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SMITH V. VAN GORKOM

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Smith v. Van Gorkom

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***Abstract*:** *Smith v. Van Gorkom* arguably was the most important corporate law decision of the 20th century. The supreme court of a state widely criticized for allegedly leading the race to the bottom held that directors who make an uninformed decision face substantial personal liability exposure. In so doing, the court breathed new life into the law of fiduciary duties.

For example, *Van Gorkom* presaged *Unocal*'s significant expansion of judicial review of corporate takeovers. Indeed, a *Van Gorkom*-based inquiry into whether the board was fully informed remains a key component of the *Unocal* methodology. Likewise, *Van Gorkom* laid the foundation for the subsequent *Caremark* decision and the resulting expansion of judicial inquiry into whether the board of directors exercised proper oversight of its subordinates. In fact, most of the modern edifice of corporate fiduciary duties rests in some degree on the *Van Gorkom* decision.

The perception that the decision had significantly increased director liability exposure drove dramatic changes in the D&O liability insurance market. In turn, important legislative initiatives soon followed, including the now nearly universal liability limiting charter provisions authorized by Delaware General Corporation Law § 102(b)(7).

Not surprisingly, the case generated great controversy and, in fact, continues to do so. Did the Trans Union board of directors actually deserve the criticism heaped upon it by the Delaware Supreme Court? Does the Court's decision actually deserve the criticism heaped upon it by most commentators? This essay provides the back story to this remarkable decision and concludes that the gist of the decision is sound.

Keywords: board of directors, business judgment rule, Van Gorkom, Trans Union, corporate governance, Delaware

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Smith v. Van Gorkom

Stephen M. Bainbridge*

Introduction

Smith v. Van Gorkom[1] arguably was the most important corporate law decision of the 20th century. The supreme court of a state widely criticized for allegedly leading the race to the bottom[2] held that directors who make an uninformed decision are unprotected by the business judgment rule and, accordingly, face substantial personal liability exposure:

> To summarize: we hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer. We hold, therefore, that the Trial Court committed reversible error in applying the business judgment rule in favor of the director defendants in this case.[3]

In so holding, the court breathed new life into corporation law's fiduciary duties.

Van Gorkom presaged *Unocal*'s significant expansion of judicial review of corporate takeovers, for example.[4] Indeed, a *Van Gorkom*-based inquiry into whether the board was fully informed remains a key component of the *Unocal* methodology.[5] Likewise, *Van Gorkom* laid the foundation for the subsequent

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* William D. Warren Professor, UCLA School of Law. I think Bill Klein for his very helpful comments.

[1] 488 A.2d 858 (Del. 1985).

[2] *See, e.g.*, William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974).

[3] *Van Gorkom*, 488 A.2d at 893.

[4] Unocal Corp. v. Mesa Petroleum Co. , 493 A.2d 946 (Del. 1985).

[5] *Cf.* Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994 (noting that *Unocal* requires, *inter alia*, "a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision").

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Caremark decision and the resulting expansion of judicial inquiry into whether the board of directors exercised proper oversight of its subordinates.[6]

The perception that the decision had significantly increased director liability exposure drove dramatic changes in the director and officer (D&O) liability insurance market.[7] In turn, important legislative initiatives soon followed, including the now nearly universal liability limiting charter provisions authorized by Delaware General Corporation Law § 102(b)(7).[8]

Not surprisingly, the case generated great controversy and, in fact, continues to do so.[9] This essay provides the back story to this remarkable decision.

The Business Judgment Rule

In 1980, Trans Union's CEO and chairman, Jerome W. Van Gorkom, negotiated a merger between Trans Union and an entity controlled by financier Jay A. Pritzker. In due course, Trans Union's board of directors and shareholders approved the deal. Plaintiff-shareholder Smith sued, alleging that the board members had violated their fiduciary duty of care. The defendant directors contended that their decision to sell the company was protected by the business judgment rule.

The business judgment rule is corporate law's core doctrine, pervading every aspect of state corporate law, from the review of allegedly negligent decisions by directors to self-dealing transactions to board decisions to seek dismissal of

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[6] *See* In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959, (Del. Ch. 1996) (starting "with the recognition that in recent years the Delaware Supreme Court has made it clear—especially in its jurisprudence concerning takeovers, from *Smith v. Van Gorkom* through *Paramount Communications v. QVC*—the seriousness with which the corporation law views the role of the corporate board.").

[7] *See* E. Norman Veasey, et al., *Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification and Insurance*, 42 BUS. LAW. 399, 400-01 (1987) (asserting that "many D & O insurers have withdrawn from the market completely or have dramatically altered their policies to decrease the availability and scope of coverage and/or increase the premiums and the amounts deductible under existing policies").

[8] In re Walt Disney Co. Derivative Litigation, 907 A.2d 693 (Del. Ch. 2005) ("The vast majority of Delaware corporations have a provision in their certificate of incorporation that permits exculpation to the extent provided for by § 102(b)(7)."), *aff'd*, 906 A.2d 27 (Del. 2006).

[9] Bayless Manning, *Reflections and Practical Tips on Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1 (1985) (observing that many regarded the decision as "atrocious").

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shareholder litigation and so on.[10] Countless cases invoke it and countless scholars have analyzed it.[11] Yet, despite all the attention lavished on it, the business judgment rule remains poorly understood.[12] Successfully coming to grips with the seminal *Van Gorkom* decision, however, can clear up many of the mysteries surrounding the rule.

The court began its analysis by noting that the business judgment rule provides a presumption that in making a decision the directors acted on an informed basis, in good faith and in the honest belief that the decision was in the firm's best interests.[13] None of the usual triad of exceptions to the rule—i.e.,

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[10] *See, e.g.*, Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971) (fiduciary duties of controlling shareholder); Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. 1968) (operational decision); Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979) (dismissal of derivative litigation). So-called "business judgment rules" may also be found in the law of other forms of business organizations, where they likewise protect the "good faith business decisions" of the organizations' board of directors or comparable organ of authority "from interference by the courts." Lee v. Interinsurance Exchange of the Automobile Club of Southern California, 57 CAL. RPTR.2d 798, 802 (Cal. App. 1997) (holding that business judgment rule applies to business decisions of the board of governors of a reciprocal insurance exchange). See also Barnes v. State Farm Mutual Auto Insurance Co., 20 CAL. RPTR.2d 87 (Cal. App. 1993) (holding likewise as to board of mutual insurance company).

[11] *See* Kenneth B. Davis, Jr., *Once More, the Business Judgment Rule*, 2000 WIS. L. REV. 573, 573 (observing that "thousands of pages of corporate law scholarship and commentary have been devoted to" the business judgment rule).

[12] *See, e.g.*, R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1342 (1993) (arguing that neither of the most widely "avowed bases for the business judgment rule is particularly persuasive"); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 287 (1994) (arguing that "the general concept behind the rule seems unassailable" but that "a problem occurs when courts and writers attempt to inject specific content into this general proposition—immediately, a lack of consensus emerges as to what the rule really is"); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270 (1967) (noting that the business judgment rule is "one of the least understood concepts in the entire corporate field").

[13] *Van Gorkom*, 488 A.2d at 872. Much confusion has been engendered by the question of whether the business judgment rule is a procedural presumption, a substantive limitation of liability, or both. *See, e.g.*, S. Samuel Arsht, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 94 (1979) (arguing that the "single term" business judgment rule leads to confusion because it is "employed with reference to wholly different aspects of the rule's application, which are governed by disparate legal principles"); Balotti & Hanks, *supra* note 12, at 1345 (contending that the business

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fraud, illegality, or self-dealing—were present in this case, as the court acknowledged.[14]

One could perhaps have constructed a self-dealing argument by focusing on the fact that Van Gorkom was very close to the mandatory retirement age and owned 75,000 shares of Trans Union stock.[15] At $55 per share, those shares would be worth over $4 million. On the stock market, the shares had recently traded in a range of $30 to $39 per share.[16] Even at the high end of that range, his shares were worth less than $3 million. One thus could argue that Van Gorkom's large stockholdings and his imminent mandatory retirement meant that he had an incentive to sell the company. The trouble with this argument is that Van Gorkom's incentive clearly is to get the best possible price. The more money the buyer paid for Trans Union, the more money Van Gorkom would have in retirement. Consequently, his self-interest was directly in line with the interests of the shareholders, who presumably also would want the best possible price.

Interestingly, it was not the price but the structure of the transaction to which named plaintiff B. Alden Smith initially objected. Like a number of other Trans Union shareholders, Smith had acquired his stock when a company in which he was a cofounder and major stockholder was acquired by Trans Union in a tax-free reorganization.[17] Smith's Trans Union shares had a very low basis, so the decision to sell the company for cash to a private buyer rather than effecting a stock-for-stock merger with a publicly held buyer, which could have been structured so as to be a non-recognition event for tax purposes, resulted in a very large capital gains tax bill for Smith and his similarly situated fellow shareholders.[18] Unfortunately for Smith, however, the business judgment rule almost certainly would have insulated an informed choice of deal structure from judicial review:

> A complaint which alleges merely that some course of action other than that pursued by the board of directors would have been more advantageous gives rise to no cognizable cause of action. … The directors'

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judgment rule is not a presumption "in the strict evidentiary sense of the term"). This dispute is beyond the scope of this article.

[14] *Van Gorkom*, 488 A.2d at 873 ("Here, there were no allegations of fraud, bad faith, or self-dealing, or proof thereof.").

[15] *Id*. at 865-66.

[16] *Id*. at 865 n.5.

[17] WILLIAM M. OWEN, AUTOPSY OF A MERGER 161-62 (1986). (As discussed below, during the 1960s and 1970s, Trans Union had been an active acquirer of other corporations.)

[18] *Id*. at 161-62.

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> room rather than the courtroom is the appropriate forum for thrashing out purely business questions which will have an impact on profits, market prices, competitive situations, or tax advantages. … That [the directors] may be mistaken, but other courses of action might have differing consequences, or that direction might benefit some shareholders more than others presents no basis for the super imposition of judicial judgment, so long as it appears that the directors have been acting in good faith. [19]

In addition, establishing damages on a class-wide basis is far easier to do in a case based on claims relating to price than to structure. Shareholders with a high tax basis for their shares would be far less injured, if at all, by the choice of form than would Smith and those situated like him.

In any case, despite the absence of fraud, illegality, or self-dealing, the court held that the protection provided by the business judgment rule also is unavailable if the members of the board of directors fail to inform themselves of all material information reasonably available to them.[20] Concluding that the Trans Union board had failed to do so, the court remanded for a damages hearing.

The Target

Two mid-Nineteenth Century technological developments eventually led to the formation of the Trans Union Corporation.[21] The first was the rise of railroads as the principal means of long-distance freight shipping. The second was the discovery of industrial applications for petroleum. The problem thus arose of how to efficiently ship oil from the oil fields to cities and factories via railroad. The existing technology of shipping liquids in 42 gallon wooden barrels was highly labor intensive and potentially dangerous when applied to shipping mass quantities of oil.

In 1869, railroad engineers solved the problem by developing a so-called tank car consisting of a horizontal, cylindrical iron tank of up to 4,200 gallon capacity resting on a railroad flatbed car. Under prevailing practices, which remain in place today, shippers rather than railroads owned the tank cars. By 1878, John D. Rockefeller's Standard Oil Tank Car Trust controlled about 90% of the tank cars

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[19] Kamin v. American Express Co., 383 N.Y.S.2d 807, 810-12, aff'd, 387 N.Y.S.2d 993 (1st Div. 1976) (emphasis supplied).

[20] "Under the business judgment rule there is no protection for directors who have made 'an unintelligent or unadvised judgment.'" *Van Gorkom*, 488 A.2d at 872 (quoting Mitchell v. Highland-Western Glass, Del.Ch., 167 A. 831, 833 (1933)).

[21] Unless otherwise indicated, the facts recounted in this section are taken from the Union Tank Car Company's website, http://www.utlx.com.

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in existence. In 1880, Rockefeller transferred ownership of the Trust's fleet of cars to a then small rail line handling oil shipments to Chicago called the Union Tank Line Company.

As part of the long-running antitrust struggle between Standard Oil and the government, Rockefeller caused the Union Tank Line to be incorporated in July 1891, while retaining it as part of the Standard Oil conglomerate. In 1909, however, federal antitrust litigation resulted in the Union Tank Line Company being spun off from Standard Oil as a publicly traded corporation. The name was changed to Union Tank Car Company in 1919, so as to prevent confusion as to whether the company actually operated a railroad line.

Although Union Tank Car's business included a wide array of services, such as design and manufacturing of tank cars, the core of its business remained leasing cars to shippers. As the company's current website explains: "Full-service railcar leasing has been Union Tank Car's business since 1891."[22] Originally, Union Tank Car leased tank cars only to Standard Oil companies, but eventually it became a leading lessor dealing not only with Standard Oil and other oil companies, but also with manufacturers and shippers of other liquid products that required shipment in tank cars. By the 1970s, Union Tank Car owned the second largest private sector fleet of railroad cars in the world.[23]

In the late 1950s, management of the Union Tank Car decided that the company needed to diversify and began an active program of corporate acquisitions.[24] In 1969, a corporate reorganization was effected to create the Trams Union Corporation as the parent holding company for both Union Tank Car and the other newly acquired subsidiaries.[25]

By the late 1970s, Trans Union's cash flow amounted to hundreds of millions of dollars per year, which left the firm with substantial and growing cash reserves.[26] Despite that seeming good fortune, Trans Union found itself in an unusual tax quandary. Its core railroad car leasing business generated substantial depreciation deductions, which significantly reduced its taxable income.[27] At the same time, however, that business also generated substantial Investment Tax

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[22] *Id.*

[23] OWEN, *supra* note 17, at 3.

[24] *Id.* at 4.

[25] *Id.*

[26] Christian C. Day, *Corporate Governance, Conrail, and the Market*, 26 J. CORP. L. 1, 15(2000).

[27] *Roundtable Discussion: Corporate Governance*, 77 CHI.-KENT L. REV. 235, 256 (2001) (colloquy between Richard Painter, Robert Sitkoff, and Robert Pritzker).

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Credits (ITCs). Under the then-existing law, companies that made certain major capital investments, such as buying railroad cars, received a number of ITCs proportional to the size of the investment. Like most other tax credits, the ITCs allowed a dollar for dollar reduction in a company's tax bill.

Unfortunately for Trans Union, the depreciation deductions generated by its business essentially left the company with no taxable income against which to apply the tax credits. Worse yet, the tax credits had a five year life. If they were not used during those five years, they expired—a classic use 'em or lose 'em situation. Van Gorkom had joined other similarly situated business leaders in lobbying Congress for a change in the tax laws, but without success. According to Van Gorkom's account, Congress was unsympathetic to companies that didn't pay any income tax.[28] In addition, he recounted, the Congressmen with whom he dealt believed "that making the ITC refundable would be rewarding 'losers.' Their attitude was that any company which did not have taxable income probably was not a well run company."[29]

In effect, Trans Union was left with both a large cash surplus and a potentially very valuable asset—the ITCs—that would dissolve one into nothing before its value could be captured. Trans Union management regarded the situation as a "nagging problem" for which they needed a solution.[30] In July 1980, a management report to the board of directors listed such possible solutions as a repurchase of a substantial amount of the outstanding shares of the company, an increase in the dividend, and/or a major acquisition.[31]

The latter option received considerable attention in the late summer of 1980. After all, as noted, Trans Union had been actively acquiring smaller companies for many years. Acquisition of two or three large companies with substantial taxable cash flows would dry up some of Trans Union's substantial cash reserves and provide taxable income against which the ITCs could be offset.[32]

Van Gorkom finally rejected the acquisition option for several reasons. First, despite its many small acquisitions, Trans Union's main business remained railroad car leasing. A major expansion into new lines of business would change the nature of the company and, Van Gorkom worried, could have a negative impact on the company's image in the stock market. Second, the cost of acquisitions sufficiently large to solve the ITC problem would not only exhaust

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[28] OWEN, *supra* note 17, at 27.

[29] *Id.*

[30] *Van Gorkom*, 488 A.2d at 865.

[31] OWEN, *supra* note 17, at 30.

[32] *Id*.

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the company's cash reserves but would also require both taking on additional debt and issuing additional shares of common stock. Van Gorkom believed the effect on the company's balance sheet and earnings per share would be undesirable.[33]

In August of that year, after returning from a particularly discouraging meeting with Congressional leaders and staffers in Washington, Van Gorkom called a meeting with his senior management team in which the possibility of selling Trans Union to a corporation with a large amount of taxable income for the first time began to receive serious consideration.[34] If properly structured, Trans Union's tax attributes would survive such an acquisition, permitting the purchaser to use the ITCs to reduce its tax bill. Accordingly, the purchase price would reflect the otherwise difficult to capture value of those ITCs.

The Dealmakers

Jerome Van Gorkom was born in 1918, received a law degree from the University of Illinois in 1941, served in the U.S. Navy during World War II, and was a partner with the Arthur Andersen accounting firm.[35] Van Gorkom joined Trans Union Corporation in 1956 as Controller and became the firm's Chief Executive Officer in 1963.[36]

> Working hard may be stimulating to Jerome Van Gorkom in a perverse way. Part of it stems from what he calls "a Depression complex." Part of it stems from a Catholic moralist conviction he tries very hard to obscure… And part of it stems from sheer, flat-out impatience. "He's very goal-oriented, and that all translates into a man in a hurry," says Jean Allard, a partner with the law firm Sonnenschein Carlin Nath & Rosenthal …. "He can't put up with the crap that's in the way of getting the result. I really think he thinks every problem can be solved."
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> "A diplomat, he is not," says Wayne McCoy, a partner with the law firm Schiff Hardin & Waite …. "An absolute genius at accomplishing things, he is."[37]

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[33] *Id.* at 30-31.

[34] *Id.* at 31.

[35] Terry Wilson, *Jerome W. Van Gorkom; Revived Schools' Finances,* CHI. TRIB., Mar. 19. 1998.

[36] OWEN, *supra* note 17, at 6.

[37] Marney Keenan, *A Man For All Challenges: Corporations, Embassies, Charities, Civic Institutions—Jerome Van Gorkom Has Managed Them All,* CHI. TRIB., Oct. 2, 1988.

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Among other accomplishments, Van Gorkom was a long time supporter of Chicago's famed Lyric Opera and in 1977, while serving as chairman of the Lyric's board of directors, had averted a threatened shutdown.[38] He also had served as chairman of the Chicago School Finance Authority, which was credited with having saved the city's school system from insolvency.[39]

Van Gorkom's supporting cast at Trans Union included Chief Financial Officer Donald Romans, a 49 year-old Harvard MBA who had been with Trans Union for 18 years, Jack Kruizenga, the 59 year-old head of Union Tank Car, and Bruce Chelberg, Trans Union's 46 year-old President. As for Trans Union's board of directors, it "consisted of ten men, five of whom were 'inside' directors and five of whom were 'outside' directors,"[40] all purportedly individuals of a "caliber" who "are not ordinarily taken in by a 'fast shuffle.'"[41]

Jay Pritzker was a scion of a wealthy and socially prominent family. He was "a precocious student" who enrolled "at Northwestern University when he was only 14 years old."[42] At the equally tender age of 29, he gave up being a lawyer and accountant to begin his career as a corporate acquirer.[43]

Pritzker's first really big break came in 1957. As the tale goes, Pritzker was having a cup of unusually good coffee at Fat Eddie's coffee shop in the Hyatt hotel near the Los Angeles airport. Indeed, the coffee was so impressive that that Pritzker made an immediate offer to buy both the coffee shop and the hotel for $2.2 million. The offer reportedly was written on the spot on a coffee shop napkin, marking the same sort of informality that would cause problems in the subsequent Trans Union litigation. By the late 1970s, Pritzker was the head of his family's extensive business operations, including the flagship Hyatt hotel chain, which were valued at $1.5 billion.[44] The family's Marmon Group, Inc., conglomerate ranked 208th on Fortune's 500 list.[45]

> The Marmon Group name was adopted in 1964 after the acquisition of the Marmon-Herrington Company, successor to the Marmon Motor Car

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[38] *Id.*

[39] *Id.*

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

[41] *Id.*

[42] OWEN, *supra* note 17, at 7.

[43] Anthony Ramirez, *Jay Pritzker, Who Built Chain Of Hyatt Hotels, Is Dead at 76*, N.Y. TIMES, Jan. 25, 1999, at A21.

[44] OWEN, *supra* note 17, at 7.

[45] *Id.*

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> Company. An early 20th century producer of fine passenger automobiles, Marmon also manufactured the car that won the first Indianapolis 500 race in 1911.
>
> With the 1976 acquisition of Cerro Corporation, combined revenues for Marmon Group member businesses doubled to nearly $1 billion and the organization grew more diverse. By this time, member companies manufactured products including automotive equipment, metal products and materials, electrical and electronic wire and cable, retail store fixtures and more. The 1981 acquisition of Trans Union Corporation added businesses that manufacture and lease railroad tank cars, provide consumer credit information and produce water purification systems, fasteners and other products. Combined revenues that year approached $3 billion.[46]

Both Van Gorkom and Pritzker thus were prominent Chicago businessmen and philanthropists. They had served together on the school finance board. According to Robert Pritzker, Jay's brother and right hand man, moreover, they also "knew each other from skiing in Vail, and had skied together a lot."[47] When Van Gorkom needed a buyer for Trans Union, Pritzker must have seemed a logical candidate.

The Deal

On Saturday, September 20, 1980, Van Gorkom hosted a gala party at the 25th floor penthouse of the Trans Union building in Chicago to celebrate the opening of the Lyric Opera's 26th season at Chicago's Civic Opera House.[48] As noted, Van Gorkom was a long time supporter of the Lyric Opera, and his annual opening night parties were a major feature of the Chicago social circuit.[49]

Jay Pritzker was one of Van Gorkom's guests at the party. At some point in the course of the evening, Van Gorkom and Pritzker slipped out of the party and signed an agreement under which Pritzker would buy out Trans Union's shareholders at $55 per share in cash.[50] At that point in time, only two of Van

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[46] *The Marmon Group—Then*, http://www.marmon.com/History.asp?his=true&About=true.

[47] Roundtable, supra note 27, at 239.

[48] OWEN, *supra* note 17, at 1.

[49] *Id.*

[50] *Id.* at 2.

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Gorkom's subordinates and none of Trans Union's outside board members were even aware that a sale to Pritzker was in the works.[51]

The agreement contemplated that Trans Union would be merged into a newly formed subsidiary of Marmon. In a merger, two corporations combine to form a single entity. Suppose, for example, Acme Company and Ajax Corporation are about to combine via merger. Their merger is effected by filing the requisite documentation—so called "articles of merger"—with the appropriate state agency (in Delaware, where Trans Union was incorporated, it is the Division of Corporations).

After the merger, only one of the two companies will survive, but the survivor will have succeeded by operation of law to all of the assets, liabilities, rights, and obligations of the two constituent corporations.[52] The shares of each constituent corporation are thereupon converted into whatever consideration was specified in the merger agreement and the former shareholders of the constituent corporations are entitled only to the rights provided them in the merger agreement or by statute.[53]

The substance of the deal was a leveraged buyout. Pritzker would borrow funds from investment bankers, using the proceeds to buy the existing Trans Union shareholders' stock. The company's cash flow and the ITCs would help Pritzker repay the loans. At the agreed upon price of $55 per share, Pritzker would be able to substantially repay that debt out of Trans Union's projected net cash flow within just 5 years.[54]

The Legal Context

Two conceptions of the business judgment rule compete in the case law. One views the business judgment rule as a standard of liability under which courts undertake some objective review of the merits of board decisions. The other views the rule as a principle of abstention, pursuant to which courts decline to review board decisions so long as certain preconditions are satisfied.[55]

The differences between these conceptions matter a great deal. Under the former, for example, it is far more likely that claims against the board of directors

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[51] *Id*.

[52] Del. Gen. Corp. L. § 251.

[53] *Id.*

[54] *Van Gorkom*, 488 A.2d at 892.

[55] Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 87 (2004).

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will survive through the summary judgment phase of litigation, which at the very least raises the settlement value of shareholder litigation and even can have outcome-determinative effects.[56]

Choosing between these two competing conceptions requires one to begin by recognizing that the defining tension of corporate law is that between authority and accountability.[57] Because one cannot make directors more accountable without infringing on their exercise of authority, courts must be reluctant to review director decisions absent evidence of the sort of self-dealing that raises very serious accountability concerns.[58] The abstention version of the business judgment rule properly operationalizes this approach, by creating a balance pursuant to which directors are given substantial decision-making authority, but are not allowed to put their own interests ahead of those of the shareholders.

Properly understood, the business judgment rule gives boards of directors wide discretion to make decisions that might turn out badly, but no discretion to make selfish decisions. This balance is reflected in the various preconditions courts have identified that must be satisfied before directors may avail themselves of the rule's protection.

An exercise of judgment. The business judgment rule is relevant only where directors have actually exercised business judgment. A decision to refrain from action is protected just as much as a decision to act, but there is no protection where directors have made no decision at all.[59] Instead, the consequences of inaction are subject to review under the duty of care.[60]

Disinterested and independent decision makers. The business judgment rule "presupposes that the directors have no conflict of interest."[61] Hence, self-dealing is one of the classic triad of ways in which the business judgment rule's

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[56] *Id.* at 101.

[57] *Id.* at 103.

[58] *Id.* at 103-04.

[59] *See, e.g.,* Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984) ("the business judgment rule operates only in the context of director action"); *see also* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 943 (Del. 1985) (holding that "an informed decision to delegate a task is as much an exercise of business judgment as any other").

[60] *See, e.g.,* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963); In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959 (Del. Ch. 1996). For criticism of Delaware law on this point, see Stephen M. Bainbridge et al., *The Convergence of Good Faith and Oversight*, 55 UCLA L. REV. 559 (2008).

[61] Lewis v. S. L. & E., Inc., 629 F.2d 764, 769 (2d Cir. 1980).

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presumptions are rebutted.[62] "A director is interested if he will be materially affected, either to his benefit or detriment, by a decision of the board, in a manner not shared by the corporation and the shareholders."[63] Consequently, for example, a director who sells or leases property to or from the corporation is interested in that transaction.[64] Similarly, a director who contracts to provide services to the corporation is interested in that transaction.[65]

Directors also can be interested in a transaction by virtue of indirect connections. In *Bayer v. Beran,*[66] for example, the corporation hired the wife of its president. Their spousal relationship gave the president an indirect interest in the transaction. Similarly, in *Globe Woolen Co. v. Utica Gas & Electric Co.*,[67] a director of the defendant was also the president and chief stockholder of the plaintiff. By virtue of those business relationships, he was deemed interested in the transaction even though he was not a party to the contract.

In addition to lacking a personal interest in the transaction in question, a director must be independent of anyone having such an interest.[68] "A director is independent if he can base his decision 'on the corporate merits of the subject before the board rather than extraneous considerations or influences.'"[69] In particular, a director who is beholden to, or under the influence of an interested party, lacks the requisite independence.[70]

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[62] Shlensky v. Wrigley, 237 N.E.2d 776, 778 (Ill. App. 1968).

[63] Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. 1995). *See also* In re RJR Nabisco, Inc. Shareholders Litig., 1989 WL 7036 at *14 (Del. Ch. 1989) (holding that a disqualifying interest "is a financial interest in the transaction adverse to that of the corporation or its shareholders").

[64] *See, e.g.*, Lewis v. S. L. & E., Inc., 629 F.2d 764 (2d Cir.1980).

[65] *See, e.g.*, Talbot v. James, 190 S.E.2d 759 (S.C.1972).

[66] 49 N.Y.S.2d 2 (Sup. Ct. 1944).

[67] 121 N.E. 378 (N.Y. 1918). Consequently, directors are deemed to be interested when they "stand in a dual relation which prevents an unprejudiced exercise of judgment." Stoner v. Walsh, 772 F. Supp. 790, 802 (S.D.N.Y. 1991) (quoting United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 264 (1917)).

[68] *See, e.g.*, Rales v. Blasband, 634 A.2d 927, 935 (Del. 1993) ("the board must be able to act free of personal financial interest and improper extraneous influences").

[69] Seminaris v. Landa, 662 A.2d 1350, 1354 (Del. 1995) (quoting Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984)).

[70] *See* In re MAXXAM, Inc., 659 A.2d 760, 773 (Del. Ch. 1995) ("To be considered independent a director must not be 'dominated or otherwise controlled by an individual or entity interested in the transaction.' ").

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Where the board has acted collectively, it is not enough to show that a single director was interested or lacked independence. The business judgment rule will still insulate the board's decision from judicial review unless plaintiff can show that a majority of the board was interested and/or lacked independence.[71] In order to prove that the directors were not independent, plaintiff must establish personal or business relationships by which the directors are either beholden to or controlled by the interested party.[72]

Absence of fraud or illegality. The business judgment rule will not insulate from judicial review decisions tainted by fraud or illegality.[73] The key issue in this context is whether the board has a duty to act lawfully.[74] In the oft-cited *Miller v. American Telephone & Telegraph Co.*[75] decision, the Third Circuit held that directors have such a duty. AT & T failed to collect a debt owed it by the Democratic National Committee for telecommunications services provided during the 1968 Democrat Party's convention. Several AT & T shareholders brought a derivative suit against AT & T's directors, alleging that the failure to collect the debt violated both federal telecommunications and campaign finance laws. Ordinarily, a board decision not to collect a debt would be protected by the business judgment rule.[76] Citing a 1909 New York precedent,[77] however, the

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[71] *See* Odyssey Partners, L.P. v. Fleming Cos., Inc., 735 A.2d 386, 407 (Del. Ch. 1999).

[72] *See* Aronson v. Lewis, 473 A.2d 805, 815 (Del. 1984); *see also* Odyssey Partners, L.P. v. Fleming Cos., Inc., 735 A.2d 386, 407 (Del. Ch. 1999). In Kahn v. Tremont Corp., 694 A.2d 422 (Del. 1997), a committee of nominally independent directors approved a corporate acquisition. Two of the three directors were wholly passive, acquiescing in the decisions of the committee chairman, who had a significant financial relationship with a controlling shareholder. The directors' decision was not protected by the business judgment rule.

[73] *See, e.g.*, Shlensky v. Wrigley, 237 N.E.2d 776, 778 (Ill. App. 1968); *see also* Cottle v. Storer Communication, Inc., 849 F.2d 570, 575 (11th Cir. 1988) (holding that the business judgment rule protects directors "from liability absent a clear showing of fraud, bad faith or abuse of discretion").

[74] Note that the issue here is distinct from the problem of board oversight discussed above. In oversight cases, corporate employees have committed some criminal act and the board is charged with having failed to prevent those acts. Here we ask a different question; namely, what happens when the board affirmatively instructs its subordinates to violate the law?

[75] 507 F.2d 759 (3d Cir. 1974) (diversity case arising under New York corporation law).

[76] *Id.* at 762.

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Third Circuit held that the business judgment rule did not insulate defendant directors from liability for illegal acts "even though committed to benefit the corporation."[78]

Rationality. In *Sinclair Oil Corp. v. Levien*,[79] the Delaware Supreme Court held that so long as the board's decision could be attributed to any rational business purpose the business judgment rule precluded the court from substituting its judgment as to the merits of the decision for those of the board.[80] Similarly, in *Brehm v. Eisner*,[81] the court held that the business judgment rule does not apply when the board has "act[ed] in a manner that cannot be attributed to a rational business purpose."[82]

The reference to a "rational business purpose," properly understood, does not contemplate substantive review of the decision's merits. "*Sinclair*'s use of [the word] rational is to be equated with conceivable or imaginable and means only that the court will not even look at the board's judgment if there is any possibility that it was actuated by a legitimate business reason. It clearly does not mean, and cannot legitimately be cited for the proposition, that individual directors must have, and be prepared to put forth, proof of rational reasons for their decisions."[83] Consequently, as former Delaware Chancellor William Allen explained:

> [W]hether a judge or jury, considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational," provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. To employ a different rule—one that permitted an "objective" evaluation of the decision—would expose directors to substantive second

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[77] Roth v. Robertson, 118 N.Y.S. 351 (Sup. Ct. 1909).

[78] *Miller*, 507 F.2d at 762. *See also* Abrams v. Allen, 74 N.E.2d 305 (N.Y. 1947) (directors can be sued where they used corporate property to commit "an unlawful or immoral act"); Di Tomasso v. Loverro, 12 N.E.2d 570 (N.Y. App. 1937) (directors liable for entering into a contract that was an illegal restraint of trade).

[79] Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971).

[80] *Id.* at 720.

[81] Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[82] *Id.* at 264 n. 66

[83] Michael P. Dooley, Two Models of Corporate Governance, 47 Bus. Law. 461, 478-79 n.58 (1992).

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> guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests.[84]

Instead, as Chancellor Allen observed elsewhere, "such limited substantive review as the rule contemplates (i.e., is the judgment under review 'egregious' or 'irrational' or 'so beyond reason,' etc.) really is a way of inferring bad faith."[85]

The Opinion

Of all the preconditions that must be satisfied in order for the business judgment rule to insulate a board of director decision from judicial review the most important is the requirement that the decision be an informed one. Put another way, the board of directors must exercise what has been called "process due care."[86] Accordingly, the *Van Gorkom* opinion explained that "[i]n the specific context of a proposed merger of domestic corporations, a director has a duty … along with his fellow directors, to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders."[87] The court further explained that "[t]he determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'"[88] Finally, the directors' failure to do so must rise to the level of gross negligence.[89]

In the course of its opinion, the court therefore focused closely on issues of board process. Accordingly, it will be helpful to identify the various specific

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[84] In re Caremark International Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996).

[85] In re RJR Nabisco, Inc. Shareholders Litig., 1989 WL 7036 at *13 n. 13 (Del. Ch. 1989).

[86] Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000) ("Due care in the decisionmaking context is process due care only."; emphasis in original); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 66 (Del. 1989) (stating that "our due care examination has focused on a board's decision making process"); In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (stating that "compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed").

[87] *Van Gorkom*, 488 A.2d at 873 (citation and footnote omitted).

[88] *Id.* at 872 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

[89] *Id.* at 873.

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process failures committed by Van Gorkom, his subordinates, and the Trans Union board of directors.

Consultations. During his negotiations with Pritzker, Van Gorkom consulted only with Trans Union's controller (Peterson).[90] Worse yet, once he told other senior managers about the impending deal, their initial reaction was strongly negative.[91] In particular, Romans (Trans Union's CFO) objected that the price was too low, the transaction would have adverse tax consequences for some shareholders, and an option given Pritzker to buy Trans Union shares amounted to a "lock-up" that would inhibit competing offers.[92] Such evidence likely proved quite damning in the court's own decision-making process. Having evidence in the record of these types of internal disagreements obviously raised questions about the fairness of the transaction. The take-away lesson is that dealmakers should, early in the process, consult with senior management and get them "on board." In addition, Van Gorkom would have been well-advised to consult in advance with the board of directors and kept them informed as to the progress of the negotiations.

Setting the price. When selling an entire business, whether the sale is nominally structured as a merger or not, the board of directors "must focus on one primary objective—to secure the transaction offering the best value reasonably available for all stockholders."[93] In his negotiations with Pritzker, it was Van Gorkom who proposed the price of $55.[94] In evaluating the potential for a management-sponsored leveraged buyout, Romans and Chelberg had earlier determined that such a buyout would be easy at a price of $50 but very difficult at a price of $60.[95] Van Gorkom then seemingly split the difference, picking $55 out of the air as a price he would accept for his shares.[96]

The court emphasized that the price thus was based on an evaluation of the feasibility with which a leveraged deal could be financed, rather than Trans Union's "intrinsic value."[97] The court's analysis in this regard is seriously flawed.

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[90] *Van Gorkom*, 488 A.2d at 866.

[91] OWEN, *supra* note 17, at 63 (describing top managers as "stunned").

[92] *See id.* at 67 (noting that "Romans was the most vocal participant" at a management meeting held to discuss the offer).

[93] McMullin v. Beran, 765 A.2d 910, 918 (Del. 2000).

[94] *Van Gorkom*, 488 A.2d at 866.

[95] *Id.* at 865.

[96] *Id.*

[97] *See id.* at 874 (noting that the directors "were uninformed as to the intrinsic value of the Company").

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As with any other asset, a company is worth only what somebody is willing to pay for it. Although the company's only value thus is its market value, an asset can have different values in different markets. (Otherwise, arbitrage would never be profitable.) Two distinct markets are implicated in this setting. On the one hand, there is the ordinary stock market in which Trans Union's shares trade. On the other, however, there is the market for corporate control. Prices in the latter market typically exceed those in the former. Hence, we speak of a "control premium" that is paid when someone buys all of the shares of a company's stock.[98]

Trans Union's board made no effort to determine what control was worth to Pritzker, such as by ordering a valuation study, and in the absence of such a determination had no basis for deciding whether the price was a fair one. Put another way, the real issue, which is not well-framed in the majority opinion, is what the firm was worth to Pritzker and, accordingly, whether the board of directors did a good job in capturing that value on behalf of their shareholders. Roman's and Chelberg's estimate suggested that a price of up to $60 per share feasibly could be financed, albeit with some difficulty.

The difference between $60 and the $55 Pritzker agreed to pay is only $5 per share, but $5 per share times roughly 12.5 million outstanding shares works out to about $63 million, which is not chump change. Moreover, CFO Romans reportedly came to believe that Trans Union could fetch up to $65 per share,[99] suggesting the potential for an even larger damage claim.

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[98] Some scholars contend that the control premium is also attributable to a purportedly downward sloping demand curve for corporate stock. *See, e.g.*, Richard A. Booth, *The Efficient Market, Portfolio Theory, and the Downward Sloping Demand Hypothesis*, 68 N.Y.U L. REV. 1187 (1993); Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475 (1997); Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235 (1990). The existence of a control premium, however, is not inconsistent with efficient capital markets theory. Stock consists of two rights: economic and voting. A single share of stock gives the owner little control over the company. The market price of a single share of stock thus reflects nothing more than the estimated present value of the future stream of dividends payable on that share. Someone buying all, or even just a majority, of the stock, however, obviously gets significant control through his ability to elect the board of directors. Hence, their willingness to pay a control premium. They can use their control either to extract personal benefits from the corporation and/or tweak corporate policies in ways they believe will make the firm more profitable.

[99] OWEN, *supra* note 17, at 67.

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Although the court explicitly stated that boards are not obliged to hire outside financial experts, investment bankers in fact do valuation and feasibility studies for a living.[100] The well-advised board thus obtains a fairness opinion that, at least in theory, gives them some basis for evaluating what the prospective buyer could afford, and would be willing, to pay. Not surprisingly, *Van Gorkom* is sometimes referred to as the "Investment Bankers' Full Employment Act."[101]

The target directors claimed that they had satisfied their duty to be informed about the pricing issue because the original merger agreement and subsequent amendments allowed the target to escape the merger agreement with Pritzker if a competing bidder made a higher offer. Specifically, the board claimed that it placed two conditions on its acceptance of the original merger agreement: "(1) that [the target] reserved the right to accept any better offer that was made during the market test period; and (2) that [the target] could share its proprietary information with any other potential bidders."[102] The board also noted that it later amended the merger agreement to allow active solicitation of competing bids and termination of the agreement with Pritzker if the board either consummated a merger or asset sale with a third party or entered a definitive acquisition agreement on more favorable terms within a specified time period.[103] Finally, the board noted that it hired an investment banker to solicit other bids, but no firm offer materialized. In other words, the board argued that any deficiencies in its original decision were cured by a subsequent search for competing bids—the so-called market test.[104]

The court rejected this line of argument on several grounds. First, it concluded that the original merger agreement did not in fact permit the board to terminate

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[100] *Van Gorkom*, 488 A.2d at 876 ("We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law.").

[101] *See, e.g.*, Park McGinty, *The Twilight of Fiduciary Duties: On the Need For Shareholder Self-Help in an Age of Formalistic Proceduralism*, 46 EMORY L.J. 163, 193 n.42 (1997); *see also* William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It*, 70 WASH. U. L.Q. 523, 527 (1992) (opining that *Van Gorkom* "could be called the Investment Bankers' Civil Relief Act of 1985").

[102] *Van Gorkom*, 488 A.2d at 869.

[103] *Id*. at 881-84.

[104] *Id*. at 878. Trans Union also argued that the reasonableness and fairness of Pritzker's $55 per share price was confirmed by the market test. *Id*. The court, however, rejected this reasoning by ordering the trial court on remand to determine whether Trans Union's "intrinsic value" on September 20, 1980 exceeded $55 per share and to award damages based on any resulting differential. *Id*. at 893.

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the merger agreement if a higher offer emerged.[105] Second, in its view, the amendments, especially in light of the surrounding circumstances, did not permit a meaningful market test.[106] The board could no longer withdraw simply because a better offer was received. For one thing, a requirement that Trans Union use its best efforts to mail a proxy statement relating to Pritzker's offer by early January effectively shortened the market test period. For another, the announcement that Pritzker had exercised the lock-up option and had completed financing may have deterred other bidders.[107] Third, the court apparently believed that actions by Van Gorkom and other Trans Union insiders during the market test period may have chilled the bidding process. In December 1980, the investment firm of Kravis, Kohlberg & Roberts (KKR) proposed, subject to obtaining necessary financing, a leveraged buyout of Trans Union for consideration equivalent to $60 per share. KKR withdrew the offer before the board had an opportunity to consider it, purportedly because Kruizenga declined to participate.[108] General Electric Credit Corporation also made an acquisition proposal, which was withdrawn because Pritzker refused to grant an extension of the planned Trans Union shareholders meeting.[109] Finally, the package of merger agreements included a stock lock-up, a best efforts clause, and a no-shop covenant. The lock-up gave Pritzker an option, subsequently exercised, to purchase one million treasury shares of Trans Union stock (Trans Union had approximately 12 million shares outstanding) at $38 per share—75 cents over the then market price, but $17 below the merger price.[110] The best efforts clause required Trans Union's board to recommend the merger to its shareholders, subject to a fiduciary out.[111] Taken together, these provisions may have discouraged competitive bidding.

To be clear, the Court did not require a target board to shop the company among competing bidders in order to satisfy its duty of care. Rather, the gist of the opinion is that a target board must have some credible basis for determining that a proposed merger is in the best interest of shareholders. An unfettered market test is merely one means of satisfying the board's duties. As we have seen, determination of the firm's "intrinsic value," preferably in the form of a fairness

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[105] *Id.* at 880.

[106] *Id*. at 885.

[107] *Id*. at 881-84.

[108] *Id*. at 884-85.

[109] *Id*.

[110] *See id*. at 864 n.3, 883.

[111] *See id*. at 879.

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opinion by an independent financial expert, is another. Other alternatives may be available, as well.

Negotiations. Van Gorkom's negotiations with Pritzker appear to have been less than rigorous. Van Gorkom asked for a meeting, at which he basically said "if you'll pay $55, here's how you can finance the deal."[112] Pritzker counter-offered with $50 per share, which Van Gorkom rejected.[113] Pritzker then agreed to $55.[114] Pritzker's quick acceptance of the price suggests that he thought he was getting a bargain, which enhances our questions about the adequacy of the price.

In fairness, however, Pritzker's brother and successor Robert Pritzker later claimed that "from our point of view" $55 per share "didn't look like such a slam dunk. We had a huge loan against it, and for the first couple of years I thought we may have made a mistake."[115]

Time pressures. According to the court's opinion, Pritzker imposed a tight time deadline on the negotiations in order to prevent leaks and the increased stock price that usually follows such leaks.[116] According to Robert Pritzker's subsequent account, however, the timetable was initiated by Van Gorkom.[117]

In any case, the process in fact went quite quickly and many decisions were made under significant time constraints. All of which evidently troubled the court, as it several times noted that there was no crisis or emergency justifying such speed.

Does *Van Gorkom* thus imply that the board can never make quick decisions? Probably not. The speed with which the decision was made likely would have been unobjectionable if the process was otherwise adequate. A cautionary note is sounded, however, by the Delaware Supreme Court's subsequent observation that: "History has demonstrated boards 'that have failed to exercise due care are frequently boards that have been rushed.'"[118]

Information. The central issue in *Van Gorkom* was the board's failure to make an informed decision. The legal standard that emerges from the decision is straightforward—directors who are grossly negligent in failing to inform

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[112] *See* OWEN, *supra* note 17, at 43-44 (describing Van Gorkom's negotiating strategy).

[113] *Id.* at 50.

[114] *Id.*

[115] Roundtable, *supra* note 27, at 237.

[116] *Van Gorkom*, 488 A.2d at 875.

[117] Roundtable, *supra* note 27, at 236.

[118] McMullin v. Beran, 765 A.2d 910, 922 (Del. 2000).

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themselves of all material information reasonably available to them breach their fiduciary duty of care and get no protection from the business judgment rule.[119] The Delaware Supreme Court subsequently defined the term "material" in this context as "relevant and of a magnitude to be important to directors in carrying out their fiduciary duty of care in decisionmaking."[120]

The *Van Gorkom* standard thus seemingly requires an in-depth study of the problem. The board must be fully informed of facts relevant to the company's value to the bidder, the course of the negotiations, the terms of the offer and their fairness, and the like.

This standard arguably is too demanding. Information is costly and shareholders will only want managers to invest an additional dollar in gathering information where there is an additional dollar generated from better decision making.[121] In contrast to *Van Gorkom*, consider the American Law Institutes' (ALI) Principles of Corporate Governance, which require only that directors be informed to the extent that they reasonably believe to be appropriate under the circumstances.[122] Unlike the Delaware standard, at least as read literally, the ALI standard permits directors to make decisions on less than all reasonable available information, provided they reasonably believe doing so is appropriate given the situation. The time available to make the decision may require that the directors take risks to secure what appears to be a good outcome, which includes the risk that they do not have all of the relevant facts. A decision to accept that risk in order to secure the benefits of a proposed transaction will be appropriate under some circumstances.

Stepping on the board's prerogatives. Modern corporation statutes give primary responsibility for negotiating a merger agreement to the target's board of directors. The initial decision to enter into a negotiated merger transaction is reserved to the board's collective business judgment, shareholders having no

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[119] *Van Gorkom*, 488 A.2d at 872. *See also* Washington Bancorporation v. Said, 812 F. Supp. 1256, 1269 (D.D.C. 1993); Estate of Detwiler v. Offenbecher, 728 F. Supp. 103, 150 (S.D.N.Y. 1989).

[120] Brehm v. Eisner, 746 A.2d 244, 259 n.49 (Del. 2000).

[121] *Cf*. In re RJR Nabisco, Inc. S'holders Litig., 1989 WL 7036 (Del. Ch. 1989), in which Chancellor Allen observed that "information has costs." *Id*. at *19. He further opined "that the amount of information that it is prudent to have before a decision is made is itself a business judgment of the very type that courts are institutionally poorly equipped to make." *Id.*

[122] AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 4.01(c)(2) (1994).

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statutory power to initiate merger negotiations.[123] The board also has sole power to negotiate the terms on which the merger will take place and to arrive at a definitive merger agreement embodying its decisions as to these matters.[124]

As we've seen, Van Gorkom had a reputation for being an undiplomatic man in a hurry. He seems to have been something of an autocrat who made decisions in a solitary, rather than consultative, fashion. Some might suggest that strong leadership, quick action and avoidance of red tape make the business world work better or, at least, that it should be permissible for directors of particular companies to allow them to be run under such a philosophy. The *Van Gorkom* majority, however, seemingly had little regard for so-called imperial CEOs like Van Gorkom. To the contrary, the court clearly concluded that the Trans Union board had abdicated its role as a deliberative, decision-making body. One message of this case therefore is that the firm's management should take steps to assure that decisions at least appear to have been made by directors who were fully informed and consulted.

In practice, of course, there are significant limitations on the board's ability to conduct the details of a negotiation or even to gather primary sources of information about the deal. Nobody—not even the *Van Gorkom* court—seriously expects boards to read merger agreements cover to cover.[125] Reading long and boring legal documents is what boards pay their lawyers and subordinates to do. Under the circumstances, however, Trans Union's directors had a duty of inquiry. Considering the haste and other circumstances surrounding the decision, they should have pressed Van Gorkom with regard to the details of the deal. Instead, the board blindly relied on Van Gorkom's assertion that the price was fair. Van Gorkom failed to disclose, and the board failed to make sufficient inquiry to discover, key facts suggesting that the deal was not as attractive as it might seem on first blush.[126]

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[123] *Van Gorkom*, 488 A.2d at 873.

[124] Del. Gen. Corp. L. § 251(b).

[125] *Van Gorkom*, 488 A.2d at 883 n.25 ("We do not suggest that a board must read *in haec verba* every contract or legal document which it approves . . . ."). On the other hand, it's been said that if Van Gorkom had just "read the damn merger agreement, this [litigation] might not have happened." *Roundtable: The Legacy of Smith v. Van Gorkom*, DIRECTORS & BOARDS, Spr. 2000, at 28, 29 (comments of Robert Troubh).

[126] Although Delaware law provides that the directors are fully protected in relying in good faith on reports made by officers, Del. Code Ann., tit. 8, § 141(e), that protection was unavailable here. Van Gorkom's oral presentation was not a "report" because Van Gorkom himself was uninformed as to the details of the plan. *Van Gorkom*, 488 A.2d at 874-75.

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In other words, the formal structure of the corporate governance system vests most decision-making power in the board of directors, especially with regard to major corporate changes such as a merger. Facts tending to suggest that senior officers are trying to railroad a decision through the board therefore are inconsistent with that model. Unfortunately for Trans Union's directors, the Van Gorkom record was rife with such facts.

Empirical studies of real world board processes have found wide variances. Some boards exhibit substantial diligence. Such boards research issues, participate actively in discussion, and exercise critical judgment. Other boards, however, simply go through the motions of showing up and voting, without having done their homework.[127]

The Delaware Supreme Court concluded that the Trans Union directors fell into the latter category. To be sure, as we've seen, the directors were all experienced, highly qualified businesspeople. One might therefore reasonably ask why their experience and general knowledge both about the firm in general and the "nagging problem" in particular was not a sufficient basis for the decision. Put another way, based on what they knew, couldn't the board reasonably have determined that the deal Van Gorkom had struck simply was too good to pass up? The short answer seems to be that good resumes will not outweigh a distorted process. According to the court, the board was "grossly negligent in approving the 'sale' of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency."[128]

How should corporate law encourage boards to exercise due diligence in the decision-making process? Should the corporate statute specify board procedures, for example? In general, corporation codes do not mandate detailed rules of board process or procedure. How the board sets its agenda, whether formal voting rules are observed, and other matters of parliamentary procedure are left to the board's discretion. Yet, there are lots of theoretical reasons—such as Arrow's Impossibility Theorem[129]—to think that the procedural rules for aggregating individual preferences have outcome determinative effects. Laboratory

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[127] Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-making Groups*, 24 ACAD. MGMT. REV. 489, 494 (1999).

[128] *Van Gorkom*, 488 A.2d at 874.

[129] According to Arrow's Theorem, there is no consistent method of making a fair choice among three or more options. As a result, when individual preferences differ, the outcome of a decision-making process will be determined by the process itself. Kenneth J. Arrow, *A Difficulty in the Concept of Social Welfare*, 58 J. POL. ECON. 328 (1950).

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experiments on group decision making, such as studies of mock juries, confirm that procedural matters such as the taking of straw votes and the setting of agendas do affect outcomes.[130] To be sure, it is doubtful whether ex ante legislative solutions would be viable given the complexities and uncertainties of life. Ex post judicial review of board process may be beneficial, however.

Consistent with that hypothesis, *Van Gorkom* rests not on failure to comply with some judicially imposed decision-making model but on the absence of a sufficient record of any deliberative process. Put differently, if the decision-making process is adequate, the court will continue to defer to the decision that emerges from that process. The basic thrust of the opinion then is that the board must provide some credible, contemporary evidence that it knew what it was doing. If such evidence exists, the court will not impose liability—even if the decision proves to have been the wrong one.

By so focusing its opinion, the *Van Gorkom* court arguably created a set of incentives consistent with the teaching of the literature on group decision making. The decision disfavors agenda control by senior management. The decision penalizes boards that simply go through the motions. The decision encourages inquiry, deliberation, care, and process. The decision strongly encourages boards to seek outside counsel and financial advice, which is consistent with evidence that groupthink can be prevented by outside expert advice and evaluations.[131] Even the court's criticism of the board's willingness to take action after a single meeting is consistent with suggestions that a "second-chance meeting" also helps prevent groupthink.

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[130] Mock juries reviewing the same evidence, for example, regularly reach differing verdicts. *See* James H. Davis, *Some Compelling Intuitions about Group Consensus Decisions, Theoretical and Empirical Research, and Interpersonal Aggregation Phenomena: Selected Examples, 1950-1990*, 52 ORG. BEHAV. & HUMAN DECISION PROCESSES 3, 23-33 (1992) (summarizing studies); *see also* Robert C. Erffmeyer & Irving M. Lane, *Quality and Acceptance of an Evaluative Task: The Effects of Four Group Decision-Making Formats*, 9 GROUP & ORG. STUD. 509 (1984) (finding that decision-making formats have predictable effects on quality of decision). One possible explanation for such divergences is the effect of agenda control. A well known study, for example, concluded that setting a specific agenda affected an airplane club's decision as to which plane to buy. Charles R. Plott & Michael E. Levine, *A Model of Agenda Influence on Committee Decisions*, 68 AM. ECON. REV. 146 (1978); Michael E. Levine & Charles R. Plott, *Agenda Influence and its Implications*, 63 VA. L. REV. 561 (1977). Such agenda research confirms that both the way the decision is cast and the sequence in which issues are taken up affect the outcomes of such decisions.

[131] *See generally* IRVING JANIS, L. GROUPTHINK (2d ed. 1982) (discussing solutions for groupthink).

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The Short-Term Legacy

It is often said that, absent the protections of the business judgment rule, no rational person would agree to serve as a director. Especially with respect to large public corporations, the potential liability of directors takes on catastrophic dimensions.[132] After *Smith v. Van Gorkom*, D&O liability insurance became very hard to get.[133] Delaware responded to this purported crisis by adopting § 102(b)(7) of the General Corporation Law, which provides that a corporation's articles of incorporation may (but need not) contain:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title [relating to liability for unlawful dividends]; or (iv) for any transaction from which the director derived an improper personal benefit.

Most public corporations have amended their charters to include such provisions.

Several aspects of the Delaware statute seem especially noteworthy.[134] First, it applies only to directors. Although officers also are subject to a duty of care, they are denied exculpation by charter provision.[135]

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[132] No less a jurist than Learned Hand endorsed this concern. *See* Barnes v. Andrews, 298 F. 614, 617 (S.D.N.Y. 1924) ("No men of sense would take the office, if the law imposed upon them a guaranty of the general success of their companies as a penalty for any negligence."); *see also* Solimine v. Hollander, 19 A.2d 344, 348 (N.J. Ch. 1941) (indemnification of expenses required so as to encourage responsible persons to serve). This view, however, seems inconsistent with the notion that a sufficiently high return will induce even risk averse persons to take on a risky job. It's also inconsistent with the evidence that outside directors have minimal real liability exposure. *See* Bernard Black et al., *Outside Director Liability*, 58 STAN L. REV. 1055, 1121 (2006) (summarizing studies).

[133] *See generally* Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 DEL. J. CORP. L. 1 (1989).

[134] For commentary on § 102(b)(7) and comparable statutes, see Deborah A. DeMott, *Limiting Directors' Liability*, 66 WASH. U. L.Q. 295 (1988); Harvey Gelb, *Director Due Care Liability: An Assessment of the New Statutes*, 61 TEMPLE L. REV. 13 (1988); Marc I. Steinberg, *The Evisceration of the Duty of Care*, 42 SW. L.J. 919 (1988).

[135] In Arnold v. Society for Savings Bancorp, Inc., 650 A.2d 1270 (Del. 1994), the supreme court held that, as to a defendant who is both a director and an officer, an

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Second, the statute limits only the monetary liability of directors. Equitable remedies are still available. Because the real party in interest in many shareholder suits is the plaintiff's attorney rather than the shareholders, and because attorneys' fees can be recovered in connection with equitable remedies, § 102(b)(7) does not eliminate the incentive to bring shareholder litigation.

Third, the Delaware Supreme Court held in *Emerald Partners* that a § 102(b)(7) provision is an affirmative defense.[136] Defendant directors thus have the burden of proving that they are entitled to exculpation under the statute. If aggressively applied, *Emerald Partners* could mean that a § 102(b)(7) provision will rarely entitle directors to a dismissal on grounds that plaintiff's complaint fails to state a cause of action. Consequently, plaintiffs could be entitled to discovery, in which case the settlement value of such claims will go up. Thus far, however, the chancery court has continued to hold a § 102(b)(7)-based motion to dismiss is appropriate pre-discovery where plaintiff solely alleged violations of the duty of care.[137]

Finally, notice that the statute apparently distinguishes self-dealing ("improper personal benefit") from the duty of care. Chancellor Allen has suggested that *Van Gorkom* itself can be interpreted as a loyalty case.[138] Similarly, the Delaware Supreme Court has opined that *Van Gorkom* included a disclosure violation and implied that such violations have a loyalty component.[139] Ironically, a § 102(b)(7)

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exculpatory § 102(b)(7) provision applies only to actions taken solely in his capacity as a director.

[136] Emerald Partners v. Berlin, 726 A.2d 1215, 1223-24 (Del. 1999). *See also* McMullin v. Beran, 765 A.2d 910, 926 (Del. 2000).

[137] *See, e.g.*, McMillan v. Intercargo Corp., 768 A.2d 492 (Del. Ch. 2000); In re Lukens Inc. Shareholders Litig., 757 A.2d 720 (Del. Ch. 1999). The Delaware Supreme Court's most recent decision in the on-going *Emerald Partners* litigation confirms this approach, while emphasizing that limited discovery is available where plaintiff has adequately alleged a violation of the duty of loyalty or of good faith. Emerald Partners v. Berlin, 2001 WL 1568740 (Del. 2001).

[138] Gagliardi v. TriFoods Int'l, Inc., 683 A.2d 1049, 1052 n.4 (Del. Ch. 1996) ("I see it as reflecting a concern with the Trans Union board's independence and loyalty to the company's shareholders").

[139] Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1166 n.18 (Del. 1995) ("In *Van Gorkom*, it was unnecessary for this Court to state whether the disclosure violation constituted a breach of the duty of care or loyalty or was a combined breach of both since 8 Del. C. § 102(b)(7) had not yet been enacted."). In addition, according to the Sixth Circuit, a § 102(b)(7) liability limitation provision may not insulate directors from duty of

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provision thus might not have insulated the directors from liability in the very transaction that motivated the statute's adoption.

The Long-Term Legacy

Although the substantial criticism to which *Van Gorkom* has been subjected is not wholly unmerited,[140] fears that it presaged routine judicial intervention into board decision-making processes were clearly overstated. As we have seen, strict adherence to a specific decision-making model likely is not a prerequisite for the business judgment rule to be applicable. On the facts of the case before it, however, the court concluded that the board had abdicated its responsibility and allowed itself to be railroaded by management to so great an extent that deference became inappropriate.[141]

It is also highly significant that the decision at issue related to a major transaction having final period consequences. Corporate acquisitions are a classic example of what game theorists refer to as "final period problems." In repeat transactions, the risk of self-dealing by one party is constrained by the threat that other party will punish the cheating party in future transactions. In a final period transaction, this constraint disappears. Because the final period transaction is the last in the series, the threat of future punishment disappears.

Just so, the various extrajudicial constraints imposed on management in the operational context break down in corporate acquisitions. Target management is no longer subject to shareholder discipline because the target's shareholders will be bought out by the acquirer. Target management is no longer subject to market discipline because the target by definition will no longer operate in the market as an independent agency. As a result, management is no longer subject to either shareholder or market penalties for self-dealing. Accordingly, there is good reason to be skeptical of management claims to be acting in the shareholders' best interests. In turn, the resulting need in this context to hold the board accountable for its mistakes appropriately trumps the more usual tendency towards judicial deference to the board's authority.

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care claims based on intentional or reckless misconduct. McCall v. Scott, 250 F.3d 997, 1000-01 (6th Cir. 2001).

[140] For a trenchant doctrinal critique of *Van Gorkom*, which contends that the majority misused precedent, and which also summarizes criticisms made by other commentators, see William T. Quillen, *Trans Union, Business Judgment, and Neutral Principles*, 10 DEL. J. CORP. L. 465 (1985).

[141] "In fact, that word railroaded was used several times in the press." Roundtable, *supra* note 125, at 34 (comments of Robert Dilenschnieder).

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Having said that, however, *Van Gorkom* probably has resulted in many board decisions being over-processed. In many cases, even relatively minor board decisions are subjected to exhaustive review, with detailed presentations by experts. Why? The answer lies in the incentive structures of the relevant players. Who pays the bill if the director is found liable for breaching the duty of care? The director. Who pays the bill for hiring lawyers and investment bankers to advise the board? The corporation and, ultimately, the shareholders. Suppose you were faced with potentially catastrophic losses, for which somebody offered to sell you an insurance policy. Better still, you don't have to pay the premiums, someone else will do so. Buying the policy therefore doesn't cost you anything. Would not you buy it?[142]

It's also important to consider the incentives of the lawyers who advise corporations. Deciding how much time and effort to spend on making decisions is itself a business decision. Because that decision is driven by liability concerns, however, legal advice is usually critical to the making of the decision. Why might lawyers have an incentive to encourage boards to over-invest in the decision-making process? The cynical answer is that a more complicated decision-making process, which is driven by liability concerns, is likely to result in higher fees. A less cynical explanation is that the law is full of sports, mutants, and mistakes. Clients often lack the information or willingness to recognize that their situation was one of the exceptions that proves the rule. Instead, clients tend to blame the lawyer for an adverse outcome even if the lawyer did nothing wrong. Because the lawyers will be blamed even if losing the case was an act of god equivalent to a 100-year flood, lawyers are often overly cautious in giving advice. In economic terms, lawyers are risk averse. In a risky situation, the best thing for the lawyer to do is to point the client towards strategies whose outcome is certain.

In sum, the incentives of both sellers and buyers of legal advice are congruent. Lawyers have strong incentives to encourage clients to expend a lot of time, energy, and money on the decision-making process, while corporate boards of directors have strong incentives to take that advice. All of which goes to show that otherwise puzzling things become readily explicable if one understands the economic incentives at play.

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[142] "Notwithstanding the controversy around the case, it has proven advantageous to boards by creating a paradigm of appropriate—and legally defensible—behavior. With the appropriate legal guidance, boards can keep meddlesome courts away from the substantive decisions about the price in terms of the proposed acquisition." Roundtable, *supra* note 125, at 32 (comments of Donald Gogel).

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Settlement

The Delaware Supreme Court majority opinion did not resolve the case. The court remanded the case to the Delaware Chancery Court with instructions for that court to hold an evidentiary hearing to determine damages based on the extent to which "the fair value of Trans Union exceeds $55 per share."[143] Instead, however, the parties reached a settlement in which the plaintiff class received a total cash payment of $23 million (slightly less than two dollars per share). Approximately $10 million of the settlement amount was paid by the Trans Union's Board of Directors D&O liability insurance policy. Although some reports have indicated that Jay Pritzker paid $11 million of the remaining amount, his brother Robert claimed that the Pritzker family in fact paid the entire $13 million remaining over and above the insurance payout, subject only to a requirement that the defendant directors make a small contribution to charity.[144]

Robert Pritzker explained this apparent generosity by saying that "we felt that we were the beneficiaries of the whole planet."[145] In fact, however, paying the settlement on behalf of the defendant directors is an eminently sound business decision. The Pritzkers' business was buying and selling companies. Imagine that you were a director of a company that the thereafter entered into merger negotiations with the Pritzkers. Knowing that the Pritzkers had covered the Trans Union defendants settlement costs inevitably would cause you to look more favorably on doing a deal with the Pritzkers. In colloquial terms, after all, you know that the Pritzkers have got your back.

Where Are They Now?

Van Gorkom died in March 1998 at age 80.[146] In the years between the sale of Trans Union and his death, he had remained active in many business and charitable ventures, including the Lyric Opera.[147] Van Gorkom's loyalty to the Lyric is especially noteworthy, since it has been said that his "greatest mistake" "was that he should've read the merger agreement at the opera."[148] Indeed, the concise take home lesson of the case may be that one ought not conclude deals of this magnitude at the opera. Doing so suggests an unseemly cavalier attitude.

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[143] *Van Gorkom*, 488 A.2d at 893.

[144] Roundtable, *supra* note 27, at 238.

[145] *Id.*

[146] Wilson, *supra* note 35.

[147] Keenan, *supra* note 37.

[148] Roundtable, supra note 125, at 29 (comments of Robert Troubh).

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Jay Pritzker outlived Van Gorkom by not quite a year, dying in January 1999 at age 76.[149] Among the mourners at his funeral were "former Republican vice presidential candidate Jack Kemp, advice columnist Ann Landers, financier Sam Zell and Mayor Richard Daley."[150] After Pritzker's passing, his extended family exploded into a rancorous feud.[151] The fight was eventually resolved by an agreement to split the family empire up between 11 adult Pritzker cousins by 2011.[152] In 2007, famed investor Warren Buffet's Berkshire Hathaway conglomerate acquired 60% of Marmon at a price of $4.5 billion,[153] "with the remaining 40 percent to be acquired through staged acquisitions over a five to six year period."[154]

After its acquisition by Marmon, Trans Union divested its various subsidiaries, including the once core tank car business. When the process was complete, Trans Union's sole remaining business was a consumer credit reporting agency. In January 2005, Marmon spun that business off as Trans Union LLC, making Trans Union once again an independent company.[155] It is now one of the three leading consumer credit rating agencies, with revenues of over $1 billion per year.[156]

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[149] Jon Anderson, *Movers, Shakers Mourn Man Behind Hyatt Hotels*, CHI. TRIB., Jan. 26, 1999.

[150] *Id.*

[151] Susan Chandler & Kathy Bergen, *Inside the Pritzker Family Feud*, June 12, 2005.

[152] *Id.*

[153] Francesco Guerrera & James Politi, *Berkshire Caps a Week of Dazzling Dealing*, FIN. TIMES, Dec. 29, 2007, at 19.

[154] *Marmon Group—Then*, supra note 46.

[155] Kathy Bergen, *TransUnion Spinoff may be Pritzker Breakup Step*, CHI. TRIB., Jan. 19, 2005.

[156] *Id.*

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