate huge returns," why can't the market accurately discount that? Or more to the point, why do managers believe that the market can't process this long-term data so that they feel a need to focus on short-term gains at the expense of what might be a more profitable long-term investment?

JACK JACOBS: Do you have an answer for that?

ROBERT SITKOFF: Well, I'm just starting.

RICHARD PAINTER: Let's ask Mr. Pritzker. How confident do you feel in the ability of the markets to value companies as long-term investments?

ROBERT PRITZKER: Well, I'm not surprised to find that the stocks on the NASDAQ are worth half as much now, or less than half, as they were a year-and-a-half ago. Maybe they are. They are worth less because people won't pay as much for it and the market is right in that sense. But I can't believe that the fundamental company is that different.

There are a couple of problems with public companies in general—the accounting, for example. The SEC correctly says, "We want this stuff to be comparable." A person goes to his broker and evaluates one company compared to another, he can choose anything he wants, and he chooses what he thinks is going to be the best return.

24. *See id.*

25. For a general overview of this debate, see Calvin H. Johnson, *Accounting and Taxation: Accounting in Favor of Investors*, 19 CARDOZO L. REV. 637, 643–49 (1997).

So, the SEC pushes the FASB [(Financial Accounting Standards Board)] to have everything the same. And my analogy is, it would be like the NCAA having one set of rules for all sports. I mean, the accounting for a financial institution is very different from that of a foundry. But they use the same chart of accounts, basically. In our company, we must have a hundred charts of accounts, and we wouldn't consolidate a full P&L [(profit and loss)] statement. The sales you can consolidate and the profits you can consolidate. Everything else in the middle doesn't mean anything. To add the cost of goods sold of a pharmaceutical product to the cost of goods sold of a foundry product, I don't know what you'd get, but it isn't a very good pill.

RICHARD PAINTER: So, in the end the markets are quite inefficient, I gather. You're suggesting that is in part because the information given to the markets is difficult to understand and perhaps incongruent with the reality of how these businesses are run.

ROBERT PRITZKER: Well, also, you've given such a gigantic incentive to the management to be optimistic. You know, what period should you take to write off goodwill? Now I guess they're not going to write it off at all. We do it in five years; you could say ours is too fast. It's very subjective.

RICHARD PAINTER: Do you think stock options given to management increase that incentive?

ROBERT PRITZKER: No. But, interesting—I've been waiting for this to happen and it did yesterday or today. One of the unions made a big fuss about the pay of some of these senior executives. And when you see somebody who's fired because he did such a lousy job and he picks up $10 million in severance pay and stock options it makes the working stiff a little upset, and I don't understand it either.

JACK JACOBS: But isn't that part of the problem with our system for executive recruitment? I mean, I have been told that unless you can promise executives who are being asked to come on board that they will receive exactly this kind of protection, you will have difficulty recruiting them. Yet, if those executives do a lousy job they still wind up receiving a $2 million severance package.

ROBERT PRITZKER: Yes, that's true. But the way these numbers came about was that many, many years ago [someone] with the HayGroup came up with this idea of, we'll make a survey and we'll give our guy 5 percent more than the survey. And then the other person surveys it and now you've got 5 percent more, and it works like magic. There's no question that the quality of the CEO has an enormous impact on the company. But it's also the staff. In the end, the people are everything.

ISSUES ARISING OUT OF THE *CAREMARK* DECISION

WILLIAM CARNEY: Let me move on a bit. It seems to me that there's some indication the job of being a director of a public company has grown more difficult in recent years, that the responsibilities of directors to monitor and supervise the operations of the firm seem to have risen. The *Caremark* decision in the Delaware court,[26] in what I *think* is just dicta, suggests a duty to monitor for law violations, at least in some contexts.[27] And the notion of monitoring duties has been batted around for the last twenty-five years, and I think has attained increasing acceptance. My sense is that directors are sitting on fewer boards today than they did a few years ago because of the higher expectations on directors. And I'm curious about what do you think motivates people to sit on boards of public companies, given the fact that the burdens seem to be increasing and the liabilities, at least in some cases, have increased.

ROBERT PRITZKER: Speaking for myself, I won't do it.

WILLIAM CARNEY: Well, what about "those other people"?

ROBERT PRITZKER: Well, several things: One is the pay of directors has grown dramatically. You can make a lot of money being on a board. Secondly, there's a certain amount of prestige. Third, if you have the time there's a certain amount of fun, depending on the company. I always thought I'd want to be on an airline's board, but I'm not sure now. But you get to see things and do things that you wouldn't otherwise. And networking. I guess those would be the reasons.

WILLIAM CARNEY: Any questions?

ROBERT SITKOFF: I would like to ask a question that resonates with a comment that Bill made earlier. Do you have a view on reputational constraints on members of the board? Just a moment ago we were talking about the structural bias thesis—the idea that members of the board are going to be biased towards management decisions because they were probably picked by the CEO and are often executives in other corporations themselves. Yet today we say

26. *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).
27. *Id.*

that we need independent compensation committees and we need special litigation committees to decide whether to allow derivative litigation to proceed. One of the justifications for deferring to these "independent" subcommittees, such as the special litigation committee, is that the selection of and the decisions made by the members of those committees are checked by reputational constraints. If you have a reputation for always rubber-stamping compensation patterns or for always short-circuiting derivative litigation, then maybe that will make you less likely to be chosen for board membership in the first place because of the signal that your nomination would send to the market. So, my question is, when you say people agree to board membership for the glory or the money or the networking opportunities, do you think that there is a legitimate reputational check operating in the background?

ROBERT PRITZKER: Well, it's very hard. My family is the owner of our company. And I'm very serious about complying with laws and being proper, and I have a hell of a time keeping up with it. We have said over and over and over to our people, "You can't pay off, you can't sell to places that we're not supposed to sell to." Every year when they get a raise (or every decade—we try to keep costs low!) I make them sign a statement that they haven't done that. Now, with all of that, every couple of years I uncover one—you know, "How did that one get by us?" And, well, the FBI can't manage to keep straight their people, and we're not the FBI. But you know, we really are careful about adhering to both the law and what we think is proper behavior. But from time to time I find our people misbehaving.

RICHARD PAINTER: Let me ask you a question about what you expect from your lawyers if you are the director of a corporation. With the *Caremark* decision, even though much of it is dicta, there's certainly the fear of liability on the part of directors for not having detected illegal activity. If you are a director of a corporation, do you expect the lawyers for the company, if they know of illegal acts that they've reported to management, and if management won't do anything about it, to make a report to the board, including the independent directors, of what's going on?

ROBERT PRITZKER: I don't know how you really achieve it. I mean, yes, you can say, "I want a report," and be sure that's in the record and so on. You can leave a trail. Unless all the board members are attorneys they're not going to be too sensitive to some of this stuff. And asking management to do it is tough. Say, for instance, you're buying shoes in China and you say you don't want any child labor. How do you know if there's child labor there? How do you know about the guy who sells you the shoelaces? Who checks him? And how you check him? There are some practical aspects. I'm for the idea, but I'm not sure how you do it.

RICHARD PAINTER: Let's say outside counsel of the company learned there was a violation of the Foreign Corrupt Practices Act in connection with that branch in China. Would you expect them to tell the board that if they were unable to persuade management to correct the violation?

ROBERT PRITZKER: I would expect them to, but I also would be surprised if they do. I don't know if that's a fair answer.

WILLIAM CARNEY: Let me push the lawyer question a little further because you're among us.

ROBERT PRITZKER: Yes, that's what I'm nervous about!

WILLIAM CARNEY: At board meetings, do you expect to have counsel present and playing an active role in advising the board about legal issues and pointing out pitfalls?

ROBERT PRITZKER: Yes. But I also know that attorneys have a problem. You have a client—who is your client in this case?

WILLIAM CARNEY: I know the legal answer to that. The legal answer is the corporation. Many people say as a practical matter it's the CEO.

ROBERT PRITZKER: As a practical matter it is. And what is the corporation?

WILLIAM CARNEY: Well, presumably the board is the highest authority within the corporation, and thus the board represents the corporation for all these purposes.

ROBERT PRITZKER: Yes. Well, realistically, I think most in-house counsels or outside counsels feel that the management is their client, partly for practical reasons—well, for all practical reasons. Some of it's the economics of the thing, and some of it's just the practical aspect. You talk to the CEO all the time; you don't talk to the directors. You know the CEO understands the problem, and you're not sure whether the director does.

RICHARD PAINTER: But is that, perhaps, something that should be rectified? In other words, perhaps boards could try to communicate more often with counsel, ask for reports from counsel, have more lawyers in board meetings, and make it clear to counsel what they expect in terms of information?

ROBERT PRITZKER: Yes, but if you run the company on a totally legal basis you won't make your product.

JACK JACOBS: I was about to observe that the problems we have been talking about during the last ten minutes really may loosely be described as outgrowths of the *Caremark* issue. That is, to what extent does our legal system impose a duty on directors of public companies to assure that the company is in compliance with all applicable laws that pertain to the company's business? The *Caremark* case is really the first Delaware decision that we've had on that issue since the *Allis-Chalmers* case,[28] which was decided in the 1960s.

There are really two layers of difficulty, putting aside for the moment the fact that the Delaware Supreme Court has not yet spoken on this issue. One, which Mr. Pritzker alluded to, is how, in the real world, do we craft a system that can give the board any guarantee that the company's lower level employees are not violating the antitrust laws, the environmental laws, the Foreign Corrupt Practices Act, and whatever other laws to which their company may be subject, and which if violated could expose the company to significant liability? We don't have a good answer for that, except to say that the problem may be more a management issue than a lawyer's issue. That is, the lawyer's task is to guide the management in attempting—and here I am using the words of the opinion—in "good faith" to put into place a system designed to assure that the board receives the necessary flow of information.[29] The actual design and implementation, however, is for the managers. The reason I express it in those words is that, as we all are aware, there is no practical way that boards of public companies can micromanage at the grassroots level what all of the divisions of the company are or are not doing in terms of legal compliance. That is not the way our system works. The only practical alternative is a reporting system, created by the managers, that operates so that the relevant information flows up to the board level. That presents one set of issues with which as of yet we have little experience. Perhaps some guidance will come from academics like Professor [John] Coates [at Harvard Law School], who will do empirical studies on that issue and educate us about whether these information systems are effective.

28. Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963).

29. *Caremark*, 698 A.2d at 968–70.

A more serious level of issue that is potentially implicated is what happens if management at the most senior level is involved in law breaking? Then you have not just a *Caremark* problem but also a host of other problems affecting both inside and outside counsel. In this context, how, realistically, do we expect inside counsel, who may have a legal and ethical obligation to report such wrongdoing to the board, to do so where "doing the right thing" may cost them their careers? Here again, I think we need to find a way to develop practical solutions.

ROBERT SITKOFF: I would add that there is a related question about federalism in corporate law lurking in the background. It is unclear whether this duty to monitor is an independent, freestanding duty or if instead it is an outgrowth of the duty of care. Because much of the regulatory overlay with which corporate compliance regimes must deal is federal, and because the federal sentencing guidelines sometimes treat the existence of compliance systems as a mitigating factor, this could, in effect, represent a federal imposition of content to the duty of care. This imposition may be a good thing, or it may not. My point is that it takes the issue out of the competition between the states.[30]

JACK JACOBS: Just one response to that. I don't disagree with any of what you said except that at the state level it is not even clear that the duty to monitor is an outgrowth of the duty of care. If the "good faith" language in the *Caremark* opinion is taken seriously, then one could as easily argue that the monitoring duty is an outgrowth of the duty of loyalty. That is one of the issues that needs to be clarified in a future case.

WILLIAM CARNEY: In that context, back in the 1970s in the post-Watergate era, Arthur Goldberg proposed that a special committee, a monitoring committee of the board, should be set up that had its own staff and its own ability to investigate and to serve as an employee hotline.[31] That proposal essentially went nowhere. And after passage of the Foreign Corrupt Practices Act,[32] the SEC began a rulemaking

30. For seminal works on the question of federalism and corporate law, see William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U. L. Rev. 913 (1982); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

31. Arthur J. Goldberg, *Debate on Outside Directors*, N.Y. TIMES, Oct. 29, 1972, § 3, at 1.

32. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified as

proceeding to promulgate some rules about how one could appropriately monitor for illegal foreign payments. And that came up as a dry hole.[33] They were unable to come up with any scheme that would describe an appropriate monitoring system. And I think that probably gets at the real difficulty of this area: describing a system that would work.

ROBERT PRITZKER: Could I answer a question nobody asked?

WILLIAM CARNEY: Yes sir.

ROBERT PRITZKER: One thing bewilders me. Take taxes as an example. We go back to about 1976, I think—not 1776, but 1976—in our open tax years. That's because the IRS wants to waive the statute of limitations which you're forced to give. (I know it's voluntary, but try not giving it.) My guess is, if you took all the states that we're dealing with—and a lot of their taxes are dependent on the IRS—and all the years we're talking about, you'd fill more than half of this room with paper if you just took the code, the cases that are important, and the regulations. And that's just taxes. Now let's move on to people, which is much worse. You'd fill up the entire room. And we have factories that have thirty people in them for maintenance kinds of things. Who can keep track of all this stuff? The labor ones are probably the worst. And how do you define something like harassment? It's very subjective. Or even diversity—it's not easy to define some of these categories. My wife is Eurasian; she never knows what to put down. Somehow or other you can't just keep making rules and solutions to problems with rules. It's got to be a legitimate defense that you just didn't know about it. You folks are all attorneys—I'll bet you I can dig up plenty of questions you can't answer by regulations. Now consider somebody who is basically a machinist: how is that person going to do it?

amended at 15 U.S.C. §§ 78dd-1, 78dd-2 (2001)).

33. *See* Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. ILL. L. REV. 691, 716 n.119 (observing that "[i]n 1979, the SEC proposed that management disclose its opinion of whether internal accounting controls provide reasonable assurance that specified objectives were met, and describe any material weaknesses of such controls that independent accountants communicated to management"; citing the Securities Exchange Act Release No. 15,772, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,063 (April 30, 1979)). The SEC forewent that approach, however, and instead determined on a case-by-case ex post basis how much monitoring was insufficient. *Id.* (citing Securities Exchange Act Release No. 16,877, 557, Sec. Reg. & L. Rep. (BNA) No. 34, at H-1 (June 11, 1980). *See also* William J. Carney, *Section 4.01 of the American Law Institute Corporate Governance Project: Restate or Misstate?*, 66 WASH. U. L.Q. 239, 262 (1988).

MORE ON VAN GORKOM

QUESTIONER ONE: I'd like to push a little harder on the *Trans Union* case. I know where I was when the transaction happened; I was working in the tax department of a law firm. And, if I remember correctly, at that point in time the tax credits that you alluded to were actually quite precarious politically, and the potential value of them hinged on a lot of things like how public they became, and how many people in Washington found out about them and how quickly, and the scope of the magnitude of the transactions using the credits. Now, if my memory is right, can you help me with whether or not they really were a big part of the value and whether they really were precarious? And if that's right, what happened that if you read the Delaware Supreme Court's opinion you have absolutely no sense that has anything to do with what the transaction was about? What happened? Was it not there? Did the lawyers not argue it? Did the lawyers argue it and the court ignored it?

ROBERT PRITZKER: I have no idea what the court thought. But we did use the tax credits and saved money with it.

QUESTIONER ONE: Oh, I forgot the years are still open, so maybe you can't talk about it.

ROBERT PRITZKER: No, I think on that they're closed. But years are open from before then. You're absolutely right. It could have been. But I believe that's been settled.

RICHARD PAINTER: It appeared to me from the Delaware Supreme Court's opinion that it was a tax-driven transaction, that the tax credits were really only worth something if Trans Union merged with another company that had some taxes to pay to use the credits against.[34]

ROBERT SITKOFF: Although, if the tax credits were precarious because they were vulnerable to congressional action, that would be a good reason for Van Gorkom to want a one-week window. It also might explain the absence of this point from the opinion, since arguing it would give the tax credits public attention. The opinion, as I said earlier, suggested that the time frame came from the Pritzker family.

ROBERT PRITZKER: And that wasn't the case.

34. Smith v. Van Gorkom, 488 A.2d 858, 864–65 (Del. 1985).

ROBERT SITKOFF: This is something that, to my knowledge, has not been explored.

RICHARD PAINTER: Well, the opinion said that Van Gorkom was going to Washington to lobby—or somebody, I think it was Van Gorkom—was going to Washington to lobby for a bill that would allow Trans Union to use tax credits anyway even though it didn't owe any tax and that that proposal was unsuccessful.[35]

ROBERT PRITZKER: I believe that's true, but that's sort of hearsay.

ROBERT SITKOFF: If the credits were precarious, then you can imagine why no one would want a bidding war. A bidding war might alert everyone to the existence of the credits, something you'd want to avoid if they were politically precarious.

QUESTIONER ONE: Well, people knew that there were tax benefits involved, but they might not have known how big they could be in the right hands. I can't remember what the time span was, but he might well have thought that more time would have jeopardized the tax benefits.

QUESTIONER TWO: I've got a question. I was of counsel to the Texas law firm that represented Alden Smith,[36] although it was shortly after all this happened. And one of the lores of the case was that the court was inclined to take it more seriously because Alden Smith was actually a very substantial shareholder. He wasn't one of these people—I shouldn't name any names, but I know a few of them—who own one hundred or two hundred shares. He had a lot of shares, and apparently he was quite annoyed with the deal. I've never met him, and I'm curious what kind of person he was. I don't know if you ever met him.

ROBERT PRITZKER: Well, you know what Smith's problem was? His basis for his shares was very low. He had merged a company into Trans Union and had gotten many shares. That's how he got them. And the basis apparently was very low, and in our transaction we triggered the tax. That wasn't our intention, but that's the way it panned out. So, he had a legitimate reason for doing it. I don't cast aspersions—he's a nice guy.

QUESTIONER TWO: That was mostly what I wanted to know.

35. *Id.*

36. Alden Smith was a Trans Union shareholder and named plaintiff in the class action suit brought against the Trans Union Board of Directors in *Smith v. Van Gorkom*. 488 A.2d at 864.

CORPORATE CHARITABLE CONTRIBUTIONS

WILLIAM CARNEY: I have one more question on the public directors issue. This is really two issues that sort of converge on corporate contributions: one is corporate contributions to charities, and the other is corporate political contributions.[37] Warren Buffett's remarks come to mind, that he had a friend who was a fundraiser who raised funds from corporations for some charity.[38] He would go in and he would raise a lot of money from CEOs using stockholders' money, but never did he see a CEO reach in his pocket for his own checkbook and write a check for ten dollars.[39] Somehow, it's much easier to spend money when it's not your own and to be some kind of a local hero. Is that consistent with your view of what happens in public companies? Or, is charitable giving constrained in any way by boards?

ROBERT PRITZKER: I sort of feel your first comment. If the contribution has some value to the company, I can see it. But if it's just a straightforward charitable contribution, it seems to me that the shareholder can make his own decision. He doesn't need the corporation to do it for him. If that's a charity he wants to give to, he can do it.

WILLIAM CARNEY: Do you observe that kind of giving in corporations where you've sat on their boards?

ROBERT PRITZKER: Well, the one that was a public utility had some argument. But the question there was not only the shareholder, but the rate payer—should that be a deduction when he calculates his taxes? It's a very tricky question. I'm not sure how I felt about that because there was an argument from a business point of view that you should spend it. There's charity that has business value and there's charity that's honest-to-God charity.

37. For a discussion of corporate charitable contributions, see Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL L. REV. 1195 (1999). For a discussion of corporate political contributions, see Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. (forthcoming summer 2002).

38. *Hostile Takeovers and Junk Bond Financing: A Panel Discussion*, *in* KNIGHTS, RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 14 (John C. Coffee et al. eds., 1988) (remarks by Warren Buffett).

39. *Id.*

RICHARD PAINTER: How about political contributions? With this dispute over whether unions ought to be taking their members' money—

ROBERT PRITZKER: I was going to say, if everybody will "1-2-3 stop!" I'm for it.

RICHARD PAINTER: But do you really see value for the corporation? I guess there is value from these political contributions, but then the unions are just dumping in money on the other side. So I guess it's a wash.

ROBERT PRITZKER: But is it a wash?

RULES VERSUS STANDARDS

QUESTIONER THREE: Mr. Pritzker, you rightly point out that laws can fill rooms when the lawyers try to write down everything, every possible rule, and try to get very detailed. The tax code is very detailed, lots of regulations. On the other hand, when you don't do that you get cases like *Van Gorkom*. And I would offer the following suggestion: the *Van Gorkom* case is a bad case, maybe, evaluated on its own merits. But you're going to get bad cases from time to time when you don't have a very detailed set of rules and regulations to tell courts how to come out on a given set of facts. You're going to get lawyers manipulating, doing a good job. You're going get management who is unhappy with what their CEO did and maybe spin the facts a little bit in a way that they might not otherwise do. I mean, it's all about choice: you've got the choice between going forward with rules to follow or occasional cases that just are crazy. What's your preference?

ROBERT PRITZKER: Yes. I haven't thought about it as much in case law as I have in regulation, because we have thousands of people that we spend a fortune paying every day to write regulations that I think on average are not worth doing. There's no way; you can't win. The FDA drives you crazy. I've dealt with them. And yet, if you said to me, "Would you not have an FDA?" I'd have an FDA. A crazier example is the EPA. I started an Environmental Engineering Department at IIT [(Illinois Institute of Technology)] in 1965, before there was an EPA, before there was an Earth Day. I was very active in antipollution. So, I feel I have the credits. But the EPA is crazy. Most of the money goes to the legal profession (I shouldn't say that in here), and to testers and writers of reports. Most of it is not used for cleanup, and about half the cleanup we do is silly. So, I think you need to have a cost-benefit analysis. I don't think the government needs to be more efficient, they just need fewer things to do. I would eliminate departments. And that's true: there will be bad things that happen. You're not going to have a perfect system, whatever it is. But the economics are so lopsided that you could go so far as bankrupting the economy and starving people. There must be a better way to use that money.

ROBERT SITKOFF: This is not a question about corporate governance in particular. This is a more general question about the nature of legal regulation, of rules versus standards, right?

QUESTIONER THREE: That's right.

ROBERT SITKOFF: Sure, rules are over- and underinclusive but they have lower administrative costs. Standards are more contextual but that means they'll have higher decision costs. An important factor in choosing rules or standards is how much you trust the decision maker. No sensible person thinks rules are always better than standards or standards are always better than rules. The problem is figuring out which is better when, which way the analysis tips in a given context.

RICHARD PAINTER: You know, that carries over in a lot of areas of law. In the securities area, I cannot go on about how awful I think the case law is under Section 10b, Rule 10b5, which I really put under the standards end of the spectrum. And yet how many cases do you see under Section 5 of the '33 Act[40] over whether someone should have filed a registration statement or not? I mean, there the SEC rules are quite detailed, and yet people complain ad nauseam about the '33 Act and the rules thereunder and the cost of hiring lawyers to comply with them. But perhaps that may be more efficient and less expensive than hiring lawyers to litigate over these questions after the fact.

WILLIAM CARNEY: It's always more efficient to hire transactional lawyers than litigators.

RICHARD PAINTER: Having been a transactional lawyer, I think I tend to agree with that.

ROBERT PRITZKER: You know, it was always surprising to me (again, I am saying this as a non-attorney). We had a transaction that we made before Trans Union, called Cerro Corporation, and it was a very complex transaction because of the tax aims that we had. We

40. Securities Act of 1933, 15 U.S.C. § 77e (2001).

sent out an S-14 registration form. It was 180 pages, and it was really esoteric law and accounting. I think our auditor was one of the best accountants I've ever heard of and he spent three months fussing around with it himself personally. It was terribly complex. We mailed it out on a Monday morning at nine o'clock, and by ten o'clock there were five lawsuits. Now, either they were very rapid readers and very good at interpreting or they had those complaints made out before they ever saw the thing.

RICHARD PAINTER: I think the latter is the case. I know it. They had the complaints ready to go.

ROBERT PRITZKER: Well, sure they did.

JACK JACOBS: Well, as a former litigator I feel compelled to make one response to Professor Carney, and that is that while it may be the case that transactional lawyers add more value, if we killed all the litigators we would have to reinvent them very quickly.

ROBERT PRITZKER: I'd like to try, though!

THE BUSINESS JUDGMENT RULE

WILLIAM CARNEY: Let's turn, if I may, from corporate management questions to questions of corporate law. And since we have Vice Chancellor Jacobs with us here it's a chance to at least discuss some topics of fairly broad interest in Delaware law. Vice Chancellor Jacobs has raised the question of whether Delaware has developed multiple standards of care for directors in making business judgments. *Aronson v. Lewis*, on the one hand, says the standard of review is gross negligence.[41] Of course, every lawyer knows that the difference between ordinary negligence and gross is simply the addition of one word to that phrase; it doesn't really inform us much about the real standards of review. But on the other hand, we've got cases like *Smith v. Van Gorkom* and *Cede v. Technicolor*[42] where the court in arm's-length business transactions has engaged in a much closer review of board action and concluded that in these cases the boards have been deficient in their information processing function, and that

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

42. *See* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 368 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994) (stating that "a director's duty of care requires a director to take an active and direct role in the . . . sale of a company from beginning to end," and "directors individually and the board collectively . . . [must] inform themselves fully and in a deliberate manner before voting as a board upon a transaction as significant as a proposed merger or sale of the company"); *see also Van Gorkom*, 488 A.2d at 858.

we've really got two standards. And I guess the broader question is whether or not this creates confusion, perhaps for Vice Chancellors, but also for lawyers advising clients and for corporate executives in making decisions, and what implications does it have for those decisions?

JACK JACOBS: That is really a corporate lawyers' and judges' problem, so I guess Mr. Pritzker is off the hook. (He is free, nonetheless, to chime in any time he likes.) Earlier today we heard from a number of very distinguished panelists, including Professor Letsou, who spoke about the rationale for the business judgment rule.[43] This question ties directly into that issue. We have an articulated standard of review, which is gross negligence. That is what the courts say that a plaintiff must show before a board will be held liable for money damages, assuming that there is no exculpatory clause in the corporation's charter. But one of the problems with the *Van Gorkom* and *Cede v. Technicolor* decisions is that the court seems to be articulating one liability standard but in fact applying another. That is, one can read those opinions as in fact applying an ordinary negligence, rather than a gross negligence, standard. If that is correct, then you confront the business judgment rule issues that Professor Letsou was talking about directly[44] and Professor Frankel indirectly.[45] If boards can be held liable in damages for making a decision that was reasonable at the time but that turned out to be wrong—which as a matter of probability will happen in a certain number of cases—then you will make boards of directors risk averse. That is, you will create disincentives for directors to take the kinds of entrepreneurial risks that we want to encourage boards to take. I come down on the side of avoiding risk aversion as a primary policy that the business judgment standard is designed to further. And for that reason, I contend, it is dysfunctional to have a disconnect in cases that say that directors will not be held liable unless the plaintiff demonstrates a very high threshold of bad conduct, that is, gross negligence, while at the same time in fact applying a lower standard, that is, ordinary negligence. That is the concern.

RICHARD PAINTER: Also, when you apply negligence standards to questions of fact, you often find what the law and psychology

43. *See* Peter V. Letsou, *Implications of Shareholder Diversification on Corporate Law and Organization: The Case of the Business Judgment Rule*, 77 CHI.-KENT L. REV. 179 (2001).

44. *Id.*

45. Tamar Frankel, *Of Theory and Practice*, 77 CHI.-KENT L. REV. 5 (2001).

scholars refer to as hindsight bias: looking at unfortunate events that occurred in the past and overestimating the likelihood that they would have occurred beforehand. The fact finder thus says, "You should have known that this was going to happen," finding, in effect, that the actors'—the managers' and directors'—conduct was not up to the standard of care when indeed it was. This hindsight bias that is imposed on the fact finder's interpretation of facts thus compounds whatever problems there are with the legal standard to begin with.

JACK JACOBS: Right. Or, to put it in maybe more plain terms: There's a difference between a reasonable board decision that turned out to be wrong and an unreasonable board decision. Professor Frankel referred to the doctor who did a wonderful job in the operation but the patient died and the lawyer who did a superb job but lost the case.[46] Well, in many cases directors can do a superb job in making a business decision and it just turns out to be on the wrong side; it's a risk, and part of the risk is that it will not work out and that often happens. If you have an ordinary negligence standard, you run the institutional risk that the court can too easily confuse a good decision that turned out badly with a decision that was bad to begin with, i.e., negligent. And so that is one of the reasons why we have an articulated standard of review or liability that is gross negligence rather than negligence.

WILLIAM CARNEY: Is it a valid distinction to note that the two cases that we've talked about are cases charging that the board didn't have enough information to make an informed judgment, which is different from making a mistaken judgment?

JACK JACOBS: Well, both cases arose in the context of the sale of the company. In both cases the court spoke of the duty and responsibilities of the target company board, in terms of seeing to it that the shareholders' interests are properly protected when the company is being sold. In *Cede v. Technicolor*, the supreme court emphasized the need for vigilance, using language that suggests an affirmative duty to be highly proactive.[47] I have no quarrel with that approach; it is laudable. My point, however, is that the *Cede* language does not describe a standard of gross negligence. Rather, it sounds more like a standard of ordinary negligence. Obviously, that is a matter of interpretation, but I think that *Cede* exemplifies the disconnect I have referred to, which creates confusion and also

46. *Id.* at 19–20.
47. *Cede*, 634 A.2d at 368.

concern on the part of board counselors who are called upon to give advice, based on these decisions, about what is the true standard of liability.

WILLIAM CARNEY: One effect of a decision like *Trans Union*, I think, was that it was really the "Investment Bankers Civil Relief Act of 1985." Nobody's going to do a transaction without a fairness opinion any more, and fairness opinions can be cranked out virtually overnight if necessary. The year following Trans Union I was involved in a matter where the officers got a call from their investment bankers on Thursday saying, "Come from Atlanta to New York on Friday. We've got some folks who are interested in making you an offer." They made a jaw-dropping offer. It was sixty-two times trailing earnings. These folks wouldn't have had the temerity to ask for that price. Once it was offered, the only thing they wanted to say was "yes." How quickly can they say "yes"? Well, they called the board meeting for Sunday afternoon. Salomon was capable of putting together a full fairness opinion booklet with all the tabs and all the information to hopefully delude a judge into believing that this was an informed decision. And it was presented to the board, and the board was sitting there and saying, "When can we vote 'yes'?" They had no questions of Salomon, so the man from Salomon simply asked himself some questions to make the record. He said, "I suppose you're asking, would my opinion be the same if I had more time." He said, "Yes it would." So, now we've cleared up that part of the record about whether this is too rushed. I mean, this man was a good lawyer for an investment banker. He had read the *Trans Union* opinion; he'd been fully advised. And so now we've got people who skillfully know how to paper the record to provide cover for the directors.

RICHARD PAINTER: *Weinberger v. UOP*?[48]

ROBERT SITKOFF: Wasn't it in the *Weinberger* case where the investment banking opinion was written out—completely prepared—and only the price was left blank to be filled in later on?

RICHARD PAINTER: Yes, the Lehman Brothers guy was up on the ski slopes in Vermont. He flew out to Iowa with the price blank. He must have thought about it on the ski slopes and returned for his half—I believe it was half-a-million dollars compensation.

WILLIAM CARNEY: No, I think he had his young associates back in the office all weekend cranking out the numbers. I mean,

48. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

somebody's doing that job. But is the *Trans Union* and *Cede* rule more than that? Or, does it just require everybody to hire an investment banker and give a fairness opinion?

JACK JACOBS: As Golda Meir once said, I don't respond to questions phrased that way.

WILLIAM CARNEY: It was a rhetorical question.

JACK JACOBS: I know. Interestingly enough, in *Van Gorkom*, the supreme court expressly said they were not holding that a fairness opinion is required in every merger transaction.[49] But as Professor Carney and others have pointed out, the corporate bar seems to have ignored, or chosen not to believe, the supreme court's disclaimer. Perhaps because of the culture and/or financial incentives that drive many law firms and investment banks, the practice has been to obtain a fairness opinion. And this is the case despite the post–*Van Gorkom* case law, which has made it clear that there is more than one way that boards can demonstrate that they have sufficient knowledge of the value of the company to make an informed decision. A fairness opinion is only one of those ways. For better or worse, the inertia of the custom of obtaining an investment bank fairness opinion has carried more weight than the language of the opinions that recognize and allow other options.

RICHARD PAINTER: But when you're up against unpredictable legal standards plus hindsight bias, aren't you better off with it than without it if you get sued?

JACK JACOBS: Are you better off with it than without it? I suppose that depends on your comfort level. You know, there are cases where a good investment banker's fairness opinion has carried a lot of weight, and there are cases where it hasn't. If you have an interested transaction where the board's process was weak, was defective to begin with, and that raises all the red flags in the court's mind, even a good fairness opinion is not going to carry the weight that a good process will. I think the answer is: it depends.

RICHARD PAINTER: *Weinberger v. UOP* might be one of those cases.

WILLIAM CARNEY: I want to ask if anybody in the audience has any more questions? We could go on forever, but I think there's a reception waiting out there and I want to thank you all for your patience. Thank you, panel.

49. Smith v. Van Gorkom, 488 A.2d 858, 876 (Del. 1985).