The Theft of Time, Inc.?

Efficient Law and Efficient Markets

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The 1989 battle for control of Time, Inc. was riveting, in part because of the size and importance of the combatants (Time, Paramount Communications, and Warner Communications). But the battle was also noteworthy for the deference shown by the courts to Time's board of directors. The Time board chose not to submit to shareholders a last-minute takeover bid from Paramount (at a price considerably in excess of the Time shares' then-current market price), and to continue completion of a merger previously negotiated with Warner. Paramount brought suit in Delaware, the most influential jurisdiction in the nation in corporate matters, and thereby dramatically raised the issue of the courts' proper role in evaluating the behavior of corporate boards faced with a takeover. Despite Paramount's healthy premium over the market's valuation of the Time-Warner combination, in *Paramount Communications, Inc.* v. *Time, Inc.* (*"Time/Warner"*) the Delaware courts refused to interfere in the Time board's decision.

The deference that the Delaware courts accorded Time's board of directors was widely criticized. Critics were particularly skeptical about allowing Time's board to preclude Time shareholders from even considering whether to accept the Paramount bid. In a typical reaction the *Wall Street Journal*'s legal columnist wrote that "Paramount v. Time shows how far the law has moved from the notion that corporate boards exist to serve stockholders." An efficient stock market had valued the combined Time-Warner entity far below the price that Paramount was willing to pay for Time, a valuation that the Time board allegedly should have respected. To show that the board had not outsmarted the market, the columnist presented a chart showing how far below the Paramount bid Time-Warner stock has subsequently traded. The law thus had seriously erred by allowing the board to ignore what the market was saying.

But this, like other critiques of *Time/Warner*, mischaracterizes the legal issue as the Delaware courts defined it, and as even the plaintiffs argued it. It also reveals a misunderstanding of the economic rationale for courts' reluctance to interfere in internal corporate affairs. The courts' role is not to force directors to embrace the efficient market hypothesis, or for that matter to make them pursue any particular course of action. Such matters are resolved by the contracts made between shareholders and their managements. Ultimately, the legal and economic role of courts is to enforce preexisting contract rights, not to punish decisions by corporate management that may have been mistaken. Correctly understood, the *Time/Warner* decision in fact

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was very good tidings, in terms of both economics and law. Correctly understood, any errors were those of Time's board, not of the courts.

The Time-Paramount Battle

Two facts are critical for understanding the Time-Paramount dispute. First, the Time board was dominated by outside directors with distinguished credentials in other enterprises. Only four of twelve Time board members were "insiders" whose principal activities depended on continued employment at Time. One outside director, Henry R. Luce III (son of Time's founder), had a large amount of his personal and Luce Foundation wealth invested in Time stock.

Second, Time management and its board had since 1983 spent considerable time studying the profitability of vertically integrating into the production of cable programming and related entertainment ventures. By 1987, after considering mergers with or acquisitions of many entertainment and communications firms, Time's management concluded that Warner communications represented the best fit with Time. In so deciding, management considered and rejected the possibility of combining with Paramount Communications.

Time management had initiated joint venture discussions with Warner in 1987, but they failed because of tax and other problems. But Warner soon reemerged as the focus of Time management's strategic thinking. By July 1988 Time's management proposed new negotiations with Warner. This second round of talks, surmounting difficult negotiations over issues such as board control and management succession, led to a merger agreement in March 1989. Time also entered into a"no-shop" agreement, promising that it would neither solicit nor encourage any takeover attempts. As part of that promise, Time concluded a lock-up exchange agreement, under which each company would receive between 9 and 11 percent of the shares of the other.

In some respects the merger appeared to be an acquisition of Time by Warner. Warner shareholders would control 61 percent of the common stock of the new Time-Warner company and 50 percent of the board. In several critical respects, however, Time's existing board would retain control of the new entity. A Time executive would be the sole chief executive officer (after five years of sharing the position with a Warner executive). The "Time culture," a major concern of the Time board, was preserved by ensuring that the senior editor of *Time* magazine would retain editorial independence from management by reporting to a special committee of the board.

The structure of the merger, a stock-for-stock exchange, required Time shareholder approval, and a vote was set for June 1989. All this careful planning was interrupted by Paramount's surprise bid of $175 (later raised to $200) per share for Time stock. When the bid was announced, Time stock rose $44 to $170 per share, and ultimately reached $182.75 per share. Paramount indicated that its bids were fully negotiable, although it conditioned them on Time's relinquishing various defensive takeover measures it had in place and receiving certain regulatory approvals (standard conditions in any hostile bid).

Time's board never considered the Paramount bid seriously, in the stated belief that it had a binding commitment to Warner. The board also concluded that Paramount's initial offer was inadequate, despite advice from its investment bankers before Paramount's bid that the stock of the merged Time-Warner would initially trade at about $150, and possibly as high as $175. After the Paramount bid, the board was advised that, although the market would not immediately recognize the long-term benefits of the merger, Time-Warner's stock ultimately would trade at much higher prices—as much as $402 per share by 1993—as the synergies of the merger were realized.

Nevertheless, Time's board feared that shareholders would not share its view of likely future values and took steps to protect the Time-Warner combination. By restructuring the deal as a cash bid for Warner shares (at a 56 percent premium over Warner's stock price before the merger announcement), a vote by Time shareholders could be avoided. The cash bid had the advantage of accelerating the combination, since no proxy statement or waiting period for shareholder notice was needed. The acquisition thus could close within 20 business days, well before Paramount could secure regulatory approvals for its bid. To finance the bid Time-Warner would incur new debt of at

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least $10 billion, which would effectively wipe out all current earnings of the combined entities after interest payments.

Paramount sued to enjoin Time's purchase of Warner shares, but the Delaware Chancery Court denied a preliminary injunction. The Delaware Supreme Court affirmed the denial in July 1989, although its written opinion was not issued until February 1990. Time thus was able to complete its share purchase without further interference from Paramount and without a shareholder vote.

Doubts about the Deal

There are many reasons to second-guess the decision made by Time's board. Most prominently, Time-Warner's stock has fared indifferently since the purchase of Warner shares. Time shares traded between $105 and $122⅝ during March, after news of the merger agreement with Warner but before the announcement of the Paramount bid. The price stood at $126 when Paramount made its bid. In May 1991, Time-Warner traded at around $119.

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The deal's denouement points up the efficiency of the market in this case. With the information of the impending Time-Warner combination, investors registered the value of the new entity at a value considerably lower than those predicted by the Time board and its investment advisors. Even the value ascribed to the new firm at the time—some $125—has proven to be higher than current prices. But that may well be due to the fact that the way in which Time eventually completed the transaction required the assumption of considerable debt and differed substantially from the original proposal. In any event, the market's prediction was far better than that of Time and its experts.

There was other contemporaneous evidence that Time was paying an excessively high price for Warner shares. Time offered a 12 percent premium for Warner in the initial merger proposal. Warner's investment bankers described this offer as "one hell of a deal" for Warner. Yet Time ultimately paid a 56 percent premium in the subsequent cash bid. Time's advisors conceded that the market would not value the combined Time-Warner as highly as Paramount's cash bid upon completion, but instead insisted that these markets were inefficient in failing to recognize the synergies present in the merger.

The steady escalation of the future prices predicted by Time's own investment bankers hardly seem sufficient to justify the Time board's belief that Time shareholders ultimately would realize gains greater than those offered by the Paramount bid. The predictions were only revised in response to the Paramount offer, and were extraordinarily imprecise. For 1993, for example, one advisor predicted a range of Time-Warner prices from $208 to $402, a prediction that the Chancery Court described as "a range that a Texan might feel at home on."

In short, today's prices confirm initial market reactions and show that Time's shareholders would have been correct to prefer Paramount's bid to the Warner deal. By restructuring that deal to avoid a shareholder vote, critics of the *Time/Warner* decision charge, Time's board essentially stole from shareholders a chance to make an instant gain of some 60 percent on their investments. The Delaware decision thus seems indefensible, "a low point in the property rights of stockholders," as the *Wall Street Journal* columnist called it.

The Nature of the Corporation and the Purpose of Law

Appreciating what was at stake in *Time/Warner* does indeed require an understanding of property rights within the firm. Those rights are established principally by contract. Far from ignoring corporate property rights, however, the Delaware Supreme Court explicitly upheld them.

The essence of the corporation is the contractual division of labor between owners (shareholders) and operators (management) of the firm. Under this mutually agreed upon separation of ownership and control, management is responsible for conducting the firm's affairs. Shareholders who wish to reserve certain decisions to themselves can write those exceptional matters into the contract (articles of incorporation). Owners who wish instead to be the day-to-day operators of their own firms typically write a different contract altogether, for example by forming a sole proprietorship or partnership rather than a corporation.

The law's role in this system is simply to enforce the allocation of property rights established by contract—a task that includes interpreting the agreement's ambiguous terms and providing missing terms for contingencies not mentioned in the contract. As in contract law more generally, judges have been reluctant to substitute their judgment for that of the parties. Thus, under the "business judgment rule," courts almost never enjoin or punish directors' decisions, as long as they are honest attempts to make money for shareholders. Judicial intervention is not unusual when directors are acting in their own, not shareholders', interest. But one can count on one hand the number of times that courts in this country have intervened in a disinterested board decision, however mistaken it turns out to be. Finding those cases, one corporate law scholar has written, is "a search for a very small number of needles in a very large haystack."

Legally, the business judgment rule is based on the same reluctance to substitute courts' judgments for those of relevant parties that pervades the law generally. Economically, the rationale behind the business judgment rule is fourfold. First, economic welfare is maximized by allowing affected parties themselves to decide contractually on the allocation of resources.

Second, and relatedly, judges are poorly equipped and positioned to decide whether directors' decisions make good business sense. Specialized managers, with more complete information, will typically make better evaluations of alternative choices than judges can. Judicial restraint reflects the realization that courts' business acumen is inherently inferior to that of businessmen.

Third, deference to directors' decisions encourages taking prudent risks under conditions of uncertainty. It is easy to criticize what in hindsight turns out to have been a mistake, even when the decision seemed a reasonable one at the time. Were courts routinely to hold directors liable for prudent but mistaken decisions, directors naturally would shrink from transactions that offered profits commensurate with their risks and that would therefore benefit shareholders.

Fourth, shareholders have ways to protect themselves from director error. As noted, they can reserve to themselves any decision that they wish to make. Management mistakes may go unpunished at the time, but shareholders can punish errors after the fact by removing erring managers. They can fire a management team that does not conduct the firm's affairs as the shareholders want. The information needed to appraise management's performance is

"Then go ahead with the merger."
"Make them the offer we discussed."
"How many shares are outstanding?"

"Pineapple will be fine."
"All right dear, then vegetable soup."
"Of course they'll like vegetable soup . . ."

provided daily by prices in stock markets.

In short, absent self-interested defalcations by directors, a purchaser of shares essentially enters into an agreement that the board will conduct those affairs not reserved for shareholder decision. If Mr. Jones or Ms. Smith wants to help manage a car company, buying General Motors or Ford stock is not the way to achieve that goal (unless one buys enough to choose the managers).

Corporate Law and Takeovers

No principle of law was better established than the business judgment rule, at least until the recent rise of takeover-related litigation. In the past decade, well-publicized takeover battles featuring offensive

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tactics and defensive maneuvers relatively unfamiliar to courts have caused judges to intervene in management decisions more frequently. The results of a series of cases leading up to *Time/Warner* have been unfortunate. In one infamous case, *Smith* v. *Van Gorkom*, the Delaware courts imposed liability on members of the board of Transunion Corporation, a majority of which was composed of distinguished and disinterested outsiders, for accepting a buyout offer at a 38 percent premium over market without an elaborate paper record of advice from experts and a nationwide search for higher bidders. The Delaware courts seemed to be telling boards that a good price that made all shareholders better off was not enough; they must search exhaustively for the highest possible price—the "perfect" solution—before they could take any action.

Absent some specific reason to think that management is promoting its own welfare over that of shareholders, judicial intervention into internal firm affairs is legally unwarranted and economically undesirable in the takeover context as in other corporate domains.

The *Transunion* case, which one corporate law scholar has called "surely one of the worst decisions in the history of corporate law," has been followed by other equally dubious bits of judicial intervention into takeover disputes. In *Unocal* v. *Mesa Petroleum, Inc.*, the Delaware Supreme Court embarked on a detailed review of the defensive tactic (share repurchases) used by Unocal to repel a takeover attempted by T. Boone Pickens. Although the court ultimately did not disagree with what Unocal had done, the searching analysis of disinterested board action was another retreat from the business judgment rule. The court made it clear that boards would no longer be automatically accorded the deference of the business judgment rule in the absence of evidence of self-interest, but would first have to present the court with detailed evidence of the nature of the threat to corporate or shareholder welfare and of the reasonableness of their response to it. In short, decisions of corporate boards were to be subjected to closer scrutiny than determinations of the typical administrative agency.

Likewise, in *MacAndrews & Forbes, Inc.* v. *Revlon, Inc.*, the Delaware Supreme Court issued detailed instructions as to when a firm was legally "in play," and what the board's duties in that case were. In particular, the board was told when it must cease defending against a takeover and instead facilitate its completion by holding an auction among competing bidders. Later lower court decisions implemented these decisions by engaging in close scrutiny of whether boards were using takeover defenses that were too strong for the threat posed, and when a takeover bid ceased to be a threat. The result was the beginning of a finely tuned system of judicial regulation of board behavior.

Judges' initial uncertainty about the wisdom of applying the business judgment rule in takeover contests was perhaps understandable. In addition to the novelty of takeover tactics and countertactics, judges seemed suspicious of management motives when changes in corporate control were at issue. Successful takeovers are often followed by changes in the managerial ranks. Thus, courts worried, defensive tactics might be motivated by management desires to preserve their positions at shareholders' expense. With the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders," as the *Unocal* court put it, the business judgment rule seemingly should no longer apply.

But the rationale for the business judgment rule is just as applicable in takeover cases as in others. Courts usually have no way to distinguish disinterested from self-interested defensive tactics. Indeed, this disability leaves outside directors nearly as suspect as inside directors under the *Unocal* test. Management (and outside directors) frequently will honestly believe that a bid is inadequate. Since first bids are almost never the highest offer that a firm can get, management needs some defensive measure to fend off those offers. What looks like a self-interested attempt to preserve management's jobs can in fact be a reasonable gamble to increase shareholder welfare. Shareholders can always punish mistakes by changing directors. And shareholders can and frequently do protect against excessive management interest in job preservation by providing directors and managers with ample incentives, in the form of stock ownership and options, to align their interests with those of shareholders.

So, for example, an empirical study of one defensive tactic, filing suit against a raider, found that in 77 percent of the instances where the first offer was defeated there was eventually a change in corporate control—but at a higher premium for shareholders. Even in the 23 percent of cases in which there never was a second bid, it cannot be inferred that a selfish desire to preserve management's jobs motivated the defensive tactics, or even that the decision was the wrong one at the time. The board may well have made a reasonable gamble for a higher price, but lost. In those instances shareholders could always fire unsuccessful management, if they chose.

Thus, there is growing appreciation that the rationale for the business judgment rule applies with full force in the takeover context. Absent some specific reason to think that management is promoting its own welfare over that of shareholders, judicial intervention into internal firm affairs is legally unwarranted and economically undesirable in the takeover context as in other corporate domains. Retreat from the business judgment rule in the Delaware courts in cases such as *Revlon* and *Unocal* has seemed more and more unwise.

The Glad Tidings of the *Time/Warner* Decision

The *Time/Warner* decision is good news because the decision returns control of the corporation to managers and shareholders. It does so by reducing Delaware courts' ability to intervene in corporate affairs.

It is important to note what was not at stake in the case. The case was not about managerial entrenchment at shareholders' expense. Some evidence did suggest that Time's management was principally interested in retaining control of a major corporate institution. Management insisted on the preservation of Time's "corporate culture" as a condition in any deal. Other evidence suggested that the Time's board's reactions were those of management feeling itself under attack, not looking to expand the firm. No-shop agreements and lock-up options are standard tactics of takeover targets dealing with white knights, not of bidders. Time also paid major banks a "dry-up" fee to refrain from financing bids for Time, not for Warner.

But this evidence is equally consistent with a disinterested board honestly concluding that its plans for the firm, not some other group's projects, represented the best corporate course for Time shareholders. The Delaware court was particularly impressed that all but one of Time's outside directors favored the Warner deal (and the one who disagreed did so for reasons unrelated to the competing Paramount bid). Most important, plans for the combination with Warner had been in the offing long before Paramount's bid, "only after what could be fairly characterized as an exhaustive appraisal f Time's future as a corporation." A combination .vith Paramount had been studied years before Paramount's bid, but rejected in favor of the Warner deal solely for business reasons.

Since continuing the Time-Warner deal was apparently motivated by business reasons, not self-interest, the Delaware Supreme Court held that the issue in the case was simply whether Time was "entitled to the benefit and protection of the business judgment rule." Paramount's bid could reasonably be viewed as a threat to corporate policy, although the market valued it more highly than it did the Time-Warner deal. Time's board may have been wrong in disagreeing with the market's reaction to its proposed Warner deal. But to enjoin the transaction "would involve the court in substituting its judgment for what is a 'better' deal for that of a corporation's board of directors."

Thus, far from ignoring shareholders' property rights, *Time/Warner* moves the Delaware courts back to the traditional and more desirable role of the law: respecting and enforcing the property rights that the parties themselves have defined contractually. As the court itself said, the fundamental nature of the corporation is that the board, not shareholders, has "the duty to manage the business and affairs of the corporation."

The most telling aspect of the business judgment deference accorded the board in *Time/Warner*—and the aspect most irritating to its critics—is the absence of any discussion of whether Time's decision to continue the Warner deal and to ignore the Paramount bid was a good financial decision. Nowhere in the opinion does the court even raise this point. True to the business judgment rule, the court simply states in the abstract that "it is not [a] breach of faith for directors to determine that the present stock market price of shares is not representative of true value."

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This stance galls some believers in the efficient market hypothesis. Two writers have taken the position that when a board ignores market prices in favor of its own decision about value, the board ought to be required to demonstrate what perceived market failure justifies the board's reliance on its own judgment, and a court should exercise its own judgment in weighing whether management's plans are likely to improve on the value of a hostile bid.

But a management obligation to follow the efficient market hypothesis has never been part of the law, nor of shareholders' property rights. Shareholders who wish to acquire the right to rely on efficient markets need only insert language in their corporate charters that they be allowed to vote and that management remain passive whenever an offer for their shares is announced. There are many reasons, including management's ability to dicker for a higher premium, why shareholders rationally would prefer not to have such language in their charters.

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Will Judicial Deference Persist?

Perhaps at the time and certainly in retrospect, one could well conclude that the Time board was wrong to persist in completing the Warner share purchase. But criticism of the *Time/Warner* decision, as opposed to the Time-Warner transaction, seriously mischaracterizes the role of courts. In revitalizing the business judgment rule in the takeover context, the Delaware court did not hold that the Warner transaction was wise—indeed, it did not even discuss the substantive terms or merits of the deal. The sole ground for the decision was enforcement of the respective property rights established by shareholders and management.

In reestablishing the law's traditional hands-off attitude in the face of disagreements over corporate policy, the Delaware Supreme Court conspicuously backed away from its prior interventionist forays in cases like *Revlon* and *Unocal.* But those cases were themselves revisions of well-established corporate common law, which the Delaware Court felt free at the time to override. Therefore, the principal issue today growing out of *Time/Warner* is whether the Delaware Supreme Court meant what it said in that case, or whether some return to the *Revlon-Unocal* approach is still likely. As one commentary on the *Time/Warner* decision has noted, "the only thing certain in either fashion or the takeover business is that nothing ever stays the same for very long." One can hope, however, that the business judgment rule rediscovered in *Time/Warner* will not soon go out of style in Delaware.