

SMITH v. VAN GORKOM: INSIGHTS ABOUT C.E.O.s, CORPORATE LAW RULES, AND THE JURISDICTIONAL COMPETITION FOR CORPORATE CHARTERS

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INTRODUCTION

After fifteen years, *Smith v. Van Gorkom* remains intellectually frustrating. The annoyance stems from the fact that, while the decision may have dramatically improved the quality of deliberations in corporate boardrooms, the imposition of liability on the defendants in the case seems profoundly unjust.

When *Smith v. Van Gorkom* was decided, the mergers and acquisitions ("M&A") industry was in its infancy. The Trans Union board made its decision in 1980. At that time, when making a decision about a control transaction, industry practice called for directors to evaluate three things:

premium to market, price to book, and price/earnings ratio. That was the guts of what was done, and all the firms created the database from scratch. There weren't EBITDA multiples or detailed DCF analysis. There were occasionally some industry comparables . . . but M&A valuation was rather unsophisticated by current standards.¹

By today's standards, the board's procedures seem woefully inadequate. There was no modern third-party valuation analysis of any kind. No investment bankers were hired. The analysis that was done by management was not thorough. The board did not read the merger agreement, much less discuss and deliberate its contents in any detail.²

But although the board's decision was not cloaked in the same elabo-

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¹ *Roundtable: The Legacy of Smith v. Van Gorkom*, 24 DIRECTORS & BOARDS 28, 29 (2000) (comment by investment executive Stephen Waters). The term EBITDA is an acronym for the accounting number that expresses a company's "earnings before interest, taxes, depreciation and amortization." See <http://interactive.wsj.com/documents/glossary.htm>. The term DCF stands for "discounted cash flow."

² *Roundtable: The Legacy of Smith v. Van Gorkom*, *supra* note 1, at 28.

rate procedural framework that has become the norm in modern boardrooms when directors are considering actions that involve organic changes to the corporate structure, this alone does not mean it was a bad decision from the economic perspective of the shareholders,³ or even that it was legally inadequate.⁴ On the directors' side of the ledger, of course, is the fact that the board of directors was acting in good faith, and in a manner it thought was in the best interests of the firm's shareholders.

The board's decision was not tainted by even a hint of self-dealing or conflict of interest. There has never been a serious argument that *Smith v. Van Gorkom* was a duty of loyalty case in disguise. These directors were not inept, lazy, or corrupt. In addition, the board of Trans Union consisted of a group of men with a vast wealth of experience. The five inside directors had been with the company an average of 23.2 years each, and had an average of 13.6 years of experience as corporate directors.⁵ The outside directors included Alan Wallis, the highly respected dean of the University of Chicago Business School, and four chief executive officers of Chicago-based companies. These distinguished directors brought their expertise and experience to bear on the decision about whether to approve the merger. For the Delaware Supreme Court to fail to respect their decision seems fundamentally inconsistent with the basic principles of the business judgment rule. This inconsistency, combined with the harsh tone of the decision and the debilitating threat of financial ruin from the personal liability to which the directors were exposed, are what make the decision such a profoundly frustrating intellectual challenge for corporate law scholars.

This Article explores three under-analyzed aspects of the decision. First, it examines the relationship between Jerome Van Gorkom, the Trans Union CEO, and the rest of the Trans Union board. Part I argues that a particularly odd aspect of the case is the way the entire board was punished for Mr. Van Gorkom's failure to follow adequate procedures and inform the board fully about certain critical aspects of the transaction.

Part II explains that the case is less frustrating once we realize that Delaware law, like corporate law generally, provides a set of one-size-fits-all, "cookie cutter" rules that apply to all corporations. This means the same set of rules that apply to honest upstanding boards like Trans Union also must be made to work for the small but troubling set of corporations with pathological boards whose directors are inept, lazy, corrupt, or some combination of the three.

Part III discusses *Smith v. Van Gorkom* in the context of the jurisdictional competition for corporate charters. Here I argue that far from hurting

³ See Fred S. McChesney, *A Bird in the Hand and Liability in the Bush: Why Van Gorkom Still Rankles, Probably*, 96 NW. U. L. REV. 631 (2002).

⁴ Leo Herzel & Leo Katz, *Smith v. Van Gorkom: The Business of Judging Business Judgment*, 41 BUS. LAW. 1187 (1986).

⁵ *Smith v. Van Gorkom*, 488 A.2d 858, 894 (Del. 1985) (McNeilly, J., dissenting).

Delaware in the intense competition for the chartering business of major corporations, the decision likely helped Delaware because it provided direct, tangible, and sustainable benefits to the lawyers and investment bankers who advise corporations on business-chartering decisions.

Part IV concludes, reconciling these observations by showing that they all support the interest group theory of the legal rules that govern the behavior of Delaware chartered corporations. Delaware has market power in the jurisdictional competition for corporate charters because it enjoys a “first-mover” advantage in this competition. This market power provides the opportunity for Delaware to charge more to businesses incorporating there than would be possible in an environment of perfect competition. These fees, however, do not go only, or even primarily, into the state’s coffers. Rather, Delaware’s market power manifests itself in the form of legal rules that increase the demand for the services of law firms and investment bankers by firms incorporated in Delaware. In turn, these groups help keep Delaware in its dominant position in the jurisdictional competition for charters by continuing to recommend that companies incorporate there.

I. THE REAL CULPRIT?

One aspect of the *Smith v. Van Gorkom* case that has gone unexplored is the curious relationship between Jerome W. Van Gorkom, Trans Union’s chairman and chief executive officer, and the rest of the Trans Union board. This Part advances the hypothesis that a more plausible justification for the court’s decision was the board’s inappropriate reliance on Van Gorkom’s judgment and negotiating. From this point of view, the board’s failure was not, as is generally supposed, entirely a failure of process. Rather, the board’s failures were: (a) that it did not seem to realize that Van Gorkom was not a representative shareholder; (b) that it delegated too much power to Van Gorkom in his negotiations with the acquirer; and (c) that it did not properly monitor Van Gorkom’s negotiations with the acquirer.

From this perspective, the board perhaps deserves some blame, but the lion’s share of the blame for any harm imposed on shareholders by the Trans Union–Pritzker merger falls on the shoulders of Van Gorkom, rather than the Trans Union board.

A. *Van Gorkom’s Interest in Selling*

Jerome Van Gorkom owned a substantial block of stock in his company, and was “made a multimillionaire when his Trans Union stock holdings were cashed out at the merger.”⁶ In addition, the Delaware Supreme Court found it “noteworthy” that Van Gorkom was “approaching 65 years of age and mandatory retirement” at the time of the challenged transaction.⁷

⁶ William M. Owen, *A CEO Named Van Gorkom*, 24 *DIRECTORS & BOARDS* 35, 35 (2000).

⁷ *Van Gorkom*, 488 A.2d at 866.

Presumably, this was “noteworthy” because Van Gorkom may have had an interest in liquidating his shares.

By contrast, many, if not most, Trans Union shareholders were in a much different position. Trans Union had been in an acquisition mode for some time prior to its acquisition by the Pritzker group. Specifically, the company had made at least 42 acquisitions, ranging in size from \$36,000 to \$24 million.⁸ These transactions, unlike the transaction challenged in *Smith v. Van Gorkom*, generally were structured in the form of stock exchanges, in which Trans Union offered its own stock to the shareholders of the target firm in exchange for their shares. These exchange transactions were not taxable events from the standpoint of the target firm shareholders. Fully one-third of Trans Union’s shareholders had acquired their Trans Union shares in this way: 4.3 million shares of Trans Union’s 12.5 million outstanding shares had been distributed in the context of acquisition exchanges.⁹

Thus, many Trans Union shareholders, including B. Alden Smith, the named plaintiff in the case, were Trans Union shareholders by virtue of their first being shareholders in firms that Trans Union acquired. These shareholders had paid low prices for the stock of the small companies that were subsequently acquired by Trans Union. This meant, of course, that their tax basis at the time of the deal between Trans Union and Pritzker was very low. The transaction with Pritzker would result in substantial and unavoidable tax liability for these shareholders. Mr. Smith was bitterly opposed to the merger for that reason.

Despite Van Gorkom’s considerable equity stake in the company,¹⁰ then, his interest in hurriedly consummating an all-cash transaction with Pritzker was not representative of the interests of other shareholders. As a consequence, the board should have been unwilling to grant Van Gorkom’s view about the advisability of the merger as much respect as it otherwise might. This point is underscored by the fact that Donald Romans, Trans Union’s chief financial officer, specifically had “suggested that consideration should be given to the adverse tax consequences of an all-cash deal for low-basis shareholders.”¹¹ There is no evidence that this suggestion was ever followed.

Strikingly, it appears that the most important aspect of the transaction, the price Trans Union shareholders were to receive, was determined not on the basis of what the company was worth, but rather, on the basis of the price that Van Gorkom wanted to receive for the shares he owned.¹² Be-

⁸ William M. Owen, *A Shareholder Named Smith*, 24 *DIRECTORS & BOARDS* 39, 39 (2000).

⁹ *Id.*

¹⁰ Mr. Van Gorkom owned 75,000 shares. *Van Gorkom*, 488 A.2d at 865.

¹¹ *Id.* at 867.

¹² At a meeting on September 5, 1980 with Senior Management of Trans Union at which the issue of a leveraged buy out of the company was discussed, there was no effort to determine the fair or appro-

cause Van Gorkom was not representative of the shareholding population as a whole, merely accepting the price he thought was adequate was inappropriate. Moreover, basic economic theory posits that supply curves slope up and demand curves slope down. The aggregated preferences of all purchasers and potential purchasers form the supply curve for a particular security, while the aggregated preferences of all sellers and potential sellers for a security combine to form the demand curve.¹³ Van Gorkom's private, subjective opinion about the price he would be willing to accept for his shares forms but one point on the supply curve for Trans Union's shares. Other shareholders, with different views about the company's prospects, different tax burdens, different patterns of consumption and investment reflecting different stages in the life cycle, and different needs, would necessarily have different views about the price at which the company should be sold. It made no sense to let Van Gorkom's views govern.

Another reason the board likely was wrong to grant deference to Mr. Van Gorkom's view was the unusually high degree of dissension within the Trans Union management group. Apparently, a number of Trans Union officers wanted to arrange a leveraged buyout by management as a means of transferring control of the company, but Van Gorkom rejected this out of hand. There were strong reasons to believe a leveraged buyout would have been an appropriate mechanism for recapitalizing Trans Union and for effectuating a value-enhancing change of control. But again, Van Gorkom's private views controlled: he simply decided he didn't want to sell the company to management, regardless of whether the management group valued the company more highly than other potential purchasers. Perhaps this was because Van Gorkom was philosophically opposed to management buyouts.¹⁴ Perhaps Van Gorkom objected because he was to have been left out of the management group that would have been bidding for the company.¹⁵

Trans Union generated a significant amount of stable cash flow.¹⁶ This made the company an ideal candidate for a leveraged buyout because the steady cash flow would enable the company to support the debt service payments associated with its post buy out, highly leveraged capital structure. It is not clear why Van Gorkom was so adamantly opposed to the idea of a leveraged buyout. At one point, Van Gorkom claimed he opposed a leveraged buy out for Trans Union because such a transaction would in-

appropriate level for the firm's stock. But when various prices were discussed, Van Gorkom stated that "he would be willing to take \$55 per share for his 75,000 shares." *Van Gorkom*, 488 A.2d at 865.

¹³ See PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 48-64 (14th ed. 1992).

¹⁴ *Van Gorkom*, 488 A.2d at 865 (noting that Van Gorkom opposed management buy out as "involving a potential conflict of interest for management").

¹⁵ WILLIAM M. OWEN, *AUTOPSY OF A MERGER* 142 (1986) ("The list [of Trans Union managers who would be invited to participate in the leveraged buyout] did not contain the names of either Van Gorkom or [Bruce S.] Chelberg [President of Trans Union]. Neither Van Gorkom nor Chelberg had been asked to participate. There would be no role for them in the new company.").

¹⁶ *Id.* at 24.

volve a conflict of interest.¹⁷ But this seems implausible in this situation because nobody on the Trans Union board, including Van Gorkom, was to be a participant in the buyout.

Leveraged buyouts by management can involve conflicts of interest. On the one hand, since management has organized the purchasing group, management has an incentive to buy the company at the lowest possible price. On the other hand, management owes fiduciary duties to shareholders to obtain the highest possible prices for their shares in any control transaction. A management group interested in a leveraged buy out might not pursue other bidders, and even might be tempted actively to discourage them. Management also might try to get the board and the shareholders to accept a "low ball" offer for the firm.

There are ways of mitigating these conflicts of interest to protect the shareholders. In particular, an independent board of directors can intercede to negotiate against management on behalf of the shareholders. Similarly, the board can retain a disinterested and unaffiliated person to negotiate on behalf of the public shareholders. Moreover, the usual conflict between management and shareholders inherent in leveraged buy outs did not really exist in the case of Trans Union because, as mentioned above, Van Gorkom was nearing retirement and would not be participating in any buy out of the company. Consequently, his interests were not compromised by his status as an officer.

Moreover, the real conflict of interest appears to have manifested itself in Van Gorkom's behavior, rather than in the behavior of the management who might have participated in a leveraged buyout. It appears that Romans's proposal to do a leveraged buy out was what put "the idea of being acquired on the table" and prompted Van Gorkom "to test the waters" to determine whether the company should be sold.¹⁸ Although it was "widely assumed" that Pritzker sought out Trans Union as a target, in fact, the opposite was true. Van Gorkom not only initiated merger discussions with Pritzker, but he did so without informing any of his senior management.¹⁹

The best analysis of Van Gorkom's motives for pursuing a sale of the company to Pritzker was that

[b]ecause Mr. Van Gorkom . . . is approaching retirement, insiders suspect he would rather sell out than . . . take on the challenge of restructuring the company or prematurely turning the gavel over to somebody else. That leads insiders to speculate that Mr. Van Gorkom acted impulsively and without consulting either his managers or his outside advisers. Trans Union's executive suite continues to be rocked by dissent, with most of the management

¹⁷ *Van Gorkom*, 488 A.2d at 865.

¹⁸ OWEN, *supra* note 15, at 39.

¹⁹ *Id.* at 80.

team alienated from Mr. Van Gorkom.²⁰

In other words, it appears as though Mr. Van Gorkom acted autocratically and self-interestedly in the way he approached this transaction. He also appears to have provided limited opportunities for his fellow directors and managers to become involved either in negotiating the transaction or in discussing its merits.

B. Van Gorkom's Attempt to Wrest Control of Trans Union from the Board

An elemental principle of Delaware corporate law is that the business and affairs of the corporation are to be run by or under the direction of the board of directors.²¹ Van Gorkom ignored this fundamental tenet of corporate law by unilaterally negotiating the sale of Trans Union without the involvement of his board.

The negotiation of a merger represents the soft underbelly of American corporate governance. On the one hand, it seems logical that negotiations should be transparent to prevent management from negotiating such onerous terms that the transaction falls through. On the other hand, the transaction must remain confidential to protect its integrity. If news of the transaction leaks out, the bidder is subject to exploitation by free-riding rival bidders. Even in the absence of such rival bidders, leaks of information about the pendency of the bid inevitably will cause the target firm's share price to rise, thus reducing the desirability of the deal from the bidder's perspective.

This problem is not easy to resolve. The mere fact that the target firm board is aware of the negotiations with a potential acquirer is not sufficient to protect the integrity of the negotiating process. Target firm managers intent on undermining a transaction can do so in many subtle ways during the negotiations if they are not carefully monitored. These negotiations may never be disclosed because they will be deemed immaterial and, therefore, not subject to disclosure if there is no realistic chance that they would result in a change in control. Similarly, where the CEO is intent on selling the company to a particular bidder in a hurried fashion, it will often be difficult for the board to monitor the negotiations from afar to insure the company's interests are being protected.

But here it appears the board was entirely shut out. According to an insider's account, Van Gorkom signed the merger agreement on the evening of Saturday, September 30, 1980, during a black-tie party for the Chicago Lyric Opera hosted by Trans Union Corporation at its headquarters. The agreement was signed without the Trans Union board having read it:

As the festivities continued, Van Gorkom quietly stepped out. Garbed in his formal black suit with tails and a white bow tie, he dropped down to the

²⁰ Herbert Greenberg, *Behind the Turmoil at Trans Union*, CRAIN'S BUS. DAILY, Jan. 12, 1981, at 1.

²¹ DEL. CODE ANN. tit. 8, § 141(a) (2001).

floor below carrying a tray laden with drinks. There, a group of lawyers—the beneficiaries of his thoughtfulness—was working diligently putting the finishing touches on agreements that provided for a \$688 million merger of Trans Union with the Pritzker interests. It was a deal so cloaked in secrecy that, with two exceptions, none of the members of Trans Union’s top management or board of directors had any inkling of what was afoot until that very day.²²

In other words, Van Gorkom did not permit the Trans Union board to carry out its responsibility to monitor management’s negotiations with the acquiring firm because he did not inform them that such negotiations were being conducted. The opinion of the Delaware Supreme Court in *Smith v. Van Gorkom* does not make clear how the board could have fulfilled its fiduciary responsibilities in light of the fact that the CEO, Van Gorkom, presented it with a *fait accompli* in the form of a prepackaged, apparently fully negotiated, merger document.

To understand the board’s position, one must understand the sequence of events. On September 18, 1980, Van Gorkom met with Jay Pritzker and persuaded Pritzker to make an offer to purchase one hundred percent of Trans Union’s shares for fifty-five dollars per share. From there it appears that Pritzker dominated the negotiations. Pritzker “insisted that the Trans Union Board act on his merger proposal within the next three days, stating to Van Gorkom: ‘We have to have a decision by no later than Sunday (evening, September 21).’”²³ The board did not convene until noon on September 20, only one day before the expiration of Pritzker’s offer.²⁴

The time pressure on the board was tremendous. Adding to the pressure, the lawyer Van Gorkom had retained to advise Trans Union on the merger told the board members not only that no fairness opinion was required, but also that they “might be sued” if they failed to accept the offer.²⁵ Van Gorkom placed pressure on the board. He maneuvered the board into a position from which it was virtually impossible to exercise its fiduciary duty of care.

The court in *Smith v. Van Gorkom* grounded its decision on its finding that “Trans Union’s Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal on September 20.”²⁶ However, a better explanation is that the board was found liable because it put too much trust in the company’s CEO who was defending the merger, perhaps for personal reasons, and whose interests were not well aligned with those of the shareholders. At one point, the dissent recognizes this, observing that “[t]he majority has spoken and has effectively said that Trans Union’s Directors have been the victims of a

²² OWEN, *supra* note 15, at 2.

²³ *Smith v. Van Gorkom*, 488 A.2d 858, 867 (Del. 1985).

²⁴ *Id.*

²⁵ *Id.* at 868.

²⁶ *Id.* at 881.

'fast shuffle' by Van Gorkom and Pritzker."²⁷

This aspect of the case provides a highly relevant lesson for boards today because it suggests that the appropriate relationship between managers and boards of directors is more adversarial than most lawyers believe is appropriate. The Trans Union board suffered from allowing itself to develop a very cozy relationship with management. This is exactly the trap that appears to have snared the Enron Corporation board of directors. Like the Trans Union board, the Enron board was too trusting of management, particularly where management was acting self-interestedly.

Moreover, it appears that the Trans Union board was given erroneous information that tended to increase its inclination to accept the Pritzker bid. First, it appears the board was under the mistaken impression that the fifty-five dollars per share sales price for the company had initially been suggested to Van Gorkom by Pritzker, when in fact it was Van Gorkom who suggested the price.²⁸ Worse, it appears Van Gorkom failed to disclose, and may ultimately even have sabotaged, the only competing proposal for Trans Union. This proposal, procured through the efforts of senior management unhappy with the Pritzker offer (particularly Trans Union CFO Donald Romans), was submitted by the investment firm Kolberg, Kravis, Roberts & Co. ("KKR").²⁹ Henry Kravis and Donald Romans delivered by hand a formal written offer to purchase all of Trans Union's Assets for sixty dollars per share, although the offer was contingent on KKR's ability to procure a relatively modest amount of additional financing.³⁰ The KKR bid was superior in price to the Pritzker bid, but it had the drawback of including senior management—but not Van Gorkom—in the purchasing group.

The KKR offer was in the form of a letter addressed to the Trans Union board of directors. The letter requested that Kravis be allowed to make his offer in person at the board meeting scheduled for the afternoon of December 2, the same day the offer was delivered to Van Gorkom.³¹

Van Gorkom's reaction to this superior offer was "completely negative," even though the offer Van Gorkom negotiated with Pritzker had contained the same financing condition.³² Van Gorkom refused to announce publicly the KKR bid on the spurious grounds that the offer might "chill" any other offer.³³ This refusal was inconsistent and wrong. It was inconsistent with Van Gorkom's endorsement of a press release following the Pritz-

²⁷ *Id.* at 894.

²⁸ *Id.* at 868.

²⁹ *Id.* at 884.

³⁰ KKR had obtained all but \$130 million of the \$650 million in financing that would be required to complete the transaction, and stated that it was "confident" that commitments for the rest could be obtained in less than a month's time. *Id.*

³¹ *Id.*

³² *Id.*

³³ *Id.* at 885.

ker proposal, and it was wrong because such a press release would likely encourage, rather than discourage, competing offers. Van Gorkom himself recognized this.³⁴

Worse, it appears Van Gorkom may have worked to cause KKR to withdraw its offer prior to the board meeting at which it was to have been presented. KKR was known for making offers only with the encouragement of incumbent management,³⁵ and incumbent management participation was an integral part of its bid for Trans Union. After learning of the KKR bid, Van Gorkom conferred with Jack R. Kruiuzenga, the president of Trans Union's most important subsidiary, the Union Tank Car Group (described by the court as the "rail car leasing operation").³⁶ Kruiuzenga then made what the court described as a "sudden decision" to withdraw from the KKR purchasing group.³⁷ Later, as the dark clouds of litigation began to close around Van Gorkom, he denied responsibility for Kruiuzenga's decision to withdraw from what would have been a very challenging and lucrative position. But the undisputed fact is that Kruiuzenga's decision to withdraw from the KKR purchasing group caused Kravis to withdraw his offer. KKR's withdrawal

was in line with KKR's position that it does deals only on a friendly basis. In view of the reception that had been accorded the KKR offer and the split that now existed in Trans Union's management, it was clear that what had begun as a friendly deal had almost instantaneously been transformed into a rather acrimonious one. It also was clear that Van Gorkom was perturbed that Romans and [Sidney H.] Bonser [head of Trans Union's rail car leasing group] were part of the buyout proposal. Perhaps more importantly, Kruiuzenga, one of the company's most key employees, now had decided not to participate but instead to strongly oppose the deal. Under those circumstances, KKR did not wish to proceed.³⁸

Stunningly, Van Gorkom did not inform the Trans Union board about the KKR offer on the grounds that, by the time the meeting had convened, the offer had been withdrawn. This is an outrageous failure of disclosure on Van Gorkom's part because Kruiuzenga might well have joined the management group participating in KKR's bid if he had thought the bid had the board's approval.

Evidence from behavioral psychology indicates that the mere fact that KKR was prepared to make a superior competing bid, regardless of whether the Trans Union board was aware of the rival bid when it agreed to the

³⁴ *Id.* at 885 n.27 (noting that at the time of the press release announcing the Pritzker bid, "Van Gorkom had then justified a press release as encouraging rather than chilling later offers").

³⁵ OWEN, *supra* note 15, at 9 ("KKR considered management participation an essential ingredient of its buyout formula, providing tremendous motivation and impetus for a successful venture.").

³⁶ *Van Gorkom*, 488 A.2d at 885.

³⁷ *Id.*

³⁸ OWEN, *supra* note 15, at 149.

merger with Pritzker, might well lead to the conclusion that the bid accepted by management was inadequate. This is because the damages to the Trans Union shareholders from the acceptance of the Pritzker offer depended on whether there would be a subsequent superior bid for the company, and on the probability of such a subsequent bid actually occurring.³⁹ Observing that there actually was a superior bid for Trans Union, even if the bid was withdrawn, could have distorted the views of the judges about the abstract issue of whether it was likely that a genuine superior bid subsequently would have materialized if the Pritzker bid were turned down. Like other people, judges are susceptible to cognitive biases. For example, evidence from behavioral psychology indicates that one way that people's decision-making capabilities can be distorted relates to perceptions of risk.⁴⁰ People's perceptions of risk are influenced by their ability to recall examples of the risk being realized.⁴¹ Applying this basic insight to *Van Gorkom* is straightforward: the fact that there actually was a superior subsequent bid for Trans Union naturally would cause the judges evaluating the directors' decisions to overestimate the actual probability that such a bid would occur at the time the directors were making their decision.

Put another way, the perception of a risk of harm will increase if the harm actually occurs.⁴² From the perspective of the Delaware Supreme Court, the relevant risk, which was the risk of a subsequent superior bid, actually did occur. This, in turn, caused the judges to think the risk of this event was higher than it really was, and may have contributed to the judges' intense skepticism about the validity of the Trans Union board's decision-making process.

C. The Board's Monitoring of *Van Gorkom's* Negotiations with Pritzker

The above discussion raises the possibility that the lion's share of the blame for wrongdoing lay not with the Trans Union board, but with the way Van Gorkom managed the negotiating process. He gave the impression that the fifty-five dollars per share offer was instigated by Pritzker, when it was not. He negotiated unilaterally with Pritzker without informing his board. He waited until the last possible minute before calling the board meeting to approve the merger. He actively discouraged competing bids. At the September 20, 1980 board meeting at which the original merger agreement was approved, the only members of senior management allowed to attend were Chelberg and Petersen. Not coincidentally, Chelberg and Petersen were the

³⁹ This is the point of Professor McChesney's Article for this symposium. See McChesney, *supra* note 3.

⁴⁰ Daniel Kahneman & Amos Tversky, *Conflict Resolution: A Cognitive Perspective*, in BARRIERS TO CONFLICT RESOLUTION 44 (Kenneth J. Arrow et al. eds., 1995).

⁴¹ *Id.*

⁴² Timur Kuran & Cass Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683 (1999).

only members of senior management who supported the proposal.⁴³

It seems reasonable to surmise, under these facts, that the Trans Union board would have been in a position to negotiate a better price with Pritzker had it known all of the relevant facts. If the board had been fully informed by Van Gorkom, it would have known it was in a stronger bargaining position, and would have been justified in taking a stronger bargaining position with Pritzker.

The board in Trans Union has been faulted for failing to adequately consider the Pritzker bid. But an equally plausible interpretation of the facts is that the Trans Union CEO should have been faulted for not giving the board an adequate framework from which it could consider the bid. In particular, if the board had known of the KKR bid, it would have been able to negotiate more effectively with Pritzker, thereby relieving itself of liability.

Of course, putting most of the blame on Van Gorkom does not absolve the directors of blame. For example, the directors knew when they approved the transaction that there was no fairness opinion from investment bankers. They knew that there were no investment bankers or other outside valuation experts at the meeting where the merger was discussed. The directors also knew they had not been furnished copies of the merger agreement, and certainly they knew they had not read the merger agreement before approving it.

The board based its initial decision to approve the merger offer "primarily on Van Gorkom's representations."⁴⁴ However, it seems clear that the highly experienced Trans Union board would not have failed to delve more deeply into the particulars of this merger if it had been fully informed by Van Gorkom (a) of the existence of a rival bid for the company; (b) of the fact that Van Gorkom, and not Pritzker, had suggested the transaction and the price; (c) that senior management was opposed to the deal; (d) that the price was formulated to meet Van Gorkom's private views about the sum he wanted to receive for his shares, rather than on the basis of a sound financial estimate of the real economic worth of the firm to a bidder in an arm's length transaction; and (e) that there had been no real negotiations with Pritzker.

It is only against this background of the board's ignorance that its seemingly bizarre failure even to suggest a higher price to Pritzker is comprehensible. This analysis reveals that the core flaw on the part of the Trans Union board did not lie in its failure to adequately consider the Pritzker offer. Rather, the board erred in placing too much trust in the company's CEO, and especially in giving the CEO too much latitude to negotiate with Pritzker.

⁴³ Smith v. Van Gorkom, 488 A.2d at 867 ("No member of Management, except Chelberg and Peterson, supported the proposal.").

⁴⁴ *Id.* at 874.

The directors were unable to prevent Van Gorkom from negotiating unilaterally with Pritzker, because they were unaware that Van Gorkom had begun negotiations until they were presented with a fully negotiated offer. The fully negotiated offer, however, should have raised a red flag with the directors; upon learning that Van Gorkom had negotiated unilaterally with Pritzker, the directors should have wondered why Van Gorkom was trying to assume so much control over the process.

II. THE "ONE-SIZE FITS ALL" PROBLEM

The court's decision in *Smith v. Van Gorkom* has been criticized by the dissent for not giving sufficient deference to the immense skill and experience of the Trans Union board.⁴⁵ The dissent by Justice McNeilly spends seven full paragraphs extolling the virtues of the board, observing along the way that "[d]irectors of this caliber are not ordinarily taken in by a 'fast shuffle.'"⁴⁶ This remark bolsters the argument in the previous Part of this Article and reveals a vast gulf between the ways the majority and minority opinions perceived this case. The majority viewed the legal problem as the failure of the Trans Union board to follow the procedural steps necessary to insure that their decision to approve the merger was the product of an informed business judgment.

The minority viewed the legal question as whether the CEO of Trans Union duped the board, and concluded that he had not. For the reasons developed in the preceding Part, the minority is demonstrably wrong. In particular, if the board had known about the process by which the purchase price had been determined; the commitment by Van Gorkom to do a deal with Pritzker to the exclusion of other bidders, particularly KKR; and Van Gorkom's systematic and strategic rationing of the information that he supplied to the board to maximize the probability that the board would reach the result he wanted; it is likely the board would have responded very differently to the Pritzker offer.

Nevertheless, the majority's view of the procedures that should be followed by a board is fascinating, particularly when juxtaposed against the impressive credentials of the board. Essentially, the dissent in *Van Gorkom* poses a difficult question: why should a board with the wisdom and experience of the Trans Union board have had to submit itself to the cumbersome, baroque procedures envisioned by the majority? The dissent makes the telling point that the directors' sophistication, experience, and intimate knowledge of the company's business and prospects made it unnecessary for them to go through a formalistic ritual when considering the Pritzker offer. According to Justice McNeilly, the directors

knew Trans Union like the back of their hands and were more than well quali-

⁴⁵ *Van Gorkom*, 488 A.2d at 894 (McNeilly, J., dissenting).

⁴⁶ *Id.*

fied to make *on the spot informed business judgments* concerning the affairs of Trans Union including a 100% sale of the corporation. Lest we forget, the corporate world of then and now operates on what is so aptly referred to as “the fast track.” These men were at the time an integral part of that world, all professional business men, not intellectual figureheads.⁴⁷

The dissent was undoubtedly accurate in its factual description of the Trans Union board. But its legal analysis is flawed, or at best incomplete. The problem is the dissent’s distinction between well-qualified directors—like the Trans Union directors—who are competent to make decisions “at the speed of business,”⁴⁸ and other, less competent directors, who might need more time to consider their actions.

Such an approach to corporate governance would be unworkable. Directors often would not know in advance whether they would later be deemed sufficiently competent to qualify for “fast track” decision-making. The delicate issue of determining the precise parameters of directors’ expertise would be even more difficult. Certain directors might be expert at accounting issues, but not at mergers and acquisitions, or strategic planning, or research and development, or human resources, to name only a few. Further, because directors of any particular company will have a wide range of skill and experience, the court would have to decide whether to grant deference to the skill, experience, and expertise of a board as a whole, or to directors individually. Perhaps some directors would be required to obtain expert advice, to inform themselves of the relevant issues, and to deliberate fully and carefully, while other, more expert directors could merely decide on the basis of their experience and business acumen.

In other words, it appears the practical need for a uniform, “one-size-fits-all” evaluative standard for the conduct of directors renders the contextual, case-by-case approach suggested by Justice McNeilly unworkable. Once we determine that corporate directors are obliged to use due care when carrying out their directorial responsibilities, we cannot exempt certain directors on the grounds that their greater expertise allows them to skip steps in the deliberative process.

This, in turn, means that the deliberative process, which inevitably will be structured by lawyers, will necessarily be structured as a “one-size-fits-all” cookie-cutter affair. Law firms will structure the deliberative process the same way for all of their board clients to make sure that the clients are not held to have failed to reach an *informed* decision. This analysis has three implications that lead to a better understanding of the nature of corporate governance in the United States.

First, this one-size-fits-all, cookie-cutter approach is likely to stifle innovation. Once a safe harbor has been constructed, lawyers and clients will

⁴⁷ *Id.* at 895 (emphasis added).

⁴⁸ The reference here is to the Microsoft slogan, “business at the speed of thought.” See <http://www.speed-of-thought.com>.

be extremely reluctant to depart from it. There are strong disincentives to streamlining the decisional process, regardless of whether such streamlining might result in making corporate governance more efficient.

Second, it appears that this aspect of the opinion may produce benefits for the shareholders of the small number of pathological firms controlled by avaricious, dishonest management and directors. *Smith v. Van Gorkom* makes clear that directors and their lawyers will have to structure a careful deliberative process at which they receive and read the appropriate documents relevant to the transaction before making any important decision. This deliberative process is most likely to improve the decision-making process in firms with weak corporate governance, in firms with poorly informed directors, and in firms with dishonest directors, who will be threatened with liability if the transaction they are approving cannot be defended.

But the elaborate procedures that now shroud the board's deliberative process impose costs on the vast majority of firms that are under the management of competent, honest, well-meaning directors and officers. Of course, the deliberations required by *Smith v. Van Gorkom* will still be efficient from an economic perspective if the benefits outweigh the costs. It is possible that large benefits from the increased deliberation in the small universe of pathological firms compensates for what may be relatively small administrative costs imposed on a very large number of honest firms.

Finally, it is likely that the opinion in *Smith v. Van Gorkom* has had a subtle yet profound effect on the composition of board of directors of U.S. corporations. By changing the nature of the job of being a corporate director, the opinion may have changed the sort of people who are interested in becoming directors. The entrepreneurial, swashbuckling, seat-of-the-pants decision-makers who feel comfortable making spontaneous decisions likely will be uncomfortable or unhappy in the bureaucratized environment created by *Smith v. Van Gorkom*. By contrast, those who enjoy operating within the slow-moving, carefully scripted, decisional environment that the majority in *Smith v. Van Gorkom* favored will find the job of corporate director more enticing than before. This "selection effect" could undermine the entrepreneurial focus of U.S. business.

III. *VAN GORKOM* AND THE JURISDICTIONAL COMPETITION FOR CORPORATE CHARTERS

The Delaware Supreme Court's opinion in *Smith v. Van Gorkom* sent shock waves through the corporate world. The decision "reverberated mightily through the boardrooms of Corporate America, contributing to a huge escalation in D&O insurance rates and a reexamination by many executives of the personal risks of board service."⁴⁹ Of course, the court's decision, which imposed significant personal liability on every member of the

⁴⁹ Roundtable: *The Legacy of Smith v. Van Gorkom*, *supra* note 1, at 28.

Trans Union board, was not well received in the corporate community.

Prior to the decision, it seemed simply unthinkable that these honest, hard-working, experienced executives, all of whom were acting in good faith and with the best interests of the shareholders in mind, could be held grossly negligent and exposed to personal ruin as the result of a garden variety business decision on a merger that greatly enhanced shareholder wealth. Judge Marvel's decision for the Court of Chancery upholding the actions of the directors was unequivocal.⁵⁰ Relying on the "market value of Trans Union's stock, the business acumen of the members of the board of Trans Union, the substantial premium over market offered by the Pritzkers and the ultimate effect on the merger price provided by the prospect of other bids for the stock in question," the Chancery Court concluded that the Trans Union board "did not act recklessly or improvidently in determining a course of action which they believed to be in the best interest of the stockholders of Trans Union."⁵¹

By contrast, the Delaware Supreme Court's opinion appeared to be a sharp departure both from prior law and from prior, well-settled expectations about management's ability to rely on that court to provide a sympathetic audience for corporate disputes in which their integrity or competence is impugned.⁵² Because of the incredible notoriety of the case, the opinion provides a valuable window on the nature of corporate federalism in the United States.

In theory, of course, the United States has a federalist system of jurisdictional competition for corporate charters.⁵³ Under this system, states compete with one another for chartering business. Three rival theories vie to account for the nature of this competition.

A. *Jurisdictional Competition as a Race for the Bottom*

The oldest theory is the "race-to-the-bottom" concept that portrays the state of Delaware as a deplorable "competition in laxity"⁵⁴ in which Delaware panders to corporate managers to attract the fees associated with their incorporation business.⁵⁵ According to this theory, which has such notable

⁵⁰ The decision of the Chancery Court, *Smith v. Pritzker*, CA 6432, July 6, 1982 (Marvel, J.), was not published, but it is available as Appendix II in *Autopsy of a Merger*, William M. Owen's book about the transaction, OWEN, *supra* note 15, at 268.

⁵¹ *Id.* at 274.

⁵² See Jonathan Macey & Geoffrey Miller, *Trans Union Reconsidered*, 98 YALE L.J. 127, 129 (1988).

⁵³ Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 265-73 (1985).

⁵⁴ The term "competition in laxity" is meant to evoke Justice Brandeis's famous dissent in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 559 (1933), in which he characterized the competition among the states for chartering revenues as a competition "not of diligence but of laxity."

⁵⁵ William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974).

exponents as William Cary, former Chair of the Securities and Exchange Commission; Ralph Nader, US Presidential candidate in 2000; and Joel Seligman, well-known scholar and law school dean; the jurisdictional competition for corporate charters exploits shareholders and panders to management interests to gain chartering business.⁵⁶

Commentators who support the “race-to-the-bottom” theory believe that corruption and the quest for franchising fees at the state level has caused a steady deterioration in the quality of corporate law. The premise of the theory is that management, not shareholders or other groups, are the key decision-makers within companies regarding the decision about where such companies should locate themselves for jurisdictional purposes.

Smith v. Van Gorkom provides an opportunity to test the race-to-the-bottom theory. The case provides a useful opportunity to test the race-to-the-bottom theory because, *regardless of the way one interprets the decision*, the outcome is not consistent with the race-to-the-bottom theory. As every perspective on the result in *Smith v. Van Gorkom* recognizes, the court reaches a result that is antagonistic to management’s interests. In particular, most commentators take the view that the opinion undermines the traditional respect afforded to management under the business judgment rule.⁵⁷ If this reading of the decision is correct, it is flatly inconsistent with the race-to-the-bottom theory.

An alternative interpretation is that the opinion deserves praise because directors *should* be required to monitor management more assiduously than they traditionally have done.⁵⁸ This interpretation is also inconsistent with the race-to-the-bottom theory, however, because it presumes that the court thinks that Delaware managers would act irresponsibly if not closely guarded by directors, and that these directors in turn must carefully monitor the managers to fulfill their fiduciary duties to shareholders.

A large group of thoughtful commentators has taken the position that the decision in *Smith v. Van Gorkom* is about board procedure. These commentators posit that the opinion simply requires boards of directors to hire expensive professionals, such as investment bankers, and lawyers. These and other third-party advisers are retained to structure a decision-making process that will enable the board to obtain the protections of the

⁵⁶ RALPH NADER, MARK GREEN & JOEL SELIGMAN, *TAMING THE GIANT CORPORATION* (1976); Cary, *supra* note 55; see also Richard Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976); Stanley Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976); Gordon G. Young, *Federal Corporate Law, Federalism and the Federal Courts*, 41 LAW & CONTEMP. PROBS. 146 (summer 1977).

⁵⁷ See Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437, 1455 (1985); Herzel & Katz, *supra* note 4.

⁵⁸ Krishnan Chittur, *The Corporate Director’s Standard of Care: Past, Present, and Future*, 10 DEL. J. CORP. L. 505, 543 (1985) (“*Trans Union* is a long-overdue judicial affirmation of the need for better informed directors and, consequently, more responsible corporate behavior.”).

business judgment rule.⁵⁹ According to this view, the opinion creates only the appearance and not the reality of an informed decision-making process.⁶⁰ Board meetings in the wake of *Smith v. Van Gorkom* become carefully scripted plays whose primary purpose is to create a record in anticipation of litigation, rather than to improve the deliberative process. Clearly this approach cannot be reconciled with the race-to-the-bottom theory's managerialist perspective because, under this view, the decision shifts authority away from managers and into the hands of lawyers and investment bankers.

B. Jurisdictional Competition as a Race to the Top: Corporate Federalism

The principal alternative to the race-to-the-bottom theory is espoused by commentators who extol the virtues of federalism in the form of states' rights to promulgate the basic rules of corporate law in the United States. This view is espoused by market-oriented judges and scholars who are closely identified with the law and economics movement, including Frank Easterbrook,⁶¹ Roberta Romano,⁶² and Ralph Winter.⁶³ These commentators argue that a variety of competitive factors, particularly competition in the capital markets, induce states such as Delaware to enact laws that benefit and protect shareholders:

It is not in the interest of Delaware corporate management or the Delaware treasury for corporations chartered there to be at a disadvantage in raising debt or equity capital relative to corporations chartered in other states. Management must induce investors freely to choose [to buy] their firm's stock instead of, among other things, stock in companies incorporated in other states or other countries.⁶⁴

The corporate federalists take the view that competition forces corporations to incorporate in the state providing the most efficient menu of legal rules.

Because the decision in *Smith v. Van Gorkom* imposed costs on Delaware firms, it is inconsistent with the corporate federalist theory of Delaware corporate law. The decision may have imposed significant costs on shareholders in Delaware corporations. As Daniel Fischel has argued:

Shareholders are the biggest losers after *Trans Union*. Firms will have no dif-

⁵⁹ See Douglas M. Branson, *Intracorporate Process and the Avoidance of Director Liability*, 24 WAKE FOREST L. REV. 97, 103-09 (1989); Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 8-14 (1985).

⁶⁰ Charles M. Elson, *The Duty of Care, Compensation, and Stock Ownership*, 63 U. CIN. L. REV. 649, 682 (1995).

⁶¹ Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 33-35 (1983).

⁶² Romano, *supra* note 53.

⁶³ Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 290 (1977).

⁶⁴ *Id.* at 257.

ficuity finding an “expert” who is willing to state that a price at a significant premium over the market price in an arm’s-length transaction is “fair” But the cost of obtaining such an opinion is, in effect, a judicially imposed tax on corporate changes. The inevitable consequence will be that fewer transactions will occur and that when they do occur, returns to investors will be lower.⁶⁵

Thus, the decision in *Smith v. Van Gorkom* is inconsistent with the corporate federalism theory because it enhances the ability of managers to resist hostile takeovers. As I have explained elsewhere in joint work with Geoffrey Miller:

As a result of the decision, incumbent managers must delay their response to “hot” suitors who come forward with a merger proposal and insist on an immediate answer. Because of the increased duty of care and potential personal liability, managers are required to consult outside investment counsel about the fairness of the offer. This requirement can work to the manager’s advantage: they are free to find a cooperative banker willing to supply an opinion that the offer is inadequate. They also have the advantage of a breathing spell in which to marshal antitakeover defenses. *Trans Union* thus provides incumbents with a powerful weapon against rush offers by unfriendly acquirers.⁶⁶

C. *The Interest Group Theory of Delaware Corporate Law*

The third theory to explain the primacy of Delaware corporate law is the interest group hypothesis espoused by Macey and Miller.⁶⁷ According to this theory, jurisdictional competition for corporate charters is highly imperfect. Far from resembling textbook competition among rival firms, the jurisdictional competition for corporate charters is highly oligopolistic. One competitor, Delaware, dominates the competition. As a result of the dominance, Delaware is able to charge “rents” to powerful special interest groups.

Consistent with this theory, rather than benefiting managers (as the race-to-the-bottom theory would predict), or shareholders (as the corporate federalist theory would predict), the decision in *Smith v. Van Gorkom* benefits the powerful interest groups of lawyers and investment bankers who specialize in providing legal and investment banking services to Delaware companies. The opinion shifts power from corporate managers to lawyers and investment bankers. *Smith v. Van Gorkom* is unusually well known among corporate managers. As prominent corporate lawyer Ira Millstein has observed, “I have never been in a board room where I couldn’t get a director’s attention by saying: ‘Remember *Van Gorkom*.’”⁶⁸ These discrete

⁶⁵ Fischel, *supra* note 57, at 1453.

⁶⁶ Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 519 (1987).

⁶⁷ *Id.*

⁶⁸ *Roundtable: The Legacy of Smith v. Van Gorkom*, *supra* note 1, at 34.

interest groups enjoy a highly lucrative, mutually beneficial, and symbiotic relationship with Delaware firms. Specifically, these experts recommend Delaware as the place for relocating firms to move. This, in turn, creates both chartering business that benefits Delaware, and advisory business for lawyers and investment bankers.

To summarize, one universally acknowledged ramification of *Smith v. Van Gorkom* is an increase in demand for the services of lawyers and investment bankers who advise Delaware corporations. The decision tells managers that they can insulate their decisions from subsequent attack, but only if they hire investment bankers and Delaware counsel to structure the appropriate procedural framework for the decisional process. From an economic perspective, this result is the functional equivalent of imposing a transaction tax on major corporate decisions in Delaware, with the proceeds from the tax being paid to lawyers and investment bankers. These lawyers and investment bankers find this result beneficial and, thus they have strong incentives to recommend Delaware as a situs of incorporation to their clients.

Thus, consistent with the interest group theory of Delaware corporate law, the advantages that flow from Delaware's dominant position in the jurisdictional competition in corporate charters accrue not to shareholders or to managers, but to the lawyers and investment bankers who recommend Delaware to their corporate clients as their preferred situs of incorporation. Significantly, both the race-to-the-bottom theory and the corporate federalist theory predict that Delaware should have lost ground in the jurisdictional competition for corporate charters after the decision in *Smith v. Van Gorkom*. The race-to-the-bottom theory would predict that Delaware would lose ground after the decision because that theory maintains that states must pander to incumbent management in order to succeed in the competition for corporate charters. Similarly, the corporate federalist theory would predict that *Smith v. Van Gorkom* would cause Delaware to lose market share because of the high transaction costs of following the procedures that the opinion requires be followed before directors can be insulated from liability for engaging in a corporate transaction. Only the interest group theory of Delaware corporate law predicts that the opinion would not hurt, and could possibly help, Delaware's competitive position by providing benefits to those critically able to steer chartering business to Delaware: lawyers and investment bankers. And, consistent with that theory, the opinion did nothing to harm Delaware's competitive position.⁶⁹

⁶⁹ See Romano, *supra* note 53 (citing statistics on Delaware's market share); Norm Veasey, Address at the *Smith v. Van Gorkom* Symposium Dinner (May 18, 2001) (transcript on file with *Northwestern University Law Review*) (regarding Delaware's continued dominance in the jurisdictional competition for corporate charters); see also ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 6-8 (1993). Romano's data show that Delaware's revenues from incorporation continued to rise after the opinion. The corporate franchise tax as a percentage of total taxes collected rose consistently over the relevant years as follows:

CONCLUSION

It is tempting simply to dub the result in *Smith v. Van Gorkom* a mistake. And leading commentators have done just that.⁷⁰ But despite the widespread attention and resounding criticism the opinion has received, the court has never recanted or even expressed remorse for the result it reached. In fact, the decision not only remains good law, it has been explicitly affirmed in other high visibility cases, such as *Cede & Co. v. Technicolor*⁷¹ and *Paramount Communications v. QVC Network*.⁷² *Van Gorkom* is alive and well. It has weathered several business cycles and fifteen years of attack. It will outlive its critics.

The fact that we are still analyzing and debating the decision after so many years demonstrates why it is so much fun to practice and study corporate law. Virtually all of the intense debate about the case has involved analysis of the decision-making process within the board in the transactional context. This is an important perspective, and it is clearly the perspective the plaintiffs in the case wanted the Court to accept as the principal focus.

This Article has attempted to analyze *Van Gorkom* from three different perspectives. First, it analyzed the case from the perspective of the relationship between the board and the company's chief executive officer. The lack of careful deliberation by the Trans Union board is more understandable when one understands the way the CEO commandeered the negotiations with the acquirer and carefully rationed the information the board received. When the relationship between the CEO and the board is examined and un-

	FRANCHISE TAX REVENUES	FRANCHISE TAX AS A % OF TOTAL TAX COLLECTION
1980	66,738,000	12.9
1981	70,942,000	12.9
1982	76,591,000	12.9
1983	80,031,000	12.9
1984	92,270,000	12.9
1985	121,057,000	14.8
1986	132,816,000	15.0
1987	152,152,000	15.4
1988	180,583,000	17.7
1989	195,862,000	17.3
1990	200,201,000	17.7

Id. at 7-8.

⁷⁰ Fred McChesney has remarked that, "[i]f sheer wrong-headedness of result were disqualifying, *Van Gorkom* would not be worth rereading." McChesney, *supra* note 3, at 631. Daniel Fischel has called the opinion "one of the worst decisions in the history of corporate law." Fischel, *supra* note 57, at 1455.

⁷¹ 634 A.2d 345, 366-367 (Del. 1993) (applying *Van Gorkom* to determine that the Technicolor board had not made an "informed decision" in approving the sale of the company).

⁷² 637 A.2d 34, 50 (Del. 1994) (attacking the decision-making process employed by the Paramount board as "uninformed").

derstood, the result in the case can be explained, not as a failure of the board *deliberative process*, but as a failure by the board properly to *monitor* the negotiations between the company and its putative acquirer.

Second, the opinion is useful because it illustrates the basic problem with mandatory, immutable rules in the area of corporate governance. Because the court was crafting a one-size-fits-all standard of behavior, it was forced to promulgate a rule that would serve both honest, highly qualified, and experienced boards like Trans Union, and corrupt, unqualified, or inexperienced boards that constitute the real challenge for any system of corporate governance. Here this Article argued that the outcome in *Smith v. Van Gorkom* appears questionable against the backdrop of the tremendous qualifications of that board. But the opinion would not appear to be so odd if the court's admonishments about high deliberative standards, careful disclosure to shareholders, and the use of qualified independent experts had been made to a board that was of demonstrably low quality.

From this perspective, the court's decision stands as yet another argument in favor of having corporations governed by contractual rules that can be altered to suit the individual, particularized needs of a particular firm, as opposed to mandatory rules that are inviolable. This, of course, is more or less what occurred in Delaware⁷³ and throughout the nation⁷⁴ after the *Van Gorkom* opinion. Specifically, the vast majority of states revised their statutes to permit firms to immunize directors from the threat of personal liability in damages for breaching the fiduciary duty of care.⁷⁵ The statutes can be criticized on the grounds that pathological boards can adopt these statutory provisions as easily as high quality boards. Thus, because virtually all firms have taken advantage of the ability to implement exculpatory provisions, the statutory response to *Smith v. Van Gorkom* can be viewed as benefiting firms with good corporate governance at the expense of firms with weak corporate governance, while the decision itself can be viewed as benefiting firms with bad corporate governance at the expense of firms with good corporate governance.

Finally, the opinion is interesting because it can teach us about corpo-

⁷³ DEL. CODE ANN. tit. 8, § 102(b)(7) (2001).

⁷⁴ See Lawrence A. Hamermesh, *Why I Do Not Teach Van Gorkom*, 34 GA. L. REV. 477, 490 (2000). Hamermesh writes that "[a]fter *Van Gorkom* was decided in 1985, the overwhelming majority of states followed Delaware's lead and adopted statutes that either (i) permit the articles or certificate of incorporation to eliminate a director's personal liability in damages for breach of the duty of care, or (ii) eliminate such liability directly." *Id.* In fact, Indiana was the first state to confer additional protections on directors after *Van Gorkom*. Delaware followed two months later. See McChesney, *supra* note 3, at 649.

⁷⁵ See, e.g., DEL. CODE ANN. tit. 8, § 102 (b)(7) (2001); MODEL BUS. CORP. ACT § 2.02(b)(4) (1999) (eliminating personal liability for breaches of fiduciary duty of care). As of January 1999, 43 states had adopted statutes permitting firms to immunize directors from personal liability for duty-of-care violations. See ROBERT W. HAMILTON, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES: CASES & MATERIALS 783 (7th ed. 2001).

rate federalism and the jurisdictional competition for corporate charters. First and foremost, the case convincingly refutes the race-to-the-bottom theory of jurisdictional competition, which posits that Delaware competes for charters by promulgating rules that pander to management. As noted above, there is no question that the opinion is hostile to management both in tone and in result. As such, the antimanagement result should be the final nail in the coffin of the race-to-the-bottom theory.⁷⁶

The opinion supports the interest group theory of jurisdictional competition for corporate charters espoused by Macey and Miller. After *Van Gorkom*, advisors could have stopped recommending Delaware. But they did not, because the opinion operates to their benefit. The decision requires that boards follow an array of detailed and expensive procedures in order to be assured of having the benefit of the business judgment rule. The opinion has prompted lawyers to instruct their director clients to "hire expensive financial advisers, commission extensive studies and otherwise improve their paper record of their decisional process in order to reduce the risk of liability in situations similar to *Van Gorkom*."⁷⁷ This result, therefore, will increase the demand for the services of the lawyers and investment bankers who guide the decision about where to incorporate.

⁷⁶ The race-to-the-bottom theory already has been discredited. First, the available empirical evidence shows that incorporating in Delaware is a welfare-enhancing move from the point of view of the shareholders. Richard Dodd & Robert Leftwich, *The Market for Corporate Charters: 'Unhealthy Competition' Versus Federal Regulation*, 53 J. BUS. 59, 263 (1980). Second, if there really were a destructive race to the bottom, then Delaware, which leads the nation in the jurisdictional competition for corporate charters, should have the most restrictive rules governing the market for corporate control. But it does not. Winter, *supra* note 63, at 254-55; Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 858-59 (1993).

⁷⁷ Robert W. Hamilton, *Reliance and Liability Standards for Outside Directors*, 24 WAKE FOREST L. REV. 5, 28 (1989).

