Bloomberg
Law Reports®

March 20, 2012

Corporate and M&A Law

Directors & Officers

Fiduciary Duties

The Efficient Market Hypothesis under Delaware Law

Contributed by Benjamin M. Grossman, Jones Day

In order to provide directors with a better sense of the rules and the predictability that is so critical for decision making, it would be helpful if regulators who make the rules and judges who interpret them provided a more fulsome sense of the foundational economic principles on which they rely. As just one example, consider the different attitudes that the courts have shown towards the efficient market hypothesis.

Although there are different ways of phrasing the hypothesis–with varying levels of strength–Eugene Fama (1970) defined an efficient financial market as one in which the security prices fully reflect the available information.[1] Because this hypothesis interacts with the way that directors, regulators, courts, and shareholders will assess stock prices (and the decisions that directors make about them), it represents one of the most important underlying economic concepts for directors and counsel in the performance of their duties. It is thus essential to understand the different ways in which the decisions of the Delaware courts have incorporated or rejected the efficient market hypothesis.

In 1989, in the seminal case of *Paramount Communications, Inc. v. Time, Inc.*,[2] referred to as *Time-Warner*, the Delaware court seemed to disfavor the efficient market hypothesis. The relevant facts are as follows. On March 3, 1989, Time and Warner entered into a stock-for-stock merger agreement under which Warner shareholders would own 62 percent of the merged company's stock. After the transaction was announced on March 4, 1989, Time's stock traded between $105 and $126 a share. On June 7, 1989, Paramount announced an offer to acquire Time at $175 per share and on June 23 increased its offer to $200 per share. Paramount was not willing to (or could not) acquire a combined Time-Warner. Based on guidance from its financial advisor, Time's board believed that the stock of Time-Warner would trade at around $150 per share upon consummation of the merger. But Time nonetheless refused Paramount's offered premium. On June 16, 1989, Time and Warner restructured their merger as a cash acquisition of Warner so that Time could avoid seeking the shareholder approval required by the original plan. Paramount and certain Time shareholders sued to enjoin the transaction.

The Delaware Chancery Court directly addressed the efficient market hypothesis in considering whether the directors' duties permitted them to have a view of Time's value that differed from the market value. The court wrote, "does it make any sense, given

Originally published by Bloomberg Finance L.P. Reprinted with permission. Bloomberg Law Reports® is a registered trademark and service mark of Bloomberg Finance L.P.

This document and any discussions set forth herein are for informational purposes only, and should not be construed as legal advice, which has to be addressed to particular facts and circumstances involved in any given situation. Review or use of the document and any discussions does not create an attorney-client relationship with the author or publisher. To the extent that this document may contain suggested provisions, they will require modification to suit a particular transaction, jurisdiction or situation. Please consult with an attorney with the appropriate level of experience if you have any questions. Any tax information contained in the document or discussions is not intended to be used, and cannot be used, for purposes of avoiding penalties imposed under the United States Internal Revenue Code. Any opinions expressed are those of the author. Bloomberg Finance L.P. and its affiliated entities do not take responsibility for the content in this document or discussions and do not make any representation or warranty as to their completeness or accuracy.

© 2012 Bloomberg Finance L.P. All rights reserved.

what we understand or think we understand about markets, to posit the existence of a distinction between managing for current value maximization and managing for longer-term value creation – a distinction which implies, unless I am wrong, that current stock market values fail to reflect 'accurately' achievable future return?"[3] The court answered its own question with a resounding "yes." It wrote: "just as the Constitution does not enshrine Mr. Herbert Spencer's social statics, neither does the common law of directors' duties elevate the theory of a single, efficient capital market to the dignity of a sacred text. Directors may operate on the theory that the stock market valuation is 'wrong' in some sense, without breaching faith with shareholders."[4] The court rejected any rule requiring directors to maximize immediate share value in favor of the proposition that directors could take a longer view, even though the premise of the efficient market hypothesis is that the share price already reflects the longer view.

Ultimately, this case represents a critical signpost for directors, instructing them that they may take a view of the value of their own company's stock that is not necessarily the same as the view embodied in the market. Notwithstanding Paramount's offer of a 59 percent premium over the existing share price, the Delaware Supreme Court held that "[t]he fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals," that "[t]hat duty may not be delegated to the stockholders," and that "[d]irectors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy."[5]

In *VFB LLC v. Campbell Soup Company*, however, the Third Circuit seemed to endorse the efficient market hypothesis, albeit in a decidedly different context.[6] Campbell sought to dispose of certain subsidiaries and product lines (including Vlasic pickles and Swanson TV dinners) and decided to achieve this goal via a levered spin-off. In 1998, it sold the relevant subsidiaries to another subsidiary, Vlasic Foods International, Inc., referred to as VFI, in exchange for $500 million of borrowed cash and spun that entity out to its shareholders via a stock dividend. Within three years of the spin-off, however, VFI filed for bankruptcy and its creditors sued Campbell for fraudulent conveyance to unwind the sale to VFI in exchange for $500 million. The Third Circuit found that, prior to the spin-off, Campbell had "massaged" the operating results for the relevant companies, "ostensibly misleading the public about its operating record and prospects."[7] After the spin-off occurred in March 1998, these sales and earnings figures came to light.[8] Despite these issues, VFI's market capitalization remained above $1.1 billion until January 1999. Nonetheless, between 1999 and 2001, when VFI sold off the relevant assets both before and during the bankruptcy proceedings, it could only fetch $385 million for such assets (adjusted for inflation), not the $500 million that had been paid in the spin-off. The creditors claimed that, given this difference in value, the transfer should be set aside as a fraudulent transfer.

One fundamental issue in finding a transfer fraudulent is whether the debtor (here, VFI) was or became insolvent at the time of the transfer from Campbell to VFI. The district court held, and the appeals court affirmed, that there was no fraudulent conveyance in this case, primarily because VFI had a "$1.1 billion market capitalization nine months after the spin," which it believed showed that "the Division's businesses were worth indeed far more than $500 million" at the time of the transfer to VFI.[9] Both courts noted that, even after VFI's issues came to light, the stock retained its strength. Accordingly, "the post-exposure market capitalization was based on an accurate picture of VFI's position as of March 30, 1998, indicating a value of well over $500 million at that time."[10] Thus, unlike in *Paramount*, the court here endorsed the efficient market hypothesis and found that the wisdom of the market correctly valued VFI in light of all of the information available.

The *Campbell Soup* court did not identify the efficient market hypothesis by name in its opinion, but clearly understood and relied on it in its analysis. The *Campbell Soup* court acknowledged that the available information at the time of the spin-off was arguably misleading. It also acknowledged that in March 1998, equity markets in retrospect could be considered irrationally exuberant. But the court nonetheless relied on VFI's market capitalization, holding that, "[e]ven if . . . the market was suffering from some 'irrational exuberance' in establishing VFI's stock price, that" would not provide any "basis for second-guessing the value that was fairly established in open and informed trading," at least when compared to liquidation values obtained in a bankruptcy proceeding several years later.[11]

A similar attitude towards the efficient market hypothesis is evidenced in Chancellor Strine's recent decision in *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*.[12] In *Southern Peru*, Grupo Mexico–which owned 54.17 percent of the outstanding stock and 63.08 percent of the voting stock of Southern Peru–proposed that Southern Peru buy its 99.15 percent stake in Minera Mexico in exchange for $3.05 billion of Southern Peru stock. Both Southern Peru and Minera are companies focused on copper mining in Peru and Mexico respectively. Southern Peru is a publicly listed NYSE company, and Minera was a privately held Mexican company. In connection with the offer, Southern Peru formed a special committee of independent directors which retained its own legal and financial advisors in addition to a mining consultant and Mexican counsel.

Between signing and closing of the merger, the price of copper and Southern Peru's stock price had gone up in value such that, at closing, the shares issued by Southern Peru had a market value of $3.75 billion, substantially higher than the $3.1 billion contemplated at signing. There were other aspects of the transaction that troubled the court. For example, Chancellor Strine found that the forecasts and financial analysis disclosure were so faulty as to make "the total mix of information available to stockholders materially misleading."[13] He also found the Special

Committee process to be deficient, noting that "the Special Committee fell victim to a controlled mindset and allowed Grupo Mexico to dictate the terms and structure of the Merger."[14] After subjecting the transaction to review under the entire fairness standard, under which a court may substitute its judgment with respect to valuation, Chancellor Strine held that since "the deal was unfair, [Grupo Mexico] breached [its] fiduciary duty of loyalty."[15] He then undertook his own valuation of Minera to determine the fair price and awarded damages of $1.26 billion (later revised to $1.347 billion), the difference between the value of Minera at signing and the purchase price, and attorneys' fees of approximately $300 million.[16]

One of the fundamental issues presented by *Southern Peru* is whether a public company is constrained by its own market capitalization in connection with an acquisition when it uses its stock as consideration. The Special Committee believed that the stock was overvalued: "Southern Peru's market price did not reflect the fundamental value of Southern Peru and thus could not appropriately be compared to the DCF value of Minera."[17] And indeed, in *Southern Peru*, in an exchange between defendants' counsel and Chancellor Strine, defendants' counsel said that "[the Special Committee] believed, as they testified, that they were getting a bargain; that Minera was worth more than the consideration Grupo Mexico received."[18] Chancellor Strine rejected their view of fairness on the price and wrote that "[a]lthough directors are free in some situations to act on the belief that the market is wrong, they are not free to believe that they can in fact get $3.1 billion in cash for their own stock but then use that stock to acquire something they know is worth less than $3.1 billion in cash or in 'fundamental' or 'intrinsic' value terms because they believe the market is overvaluing their own stock and that on real 'fundamental' or 'intrinsic' terms the deal is therefore fair."[19]

At least from the perspective of the efficient market hypothesis, the *Southern Peru* analysis and the *Time-Warner* results seem difficult to reconcile. Chancellor Strine distinguished that earlier holding, emphasizing that in certain situations directors can act as if the market is wrong.[20] He noted that in *Time-Warner*, the Board believed that the value of the merged Time-Warner stock would eventually grow to exceed the $200 per share that Paramount was offering. In contrast, he noted that in *Southern Peru* the stock had a present cash value of $3.1 billion and was offered in exchange for something less valuable. But this distinction may not be sufficient. A consistent application of the efficient market hypothesis would indicate that the current price reflects publicly available information about a company, including everything that is known about its future. One could argue that refusing to take $200 for something the market now values at $150 is no different and no better (or worse) than selling something for $150 when the market price is $200.

The goal here is not to endorse one view of the efficient market hypothesis or necessarily to critique *Southern Peru* in light of *Time-Warner*. The efficient market hypothesis is controversial enough among economists; one would not expect courts to rely on it all of the time or reject its use entirely. There are many ways to differentiate *Southern Peru* and *Time-Warner* because of the posture of the deals, the existence or absence of a controlling shareholder and the standard under which the court reviewed the transactions.

That said, it would be helpful if courts could and would better articulate the economic ideas on which they are relying, and give guidance on how those principles will be applied to future judgments by future boards. If judges and regulators are going to use economic principles in certain circumstances but not in others, they can and should explain what about the circumstances justifies the disparate treatment and be clear about the borders of such application. As it stands, directors may be able to second guess the market–they may even have a duty to do so–but they must proceed cautiously when their judgment is that market prices do not reflect the company's value.

Benjamin M. Grossman is an M&A associate in Jones Day's New York office. The opinions expressed here are solely those of the author and do not necessarily reflect those of Jones Day or any of that firm's clients.

[1] Andrei Shleifer, *Inefficient Markets: An Introduction to Behavioral Finance* 1 (2000).

[2] 571 A.2d 1140 (Del. 1989).

[3] *Paramount Commc'ns Inc. v. Time Inc.*, C.A. Nos. 10866, 10670, 10935 (Consol.), *54 (Del. Ch. July 14, 1989), *aff'd*, 571 A.2d 1140 (Del. 1989).

[4] *Id.* at *56.

[5] *Paramount Commc'ns Inc.*, 571 A.2d at 1154.

[6] 482 F.3d 624 (2007).

[7] *Id.* at 627.

[8] *Id.* at 628.

[9] *Id.* at 631; *see also id.* at 633-34.

[10] *Id.* at 629.

[11] *Id.* at 630, 633-34.

[12] 30 A.3d 60 (Del. Ch. 2011).

[13] *Id.* at 97.

[14] *Id.* at 98.

[15] *Id.* at 114.

[16] *Id.* at 120; *In re Southern Peru Copper Corp. S'holder Derivative Litig.*, C.A. No. 961-CS (Del. Ch. Dec. 20, 2011) (final order and judgment).

[17] *Southern Peru*, 30 A.3d at 67.

[18] *Id.* at 72 n.19.

[19] *Id.* at 64.

[20] *Id.* at 105.