A THEORETIC ANALYSIS OF CORPORATE AUCTIONEERS' LIABILITY REGIMES

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In *Schneider v. Lazard Freres & Co.* a New York appellate court greatly expanded the liability of investment advisors working as corporate auctioneers. Under this new legal regime, auctioneer/advisors accused of simple negligence are exposed to billions of dollars of potential legal liabilities. This Article first reviews the existing law covering auctioneer/advisors and shows that the *Schneider* decision conflicts with the law governing general auctioneers and with the law governing the role of advisors and directors during the sale of corporate control. Next, using an auction-theoretic framework, this Article shows that *Schneider* will likely result in: (1) increased indemnification of auctioneer/advisors by corporations; (2) reduced net proceeds to selling company shareholders when there is a sale of the corporation; (3) increased use of pure cash as means-of-payment in sales of corporations; and (4) fewer sales of corporations. *Schneider*'s net impact therefore is to place shareholders in a less advantageous position than under prior law.

To demonstrate these economic effects, the authors employ a combination of principal/agent theory and auction theory. This is natural, for the advisors are hired by the directors to conduct an auction. A simple principal/agent model is the basis for the authors' prediction of indemnification; if indemnification does indeed occur, the selling corporation retains the *Schneider* liability. Rational bidders for the corporation, knowing they will assume this liability, will lower their bids, and auction theory predicts that the expected high bid will fall by more than the expected *Schneider* liability. Thus, the net effect on the selling shareholders is negative: the lower price more than offsets expected proceeds from legal suits.

I. INTRODUCTION

Auctions are now a common method used for selling companies, whether the sale is initiated by the selling company or by an unsolicited takeover bid. To facilitate the large number of auctions being conducted, an industry of corporate auctioneers has developed. These corporate

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auctioneers are primarily investment bankers, lawyers, and consultants who advise sellers on how to structure an auction and who often conduct the ensuing auction. Corporate auctioneers advise directors on all aspects of the auction process, including selecting and screening of potential bidders, managing the information flow to bidders, setting and policing the rules of the auction, and advising the seller as to which, if any, bids are acceptable.

Such an auctioneer would find a voluminous economics literature to guide it in structuring an auction to maximize the expected selling price.[1] For example, the auctioneer could find analyses of how various bidding rules affect bidding strategy and hence prices; of how to set entry fees and reserve prices; of how information disclosure affects selling prices; and of how different bidding rules affect the formation of bidder cartels. The auctioneer would also find that some general auction analysis has been brought to bear on both the business and public policy aspects of corporate auctions.[2] Curiously though, auctioneers themselves have been neglected in this literature.[3] The courts and commentators have made no more than passing reference to the economics of the party actually conducting the auction.[4]

This article aims to fill part of this void. We employ auction theory to examine the impact of recent court decisions that have highlighted corporate auctioneers' potential legal liability. Our model applies auction theory to predict that shareholders will receive lower prices in a corporate auction when the courts increase auctioneers' potential legal liability.

To illustrate this point, we examine two legal decisions that created tremendous potential legal liability for corporate auctioneers. The first

1. Paul Milgrom, *Auctions and Bidding: A Primer*, 3 J. ECON. PERSP. 3 (1989) provides an introduction to the most recent theoretical work in auctions. R. Preston McAfee & John Macmillan, *Auctions and Bidding*, 25 J. ECON. LIT. 699 (1987) gives a more in-depth review of all work to date.

2. *See, e.g.*, Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV..L. REV. 1028 (1982); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of Target Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Jonathan R. Macey, *Auction Theory, MBOs and Property Rights in Corporate Assets*, 25 WAKE FOREST L. REV. 85 (1990); Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation*, 7 J.L., ECON. & ORG. 27 (1991).

3. MeAfee & Macmillan, *supra* note 1, at 732. In fact, eases and eommentary about any aspect of investment advisor liability are scarce. Dale A. Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 214 n.31 (1988).

4. There are references to directors of the corporation as "auetioneers," but these refer to the legal duties of directors in supervising the conduct of a sale of a company, not to the directors serving as auctioneers themselves. See *infra* notes 45-47 and accompanying text for discussion on directors' "Revlon duties."

is *Mills Acquisition Co. v. Macmillan Inc.*,[5] in which the Delaware Supreme Court stated that an investment banker could be personally liable for improperly conducting an auction.[6] After *Mills Acquisition* though, the potential for finding liability under Delaware law remained relatively remote: a plaintiff had to prove both that the corporate directors breached their fiduciary duties and that the advisor had assisted in that breach.[7]

Auctioneers' potential liability dramatically increased after *Schneider v. Lazard Freres & Co.*,[8] when a New York appellate court held an investment banker could be directly liable, under agency law principles, to the acquired companies' shareholders for negligently conducting an auction. The *Schneider* case arose out of the sale of RJR Nabisco. Briefly stated, RJR's public shareholders sued the Special Committee's investment advisors who conducted the auction, claiming that they gave the RJR Special Committee faulty advice concerning the value of two competing bids. The *Schneider* court held that to win a suit against the auctioneers, RJR's shareholders needed only to prove that the auctioneers somehow acted negligently—for example, did not value a bid properly, stopped the bidding too soon, or gave one bidder an informational advantage.[9] Shareholders no longer need to prove that the directors breached their fiduciary duties. If this ruling is adopted by other courts, it would have a profound effect on auctioneer liability.

These decisions aimed to correct perceived abuses of the auction process by investment banker auctioneers that harmed the intended beneficiaries of the auction, the auctioned companies' shareholders. The message that these bankers had substantial legal exposure was undoubtedly intended by the courts to benefit shareholders. Yet, in imposing legal liability on investment bankers for the misconduct of an auction, the courts did not focus on the impact of their decisions upon the bidding and

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5. 559 A.2d 1261 (Del. 1988).

6. In *Mills Acquisition*, the Special Committee formed by the target's board of directors to handle the sale of the target company worked with an investment bank advisor whom the court described as an "auctioneer." This advisor was found to have knowingly joined two of the target company's advisors in breaching their fiduciary duties to the company's shareholders by, *inter alia*, tipping one of the two competing bidders about certain material terms of the other bidders' bid. *Id.* at 1282-84.

7. *See generally* Ronald A. Brown, Jr., Note, *Claims of Aiding and Abetting a Director's Breach of Fiduciary Duty—Does Everybody Who Deals with a Delaware Director Owe Fiduciary Duties to that Director's Shareholders?*, 15 DEL. J. CORP. L. 943 (1990).

8. Schneider v. Lazard Freres & Co., 552 N.Y.S.2d 571 (1990); *see* Donald Lund, Comment, *Toward A Standard for Third-Party Advisor Liability in Mergers and Buy-Outs: Schneider and Beyond*, 52 U. PITT. L. REV. 603, 616 (1991).

9. For further discussion of the *Schneider* decision and its impact on liability, see *infra* notes 86-89 and accompanying text.

auction process itself, the real determinants of the price paid in a corporate auction.

This Article conducts a legal and economic analysis of the liability rules for corporate auctioneers, focusing particularly on the potential effects of the *Schneider* decision. It argues that the courts were mistaken in their attempt to aid shareholders by increasing auctioneers' liability, and that the actual effect of these decisions will be to make shareholders worse off. More specifically, its findings are as follows: First, it should be expected that auctioneers will request, and that directors will grant, indemnification for the auctioneers against their *Schneider* liability. Second, there will be little or no change in the quality of advice given by auctioneers in the conduct of auctions, although the auctioneers will change their behavior in a litigation-minimizing fashion. Third, the expected auction price received by selling shareholders for their company will decline, and the decline will exceed the expected proceeds to shareholders from *Schneider* suits. Thus, selling company shareholders will be worse off than before. Fourth, there will be fewer transactions effected via non-cash payment methods, and as a result there will be fewer total transactions. Last, and overall, the economic efficiency of the market for corporate control will decline.

From the legal point of view, we argue that the *Schneider* ruling marks a significant departure from an existing regime that was consistent with general legal rulings on non-corporate auctioneers;[10] with the developing case law on directors' duties when a company is "for sale";[11] and with the traditional corporate law principle that directors of a corporation are not agents of the shareholders in the legal sense.[12] The *Schneider* ruling holds that agency law, not corporate law, governs the directors when the corporation is for sale.[13] Although we understand the *Schneider* court's concerns—one cannot read the history of the RJR buyout without worrying about the RJR shareholders being unprotected[14]—we argue that the existing legal regime and economic incentives sufficiently protect shareholders against inappropriate behavior by

10. *See infra* notes 47-49 and accompanying text.

11. *See infra* notes 50-51 and accompanying text.

12. "It is well-settled law that directors are not agents of the shareholders, or even of the corporation." Herbert M. Wachtell et al., *Investment Banker Liability to Shareholders in the Sale-of-Control Context*, 60 N.Y.L.J., March 29, 1990, at 1-3. *See infra* notes 59-61 (discussing directors' fiduciary duty as trustees on behalf of the company's shareholders).

13. *Schneider* therefore has important implications for directors' liability as well as for advisors' liability. In this paper we focus primarily on the latter.

14. *See generally* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE (1990).

directors and auctioneers.[15] The possible benefits from *Schneider* will be low because indemnification agreements will leave auctioneers' incentives unchanged. Nevertheless, the costs will be large—lower prices for shareholders, fewer transactions, and more shareholder suits and litigation costs.

Section II summarizes the institutional features of corporate auctions, in particular the roles played by advisors to the selling company (i.e., the auctioneers) and how these advisors might incur legal liability. Section III reviews existing law concerning auctioneers, including that pertaining to general auctioneers. This section also discusses the *Schneider* case and how the ruling departs from existing law on sales of corporations and the liability of auctioneers. Section IV begins by considering the issue of indemnification and then applies auction theory to determine the effects of the selling corporation acquiring potential financial liability through its indemnification of its auctioneer. We conclude the paper with a discussion of broader issues concerning legal liability versus economic incentives for affecting behavior.

II. INSTITUTIONAL FEATURES OF CORPORATE AUCTIONS AND THE ROLE OF THE AUCTIONEER

Auctions have been employed for thousands of years as an efficient device for transferring ownership of assets.[16] In the natural evolutionary search for optimal auction rules, several auction characteristics have emerged as timelessly popular. For example, the most basic rule of an auction concerns how the selling price is determined. Typically, auctions fall into one of three categories for price determination: the English, oral, or ascending-price auction; the Dutch, or descending-price auction; and the sealed-bid (first-price auction).[17] The English auction is by far the most common. Price is determined through open, oral bidding, with the last and highest bid being the selling price. In the Dutch auction, the bidding starts high and falls steadily—in some instances, the price reduction is accomplished with a clock-like mechanism; a hand of the

15. This is particularly true in light of the increased power that institutional shareholders exercise in matters of corporate governance. *See generally* Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

16. For a thorough history on the use of auctions to transfer property rights, see RALPH CASSADY, AUCTIONS AND AUCTIONEERING (1967).

17. For further discussion of the different types of price-determination methods, see, for example, David W. Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 192-93 (May 1986).

clock slowly ticks off lower and lower prices. Selling price in such an auction is determined when a bidder stops the clock; the first bidder to stop the clock wins the auction and pays the price at which he signalled a willingness to purchase. In a sealed-bid auction, bidders submit sealed bids to the seller; the bidder submitting the highest bid wins the auction. Typically with sealed-bids, the winning bidder pays the amount of his bid (a first-price sealed-bid auction), but there is a less-common version wherein the high bidder pays the amount of the second-highest bid (a second-price sealed-bid auction).[18]

While the price-determination rules may be the most basic aspect of an auction, there are other institutional characteristics that can be as important, or more so, in affecting the final price: selection of bidders; information disclosure; means-of-payment; and setting reserve prices, to name some of the more important ones.[19] These institutional characteristics vary much more widely than the basic price-determination rules. Understanding all the details of the specific auction methods used for any class of asset is therefore critical. For auctions of companies, this requires two separate analyses: one for auctions of private companies or divisions of public companies, and one for auctions of entire public companies.

A. Auctions of Private Companies or of Divisions of Public Companies

In the sale of a private company, or in the divestiture of a public company's division or subsidiary, the seller has considerable freedom to structure the auction as it pleases. This contrasts strongly with the auction of a public company, where processes are dictated to a great extent by the ability of bidders to circumvent the selling company's board of directors and/or management by making offers directly to the shareholders. With a private company, or the sale of a division of a public company, corporate law places the board and management in a position to determine who will be permitted to see confidential information; whose bids will be considered; what form bids must take; and which bid will be accepted.[20] In practice, companies use a fairly homogeneous set of practices for these auctions.

18. This method is also known as the Vickrey auction. McAfee & Macmillan, *supra* note 1, at 703.

19. See sources cited *supra* note 1 for further discussion of these auction characteristics.

20. Under Delaware law, heightened judicial scrutiny of directors' conduct of an auction is not triggered unless the partial sale constitutes a "clear break-up" of the company. Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1990).

Investment advisors are usually employed to aid the seller in conducting the auction. Employing specialist auctioneers in this capacity has several advantages. First, these advisors are experienced in conducting auctions; they conduct auctions frequently and, based on their extensive experience, are well situated to advise sellers on how to proceed. Second, even in the sale of private companies, there is the potential for conflict of interest between the owners and management; bringing in outside advisors to assist in selecting bidders and in determining the winner alleviates these problems. Third, it is important in auctions for sellers to be able to bind themselves to the rules of play: For example, an opportunistic seller would want to re-open negotiations after seeing the sealed-bids of a supposedly first and final round of bidding.[21] Buyers would have legitimate reason to be wary of such opportunism, for there is almost by definition a "last-period" aspect to any corporate auction. Thus, advisors—who have reputational capital at stake and will therefore object to opportunism—can serve the purpose of giving assurance to buyers that they will follow the auction rules. This allows the seller to commit to optimal auction rules. Finally, advisors are typically investment banks or consulting firms that know the players in the market, that is, who are the willing and able buyers. They also have good information about what should be the expected selling price. This information is essential to the seller in selecting bidders, setting a reserve price, and valuing any non-cash bids. Although such information could potentially be purchased outright, it is probably economic to have the provider of the information also be the one who puts the information to use.[22]

The process of selecting an advisor can vary from company to company. Often the selling company will have a banking or consulting relationship with a professional services firm and the choice will be a natural one. Other times the company will engage in extensive shopping. There seems, however, to be relatively little price competition among auctioneers; instead, the competition is over the quality of service

21. *See* McAfee & Macmillan, *supra* note 1, at 703.

22. The main reason for this is that information collection and decision-making, to be efficient, must proceed simultaneously. If a selling company tries to purchase the relevant information outright, it will not know beforehand exactly what information and how much information is required. Also, it will often be more efficient for the agent who collects the information to then make certain decisions internally, for the qualitative/complex nature of the information would make it costly to completely transfer the information to a separate decision-maker.

provided. In fact, pricing of auction services is rather standardized.[23] Although flat fees may also be employed either by themselves or in conjunction with contingency fees, the bulk of advisors' fees is typically tied to the value of the completed deal.[24]

Once the company selects its advisor, a typical private auction process proceeds as follows.[25] Using knowledge about the selling company and its business, the advisor chooses a number of potential purchasers and sends them a very preliminary prospectus describing the business to be sold. Often at this point the company's name will not even be mentioned. Once a prospective purchaser signs a confidentiality agreement, a more thorough prospectus will be sent along. This prospectus will contain the minimum amount of information necessary for a prospective bidder to make a financial evaluation of the company to be sold. Indeed, at this stage the advisor commonly asks for preliminary indications of interest from the prospective purchasers. The seller uses these preliminary indications to further narrow the field of bidders for entry into the next round, where more proprietary information will be disclosed.[26] Preparation of a "data room" as well as management presentations and plant visits characterize this next step in the auction process. The data room will house detailed financial statements, marketing information, and copies of the company's various contracts (utility contracts, union contracts, etc.). Throughout this entire process prospective bidders will often call on the advisors (who have instructed the selling company's management to direct all such calls to them) and ask for further disclosure of certain information.

Bidders may attempt at various stages of the process to make a pre-emptive bid. These bids will usually come before the data room stage, for they are motivated at least in part by a desire on the part of a prospective purchaser to limit the disclosure to other parties of strategical-

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23. A commonly-used pricing mechanism is the so-called Lehman formula: 5% of the first million dollars of sales price, 4% of the second million, 3% of the third, 2% of the fourth, and 1% of the remaining.

24. *See* MARTIN LIPTON & ERICA H. STEINBERGER, 2 TAKEOVERS AND FREEZEOUTS C-15-17 Appendix C(2a) (1990) for an example of a typical fee agreement.

25. For further discussion and analysis of the auction process, see Robert G. Hansen, *Auctions of Corporations* (1991) (on file with author), and *Two Sides to Every Auction*, MERGERS AND ACQUISITIONS (Nov./Dec. 1989).

26. One of the more interesting questions concerning this auction process is how the seller can use the initial bids to screen for the highest-valued bidders. It would seem that bidders would simply bid high to ensure their participation in the next round. Hansen, *supra* note 25, argues that a separating equilibrium can be maintained if sellers use the first-round bids to set a reserve price for the second auction; bidding high in the first round therefore imposes a cost (higher reserve price) on the bidder.

ly sensitive information.[27] In this case, the auction process may be aborted should the seller believe that the proffered bid is sufficiently high to merit immediate acceptance.

If no such pre-emptive bid is received, and the process moves smoothly along the path outlined above, the auction usually culminates in a final round of sealed bidding. The price determination rule is most often first-price sealed bid, but there can be pressure from losing bidders to re-open the bidding. If the advisor gives in to this pressure, its reputation with buyers will be adversely affected. If the advisor is known for reneging on the rules in this way, bidders would *lower* their initial bids because they would expect an opportunity to raise their bid if the first one is too low to win.[28] Advisors therefore have an incentive to persuade the corporation's directors that following the auction rules will lead to maximum revenues.

Choosing the winning bidder may also present certain difficulties, because the advisor/selling company may have allowed or even invited non-cash bids (debt, stock, or more complicated earn-out arrangements based upon earnings of the selling company in future years).[29] A comparison of the bids and a determination of the highest bid might require an evaluation of securities that depends upon the value of the purchaser's securities, or upon the combined value of the selling company and the purchaser. This creates uncertainty in deciding which bid is the highest bid, an uncertainty that the law reflects. Delaware law, for example, does not require the directors to accept the nominally highest bid received in the auction if there are significant contingencies attached to it, such as difficulties in valuing new securities.[30]

There are numerous steps in this auction process where an auctioneer/advisor must make strategic, risky choices, which even though reasonable ex ante, could turn out to be unfortunate ex post. In preparing the prospectus, the auctioneer might leave out what appears to be irrelevant information, that later turns out to be important; such an error could lead to a lawsuit by either the selling company's shareholders or by

27. Hansen, *supra* note 25, argues that it is the presence of information which, if it is broadcast, would reduce the value of the selling company that drives many of the institutional features of corporate auctions.

28. McAfee & Macmillan, *supra* note 1 at 703.

29. On the value of non-cash bids, see Robert G. Hansen, *A Theory for the Choice of Exchange Medium in Mergers and Acquisitions*, 60 J. BUS. 75 (1987) and *infra* notes 136-41 and accompanying text.

30. *See* Caruana v. Saligman, [1990-91 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,889, 99,370-80 (Del. Ch. Dec. 21, 1990).

a disappointed bidder.[31] Or, the auctioneer might disclose information unequally across bidders. The auctioneer could through negligence, or by choice, leave out of the final round a bidder who might be the high-valued purchaser. Most importantly, the auctioneer might incorrectly value a non-cash bid and therefore accept something other than the highest bid. Any of these errors could result in a negligence suit against the auctioneer, where the auctioneer will be hard pressed to defend against fact-finders who, despite the laws' admonishments, judge the past with perfect hindsight.

B. Auctions of Public Companies

Although an auction of a publicly traded company can be done in much the same way as an auction of a private company, auctions of public companies often differ in two aspects from those of private companies: first, the auction may be initiated by a hostile bid; and second, the directors of the selling company face more stringent legal duties.[32] These differences influence the timing of the auction process, the auction rules that can be employed, and the role of the auctioneer advisors. Of course, the auction of a public company also admits the possibility of *defensive* actions by the selling company meant to prevent its sale.[33]

31. *See* Herskowitz v. Nutri-System, Inc., 857 F.2d 179, 190 (3d Cir. 1988) (investment banker advisor to Special Committee liable to shareholders under Section 14(a) of the 1934 Exchange Act for materially false and misleading statements in proxy materials), *cert. denied*, 489 U.S. 1054, 1060 (1989); *see also* Folger Adam Co. v. PMI Industries, Inc., 938 F.2d 1529 (2d Cir. 1991) (in sale of corporate subsidiaries for stock, investment bankers whose names appeared on selling memorandum have potential securities law liability for misstatements therein).

32. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). One additional and important difference between the sale of closely-held private companies and the sale of public companies is that large groups of public shareholders are generally less capable of acting collectively to block sales of assets. The public shareholders' collective action problems may underlie the courts' decisions in *Mills Acquisition* and *Schneider.*

33. Much of the literature on corporate auctions deals with the problem of discriminating between actions taken by management to increase the sale price versus actions taken by management to protect their own interests. Some of the more recent articles applying auction theory to this problem include Peter Cramton & Alan Schwartz, *Using Auction Theory to Inform Takeover Regulation,* 7 J.L. ECON. & ORG. 27 (1991); Jonathan R. Macey, *Auction Theory, MBOs and Property Rights in Corporate Assets,* 25 WAKE FOREST L. REV. 85 (1990); Ian Ayres, *Analyzing Stock Lock-ups: Do Target Treasury Sales Foreclose or Facilitate Takeover Auctions?,* 90 COLUM. L. REV. 682 (1990); Alan Schwartz, *Search Theory and the Tender Offer Auction,* 2 J.L. ECON. & ORG. 229 (1986); Alan Schwartz, *Defensive Tactics and Optimal Search,* 5 J.L. ECON.

The selling company may find it difficult to control the timing of the auction process. Hostile bidders put "fuses" on their tender offers, attempting to force shareholders to tender their shares as early as possible, with the result that they eliminate management and the board of directors from the process entirely. These pressures on the selling company have been greatly reduced by third generation state anti-takeover statutes *and* the renewed vitality of poison pills after the *Time* decision. Yet, even if the sale of the company was initiated by the selling company's board or management, any ensuing auction can be disturbed by a pre-emptive tender offer directed to the shareholders. By comparison, in the sale of a private company pre-emptive bids are made but there is no direct route to the owner/shareholders as there is in the form of a tender offer for a publicly traded company.

A public company may also find it difficult to stick with its preferred auction rules. For example, the auctioneer may not be able to use any form of sealed bids, for if the selling company were to turn down a revised higher offer by a losing bidder, it could face a lawsuit by a shareholder, claiming that the company's board did not maximize value for its shareholders. Thus, auctions of public companies may turn into English ascending price auctions.[34] Indeed, the legal duties of directors of public corporations generally make it all the more important for them to employ auction methods that are in the shareholders' best interests—or which are at least more defensible from a legal standpoint. This situation makes the role of advisors all the more critical.

Besides helping to maximize the proceeds for the selling shareholders, the advisors should try to ensure that auction rules are structured so as to minimize the directors' legal exposure in shareholder suits. Even before *Schneider*, lawsuits after the auction of a public corporation were almost inevitable. The *Schneider* decision exacerbates this problem by expanding the scope of potential liability for the auctioneer and other third

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& ORG. 413 (1989). For a more general discussion of these issues, see John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web,* 85 MICH. L. REV. 1 (1986); Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense,* 35 STAN. L. REV. 51 (1982); Lucian Bebchuk, *The Case For Competing Tender Offers,* 95 HARV. L. REV. 1028 (1982); Frank H. Easterbrook & Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers,* 35 STAN. L. REV. 1 (1982).

34. Leebron, *supra* note 17, at 194. However, in a sealed bid auction, the seller can seek to penalize bidders that break the rules by awarding the winner a break-up fee or an asset lock-up. This proeedure gives bidders a strong incentive to make their best bid in the auction and not in a subsequent tender offer.

party professionals involved in the auction process.[35]

Of course, as auctioneers get more involved not only in the auction process but also in the company's takeover defense, then the auctioneers' potential legal liability—even before *Schneider*—expands.[36] *Schneider*, however, makes the auctioneer's role in the auction of a public company considerably more prone to litigation by expanding the avenues for auctioneer liability.[37]

III. AUCTIONEER LIABILITY, BEFORE AND AFTER *SCHNEIDER*

A. Non-Corporate Auctioneer Liability

The current state of the law regarding auctioneers outside the corporate auction sphere is quite clear: auctioneers are viewed as the agents of the seller and therefore have minimal duties to third parties.[38] This principle is an extension of the rule that "an agent is not responsible to third persons where his principal is disclosed."[39] The general limitation on the duties of an auctioneer to a buyer changes if both the

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35. Comment, *Third-Party Advisors*, *supra* note 8, at 616. For instance, shareholders can allege that the special committee's legal advisors gave poor legal advice or that its accountants negligently prepared financial statements. The potential for an outpouring of suits against advisors to the special committee is very real. In analogous circumstances, an outburst of lawsuits have been filed against lawyers and accountants acting as advisors to defunct savings and loan associations. *See* Sherry R. Sontag, *Soured Deals Snag More Professionals*, NAT'L L.J., Feb. 4, 1991, at 31.

36. We recognize that investment bankers often play a role as the target company's chief takeover defensive strategists. In this capacity, the investment banker will try and stop any sale of the company. We have limited our analysis to those situations where, as in *Revlon*, the sale of the company is inevitable. *See infra* note 47.

37. See Section III.C, *infra*, for further discussion of this point.

38. Auctioneers' liability to their principal, the seller, for the misconduct of an auction is a well established legal principle. Courts have traditionally held that an auctioneer is the seller's agent. *See, e.g.*, Miron v. Yonkers Raceway, Inc., 400 F.2d 112, 113 (2d Cir. 1968).

39. Castille v. Folck, 338 So. 2d 328, 333 (La. Ct. App. 1976). The general rule is that the auctioneer is the agent of the buyer only after "the hammer falls" and only for the limited purpose of presenting written evidence at the time of sale. *See, e.g.*, *In re* Premier Container Corp., 408 N.Y.S.2d 725, 729-30 (Sup. Ct. 1978), *modified on other grounds*, 427 N.Y.S.2d 278 (1980); *see also* Paul Reynolds, Note, Chernick v. Fasig-Tipton: *a Caveat to the Horse Trader*, 74 KY. L.J. 889, 909-10 n.140 (1985-86). Upon acceptance of the bid, the auctioneer becomes the agent of both the principal and the purchaser for the purpose of executing the memorandum that takes the transaction out of operation of the statute of frauds. Peters v. Day, 210 N.Y.S. 42, 44 (Sup. Ct. 1925).

seller and bidders pay a commission to the auctioneer.[40] Of course, as agents of the seller/principal, auctioneers must follow their principal's instructions, seek the highest price (unless the principal wants otherwise) and generally act consistently with their fiduciary duties toward their principal. To do otherwise would open the way for a suit by the principal.

Noncorporate auctioneers' liability to their seller is governed by familiar agency law principles. As the seller's agent, the auctioneer has a fiduciary duty to the seller to conduct the auction so as to get the highest price possible for the goods.[41] If the auctioneer conducts the auction in a negligent manner, the principal has a cause of action against the auctioneer.[42]

There are, of course, very significant differences between the practices of well-known art and antique auctioneers, such as Sotheby's, and corporate auctioneers. Sotheby's standard contract with its clients provides that it retains "absolute discretion" over the conduct of the auction.[43] It solicits and receives bids, then is the final authority as to which bid is accepted.

Corporate auctioneers' agency is much more restricted in scope. For example, investment bankers never wield a gavel. Their primary

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40. When an auctioneer is an agent for both the buyer and the seller, this dual ageney imposes specific duties on that auctioneer. *See* Note, Chernick v. Fasig-Tipton, *supra* note 39, at 908 n.132.

Also, the Restatement (Seeond) of Agency states:

> An agent who, to the knowledge of two principals, acts for both of them in a transaction between them, has a duty to act with fairness to each and to disclose to each all facts which he knows or should know would reasonably affect the judgment of each in permitting such dual agency, except as to a principal who has manifested that he knows such facts or docs not care to know them.

RESTATEMENT (SECOND) OF AGENCY § 392 (1958).

41. *See* Elco Shoe Mfr. v. Sisk, 183 N.E. 191, 192 (N.Y. 1932); Cristallina S.A. v. Christie, Manson & Woods Int'l, 502 N.Y.S.2d 165, 172 (1986). Furthermore, as the principal's agent, the auctioneer cannot purchase the property which it is employed to sell. Moore v. Moorc, 5 N.Y. 256, 261 (1851).

42. *See, e.g.*, *Cristallina*, 502 N.Y.S.2d at 171 (auctioneer has a fiduciary duty to act in the utmost good faith and in the interests of its principal; if auctioneer breaches that duty, it is liable for damagcs caused to the principal through breach of contract or negligence).

This liability cuts both ways because an auctioneer ean also sue the principal for taking actions inconsistent with the agency relationship. *See* Hemphill-Kunstler-Buhler v. Davis Wholesale Elec. Supply Co., 516 So.2d 402, 404 (La. App. 1987) (finding a sole shareholder liable to an auctioneer where the shareholder had disrupted the auction that the corporation had hired the auctioneer to conduct), *writ denied*, 520 So.2d 751 (1988).

43. Sotheby's Master Consignment Agreement (copy on file with the authors).

responsibility is to solicit bids and transmit them to the board of directors. The board retains all authority to accept a bid.

The Sotheby's agreement provides that the seller waives its right to sue the auctioneer for any claim arising out of the conduct of the auction.[44] In the corporate context, as we discuss in the next sections, the board of directors typically retains (though rarely exercises) the right to sue its investment bankers for improperly conducting an auction.

*B. Corporate Auctioneers' Liability Pre-*Schneider

There is a rapidly expanding body of Delaware case law that treats directors of a public corporation that is "for sale" as "auctioneers" and imposes certain duties upon them. In *Revlon, Inc. v. MacAndrews & Forbes Holdings*,[45] the Delaware Supreme Court adopted the idea of an auction as a sufficient, but not necessary, method for selling a company.[46] The court held that when a corporation is for sale "[t]he directors' role changes from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the

44. *Id.*

45. 506 A.2d 173 (Del. 1986). In *Revlon*, Ronald Perlman's company, Pantry Pride, made a hostile bid for Revlon, Inc. Revlon's board initially adopted several defensive measures and claimed that the company was not for sale. When these measures did not succeed in driving Perlman away, the company switched gears and planned its own sale of the company to a friendly bidder, Forstmann Little & Co., in a deal that would include management. The bidding between Perlman and Forstmann Little went back and forth, until the Revlon board granted Forstmann Little an asset lock-up and agreed to a no-shop provision in a deal at a price only nominally greater than that offered by Perlman. Upon learning of the deal, Perlman topped the last Forstmann Little bid and filed suit. *Id.* at 176-79.

The Delaware Supreme Court found that the Revlon board of directors acted improperly by considering the threat of a bondholder suit against the directors if they did not accept the Forstmann Little bid. The Court noted that the Revlon board ignored its duties to get the best price for shareholders by preferring the bondholders. *Id.* at 182. It went on to enjoin the lock-up and no-shop provisions. *Id.* at 185. Perlman's tender offer for the company closed shortly thereafter.

46. *Revlon's* genesis from trusts and agency common law was described in Paramount Communications Inc. v. Time, Inc., 15 DEL. J.C.L. 700, *revised*, 571 A.2d 1140 (Del. Ch. 1989): "Revlon was not a radical departure from existing Delaware, or other, law (i.e., it has always been the case that when a trustee or other fiduciary sells an asset . . . [the trustee's] duty is to seek the single goal of getting the best available price)." Ronald J. Rinaldi, Note, *Radically Altered States: Entering the "Revlon Zone,"* 90 COLUM. L. REV. 760, 770 (1990).

company."[47]

Our focus, however, is not on the role of the directors in overseeing a sale, but on the role of the advisors who actually conduct the auction. Prior to *Schneider*, the legal liability of these auctioneers was clearly defined, as revealed in *Mills Acquisition Co. v. Macmillan, Inc.*[48] The Macmillan auction was a one-sided bidding process that ended with the company's board of directors shutting out a determined potential acquiror by executing a merger agreement with a management-backed bidder. The merger agreement contained extremely favorable auction-ending crown jewel lockup[49] and no-shop[50] provisions that were never offered to the disfavored bidder even though it had the highest bid on the table at the end of the auction.[51] The court found the Macmillan directors had breached their fiduciary duties through the misconduct of the auction

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47. *Revlon*, 506 A.2d at 182. If the board chooses to auction the company, the mechanics by which bids are solicited are left to its discretion so long as it acts to benefit shareholders. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1286-87 (Del. 1989) ("Directors are not required by Delaware law to conduct an auction according to some standard formula . . . . However, the board's primary objective, and essential purpose, must remain the enhancement of the bidding process for the benefit of the stockholders.").

More generally, once the board of directors of a Delaware corporation decides to sell a company, it becomes obligated to attempt to obtain the greatest value for the stockholders. *Mills Acquisition*, 559 A.2d at 1288. The board does not have to auction the company, but may instead choose to accomplish this objective by a more appropriate method. Freedman v. Restaurant Associates Industries, Inc., [1990-91 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 95,617 (Del. Ch. Sept. 21, 1990) (quoting Barkan v. Amstead Industries, 567 A.2d 1279, 1286 (Del. 1989) ("*Revlon* does not demand that every change of control of a Delaware corporation be preceded by a heated bidding contest.")); TW Services, Inc. Shareholders Litigation, 1989 Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,179 (Del. Ch. March 2, 1989) ("[T]he so-called *Revlon* duty is not necessarily a duty to conduct an 'auction' or to keep 'a level playing field' when the firm is for sale or, indeed, to proceed in any prescribed way; rather it is the duty to exercise judgment (in good faith and prudently) in an effort to maximize immediate share value.") (footnotes omitted); Herd v. Major Realty Corp., [1990-91 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶ 95,772 (Del. Ch. Dec. 21, 1990) ("While directors undoubtedly have duties in the [*Revlon*] context . . . , they have no duty to employ a specific device such as the auction or market check mechanism."). *See also* 1 ERNEST L. FOLK ET AL., FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 141.2.5.4, at 80-81 (1990 Supp.).

48. *Mills Acquisition*, 559 A.2d 1261.

49. A crown jewel lockup purports to sell, or place under option, a company's most valuable assets, or lines of business, to a third party at a bargain price to defeat an unwanted takeover. *Mills Acquisition*, 559 A.2d at 1286 n.37.

50. A no-shop provision commits the selling corporation to negotiate only with one bidder and, in some cases, binds the selling corporation's board of directors to refuse to provide any information to other bidders. *Revlon*, 506 A.2d at 184.

51. *Mills Acquisition*, 559 A.2d at 1283-84 n.33.

because they failed to supervise the auction properly.[52]

But the *Mills Acquisition* court went further, scrutinizing investment advisors' potential legal exposure as auctioneers.[53] One of Macmillan's investment bankers "was a principal, if not the primary, 'auctioneer' of the company."[54] Finding that the banker had violated "every principle of fair dealing" by "tipping" the management-backed bidder about how to tailor its bid to top its opponent's bid, the court, in dicta, stated that the investment banker could face personal liability for aiding and abetting the Macmillan directors' breach of their fiduciary duties.[55]

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52. *Id.* at 1284 n.32. No damages were assessed against the directors, however, because the company was (eventually) sold to the highest bidder.

53. In this paper, we do not address shareholders' claims for negligent misrepresentations, that is, claims based on auctioneers' potential liability to third parties for allegedly negligent statements made by the auctioneer and relied on by these third porsons for purposes of entering into a transaction with the agent's principal. The development of this lcgal doctrine for investment bankers is traced in Comment, *Third Party Advisors, supra* note 8. For an excellent discussion of the negligent misrepresentation theory of liability for professionals, see John A. Siliciano, *Negligent Accounting and the Limits of Instrumental Tort Reform*, 86 MICH. L. REV. 1929 (1988); and Victor P. Goldberg, *Accountable Accountants: Is Third-Party Liability Necessary*, 17 J. LEGAL STUD. 295 (1988). This theory has been applied to allow a selling company's shareholders to bring suit against investment bankers advising a Special Committee when the bankcrs' advice has becn disseminated to the shareholders to encourage them to tender their stock into an offer. *See*, Wells v. Shearson Lchman/American Express, Inc., 514 N.Y.S.2d 1 (N.Y. App. Div. 1987), *rev'd on other grounds*, 530 N.Y.S.2d 517 (N.Y. 1988); Schneider v. Lazard Freres & Co., No. 06905, slip op. at 17-18 (N.Y. Sup. Ct. Aug. 16, 1989) ; Dowling v. Narragansett Capital Corp., 735 F. Supp. 1105, 1125 (D.R.I. 1990); *but see* Brug v. Enstar Group, Inc., 755 F. Supp. 1247 (D. Del. 1991) (shareholders lack standing to bring suit against financial advisors for alleged negligent misrepresentations contained in public documents).

54. *Mills Acquisition*, 559 A.2d at 1281. In fairness to the investment bankers, it should be noted that they were not a party to the litigation. No trial on the merits was ever conducted on these issues. The court's findings about the investment bankers' petential liability must therefore be considered dictum.

55. *Id.* at 1283-84, n.33. The aiding and abetting standard of liability has been criticized by some commentators as adversely affecting defendants that are merely engaged in customary business activities. Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 101 (1981) (concluding that aiding and abetting liability is inconsistent with the express language of the 1934 Seeurities Exchange Act). In most cases, the dcfendants are lawyers, accountants or investment bankers engaged by the company, whom it is all too easy for the clever plaintiff's lawyer to claim, knew, or should have known, of the allegedly fraudulent conduct of the primary defendants simply because they were also working on the transaction attacked by the plaintiff. These claims, rarely proved at trial, still retain settlemcnt value because defendants must still pay their attorneys, have their employees' time spent in depositions and trials and have their offices disrupted for document productions. *Id.* at 102. Other commcntators rcspond that these suits are necessary so that "boards and bankers know that they will be accountable for what they have done or

The aiding and abetting standard of liability requires that the plaintiff establish that a fiduciary relationship existed between the plaintiff and the directors, that the directors breached that fiduciary duty, and that the corporate auctioneer knowingly participated in that fiduciary's breach.[56] Establishing all this is difficult for a plaintiff,[57] but *Mills Acquisition* vividly illustrates the potential for spectacular success.[58]

This aiding and abetting standard of auctioneer liability derives from the traditional corporate law principle that the board of directors of a corporation is an independent institution charged with managing the corporation's business.[59] A director's duty to the company's shareholders is a fiduciary duty under quasi-trust principles.[60] Directors are also

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not done . . . ." Arthur H. Rosenbloom, *Investment Banker Liability: A Panel Discussion*, 16 DEL. J. CORP. L. 557 (1991).

The courts have balanced these concerns in an evolving rule concerning the proper standard for pleading an aiding and abetting claim. The judicial trend seems to be toward requiring the plaintiff to allege something more than ordinary business activity for aiding and abetting claims under the securities laws. *See, e.g.*, Moore v. Kayport Package Express, Inc., 885 F.2d 531, 535 (9th Cir. 1989).

56. Knowing participation by an investment banker in directors' breach of fiduciary duty requires knowledge of the directors' breach and intentional complicity in it. Associated Imports, Inc. v. ASG Indus., Inc., Civ. A. No. 5953, 1984 WL 19833 at 12 (Del. Ch. 1984) (dismissing claim of aiding and abetting liability for failure to show knowing participation). *See* Note, *Claims of Aiding and Abetting, supra* note 7, at 953 (arguing that an alleged participant cannot claim lack of knowledge if it could have been aware of a breach of fiduciary duty by "opening its eyes" and that a court will infer participation in the breach if the defendant had knowledge of the breach and failed to withdraw from the transaction).

57. These claims are frequently dismissed for failure to show that the alleged aider and abettor knowingly participated in the directors' alleged breach of their fiduciary duties. *Associated Imports*, 1984 WL 19833 at *12; *see also* Weinberger v. Rio Grande Indus., 519 A.2d 116, 131 (Del. Ch. 1986) (claim for aiding and abetting a breach of fiduciary duty against the acquiring company is dismissed for failure to establish that the acquiring company knowingly participated in a breach of fiduciary duty); *In re* Sea-Land Shareholders Litigation, 14 DEL. J. CORP. L. 377, 387 (1988) (same). *See generally* Note, *Claims of Aiding and Abetting, supra* note 7, at 944 ("the Delaware courts have often looked at these [aiding and abetting] claims with a skeptical eye, and rightly so, because a broad construction of this type of claim might impair a director's ability to deal with third parties.").

58. *See Mills Acquisition*, 559 A.2d at 1284 n.33. *Compare* Anderson v. Boothe, 103 F.R.D. 430, 441 (D. Minn. 1984) (investment bankers could not be liable as a matter of law for aiding and abetting a breach of fiduciary duty by directors to the shareholders).

59. DEL. CODE ANN. tit. 8, § 141(a) (1974) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

60. *See Mills Acquisition*, 559 A.2d at 1280: Guth v. Loft, 5 A.2d 504, 510 (Del. 1939); Lofland v. Cahill, 118 A. 1, 3 (Del. 1922). *See also* Comment, *Third-Party Liability, supra* note 8, at 618.

agents of the corporation with power to act on its behalf to fix the rights and obligations of the corporation in its dealing with third parties.[61] This distinction between a director as fiduciary and a director as an agent was aptly summarized by one commentator, "[A]s to third persons, directors are agents of the corporation, but as to the corporation itself, equity holds them liable as trustees."[62]

The directors' duties in managing the corporation's affairs include, if they choose to auction their company, conducting the auction.[63] Responsibility for the proper conduct of an auction cannot be removed from the board, although the actual conduct of the auction can be delegated to an agent, such as an experienced auctioneer. Agents of the board, or of its special committees, are agents of a fiduciary and these agents are liable to *cestui qui trust*, the shareholders, only if the fiduciaries' liability is first established and the agents have acted to participate knowingly in the breach of fiduciary duties.[64]

C. Schneider *and the Simple Negligence Standard*

The *Schneider* decision and its new standard of auctioneer liability grew out of the well-publicized auction of the RJR Nabisco Company. In the initial round of shareholder litigation concerning the transaction, a Delaware court found that a special committee of the RJR board of directors had probably not violated Delaware law in carrying out its auction of the company. The Special Committee had retained its own investment bankers and attorneys to advise it on the value of the corporation and on the proper procedures for the conduct of the auction. The investment bankers (and lawyers) were charged with handling the sensitive, but not legally novel, job of getting the two bidders to raise

61. 4 JOHN N. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 1089, at 264-65 (Spencer W. Symons ed., 5th ed. 1941).

62. 3 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 841, at 209 (perm. ed. rev. 1986). Professor Coffee has described the relationship between directors and shareholders as "sui generis" involving "a level of discretionary authority that most agents do not possess." John C. Coffee, Jr., *New York's New Doctrine of "Constructive Privity,"* N.Y.L.J., Jan. 25, 1990, at 6.

63. *Mills Acquisition*, 559 A.2d at 1280.

64. GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 901 (rev. 2d ed. 1982 & Supp. 1991); 4 AUSTIN W. SCOTT & WILLIAM F. FRATCHER, SCOTT THE LAW ON TRUSTS § 326.5 (4th ed. 1989). General principles of tort law lead to the same result. *See* RESTATEMENT (SECOND) OF TORTS § 876 (b) (1939) ("For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he . . . (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself . . . .").

their bids without discriminating between them.[65]

In *Schneider* a New York court broke new legal ground by permitting a direct shareholder action against the Special Committee's investment bankers.[66] In finding that investment bankers owed a legal duty to RJR's shareholders under agency law principles, the court disregarded the lack of privity in these parties' relationship.[67] The court decided that RJR's shareholders could state a cause of action against the investment bankers for negligently conducting the RJR auction. The specific negligence claim stated that the investment banker advised the Special Committee that the final bids submitted by the two bidders—KKR and the Management Group—were "substantially equivalent from a financial point of view" when, in fact, the latter was superior. The alleged valuation mistake, if correct, would have cost the RJR shareholders more than $1 billion.[68]

No one contested the fact that the investment bankers were agents of the RJR Special Committee.[69] Traditional principles of corporate law hold that auctioneers, like corporate officers, are hired by the board to perform a specific function and are directly responsible to the board for performing that job.[70] Should the auctioneer fail to perform its duties properly, the directors would have a cause of action against them under

65. *In re* RJR Nabisco, Inc. Shareholders Litigation, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,703 (Del. Ch. Jan. 31, 1989). This suit subsequently settled. George Anders, *RJR Settles Lawsuit Filed by Bondholders,* WALL S.J., Jan. 25, 1991, section C, page 13.

66. Schneider v. Lazard Freres & Co., 552 N.Y.S.2d 571 (1990).

67. In the appeal, the parties focused on whether there was privity of contract, or its functional equivalent, between the investment bankers and the shareholders, with each side trying to take advantage of an earlier decision by this same appellate division court in which it had found two investment bankers retained by a Special Committee to be in privity with a target company's shareholders and therefore potentially liable for negligently valuing a target company's assets. Wells v. Shearson Lehman/American Express, Inc., 514 N.Y.S.2d 1, 2 (App. Div. 1987), *rev'd on other grounds*, 526 N.E.2d 428 (N.Y. 1988). See Coffee, *supra* note 62, at 5 for further discussion of the *Wells* case and how it differs from *Schneider*.

68. *Schneider*, 552 N.Y.S.2d at 571-72.

69. An agency is "the fiduciary relation which results from the manifestation of consent by one person [principal] to another [agent] that the other shall act on his behalf and subject to his control, and consent by the other so to act." RESTATEMENT (SECOND) OF AGENCY § 1 (1958).

70. Where an investment bank is selected by the board of directors to act as an auctioneer because of its expertise in the area, the board is entitled to rely upon the auctioneer's judgment and integrity in conducting the auction. *See* Cristallana v. Christie, Manson & Woods Int'l., 502 N.Y.S.2d 165, 171 (App. Div. 1986). While the auctioneer is not a guarantor of the results of the auction, it is required to act with ordinary care and skill and to carry out its duties in a manner consistent with its skill and expertise. *Id.*

agency law.[71] Under Delaware law, the agency relationship would stop there.[72] Directors of the target company are not agents of their shareholders; thus investment bankers are not in an agency relationship with the shareholders.[73]

The *Schneider* court deviated from traditional corporate law by deciding that agency law governed the relationship between a target company's shareholders and a Special Committee of its independent directors. Directors of a corporation doing business in New York[74] are no longer corporate fiduciaries once the corporation is for sale; they become agents of the shareholders. In particular, the *Schneider* court held that, "we are of the view that the relationship between the shareholders and the special committee was essentially that of principal and agent on which principles of corporate law should not be superimposed. . . ." Apparently, the court reasoned that the RJR Special Committee was set up "specifically to protect [the interests of RJR shareholders] in the auction," and was therefore the shareholders' agent. If the RJR Special Committee was an agent of the shareholders, then its agents, the

71. See, Rosenbloom, *supra* note 55, at 597-98, and Ted J. Fiflis, *Responsibility of Investment Bankers to Shareholders*, 70 WASH. U. L.Q. 497 (1992), for a description of various claims that directors can bring against auctioneers. *See also* J. Patrick McDavitt & Patrick Garry, *The Emerging Legal Relationship Between An Investment Banker And Its Client: An Argument For A Fiduciary Relationship*, 12 HAMLINE L. REV. 43 (1989) (arguing that investment banks have a fiduciary duty to their clients); Marc I. Steinberg & Evalyn N. Lindahl, *The New Law of Squeeze-Out Mergers*, 62 WASH. U. L.Q. 351 (1984).

72. The Delaware courts rebuffed a recent attempt to replace the "aiding and abetting" standard of auctioneer liability with the *Schneider* standard. *In re* Shoetown, Inc. Stockholders Litigation ("Shoetown"), Civ. A. No. 9483, 1990 WL 13475 at *7 (Del. Ch. Feb. 12, 1990); *see also* Fulco v. Continental Cablevision, Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,345 (D. Mass. June 19, 1990) (rejecting claim that investment banks issuing a fairness opinion owe a fiduciary duty to selling corporation's shareholders).

73. For further discussion of the governing agency principles, see *supra* Section II.A.

74. The *Schneider* court ignored the internal affairs doctrine in holding that New York law governs the relationship between the directors of a Delaware corporation and the corporation. *Compare* CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 90-92 (1987) (courts should apply law of state of incorporation to a corporation's internal affairs). *See also* Coffee, *supra* note 62, at 5, col. 1 (only Delaware law should decide questions of the relationship between directors and shareholders of a Delaware corporation). Where the investment bankers' advice is not communicated to shareholders but used only by the directors to satisfy their duty of care, this is plainly a traditional internal affair to which *Schneider* cannot apply. *See* Fiflis, *supra* note 54, at 27.

investment advisors, must also be agents of the shareholders.[75] The court rejected application of corporate law stating that the sale of corporate control was "not corporate business of the type governed by traditional principles of corporate governance" because "[i]n this 'buyout' context, if something less than the highest possible price was obtained, the loss [is] sustained by the shareholders, not the corporation . . . ."[76]

Shareholders already have several legal options if they believe their company was not sold for the highest price. First, they can sue the corporation's directors for breach of fiduciary duty. Existing corporate law requires directors to maximize the revenue shareholders receive whenever they auction a corporation.[77] Not covered in such suits would be negligent actions of the auctioneer that occurred despite proper supervision by directors. However, the board could file a direct action to enforce these claims, although such claims are rarely made. In this situation, shareholders can bring a derivative claim. Such claims have onerous procedural requirements.[78] *Schneider*, while duplicative of

75. Comment, *Third Party Advisor Liability*, *supra* note 8, at 615-16, 618-19 (rejecting the *Schneider* court's interpretation of agency and arguing that it was wrongly decided).

76. *Schneider*, 552 N.Y.S.2d at 575. The court may also have been reacting to a perception apparent in the *Wells* case that investment bankers working for special committees are unprincipled in their analysis.

77. *See supra* note 47.

78. Rosenbloom, *supra* note 55, at 598. Plaintiffs would have to satisfy the procedural requirements for such a suit. *See* Aronson v. Lewis, 473 A.2d 805 (Del. 1984). Derivative actions can be "procedurally burdensome" for the plaintiff shareholder. *See* Comment, *Third Party Advisor Liability*, *supra* note 8, at 604 (arguing that shareholders have "neither the time nor the funds" to bring these claims). Nevertheless, the shareholder plaintiffs' bar brings these actions frequently. See Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) for a critique of the existing system of derivative lawsuits. Furthermore, if the board and the auctioneers collude to not maximize value for shareholders, this would violate the directors' duty to act in good faith. *See In re* RJR Nabisco, Inc. Shareholders Litigation, *supra* note 65.

Shareholders could try to bring an action alleging that the auctioneer breached its fiduciary duties to them. In one withdrawn opinion, the Delaware Supreme Court found that investment bankers advising a target corporation had a fiduciary duty to its minority shareholders. Weinburger v. UOP, Inc., 8 Del. J. Corp. L. 162 (1982) (withdrawn). This withdrawn decision has not been followed by other Delaware courts. In addition, shareholders could bring several other types of direct actions against the auctioneers, including claims under the federal securities laws or for common law fraud, although these claims require proof of scienter. Rosenbloom *supra* note 55, at 599; Comment, *Third Party Advisor Liability*, *supra* note 8, at 611. Also, a claim of negligent misrepresentation could be brought where shareholders can show they acted in reliance derivative suits on the substantive charge, would make direct claims against the auctioneer far easier to bring. Thus, *Schneider* threatens greater amounts of expensive litigation.

Nevertheless, *Schneider* might be the stimulus needed to force reforms aimed at perceived conflict of interest problems with public company auctioneers. For example, claims that investment bankers hired by special committees (at the recommendation of management) act to favor management-backed bidders,[79] or that investment bankers have too many roles in these transactions,[80] have concerned the courts and commentators. *Schneider*, by allowing shareholders a direct action against auctioneers, may lead auctioneers to behave more independently from management. This increased independence could be reflected in changes in industry practices through improved self-regulation of conflicts of interest[81] and better structured compensation agreements.[82] Of course, these same changes could take place through private action, or as a result of SEC regulations,[83] which could be implemented at significantly lower cost.

Even if some form of direct liability is needed to stop auctioneers from catering to managements' desires, rather than properly informing directors, a more limited liability regime could have this result. Indeed, holding auctioneers liable for a maximum of the amount of the fees they earn on the transaction, and forbidding indemnification or insurance against this loss, could have the desired impact without the additional

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on the investment bankers' advice. See *supra* note 53 for further discussion of the limitations on this claim.

79. *See, e.g.*, Rosenbloom, *supra* note 55, at 569-71, 600-01. In some transactions, investment bankers give financial advice to the board of directors, provide bridge loan financing and underwrite securities for the acquiror, and issue fairness opinions to the public shareholders. The potential conflicts for an investment banker in this situation are significant. *Id.*

80. Investment bankers can act to prevent any sale of the company. *See supra* note 36. *Schneider* could also have the perverse effect of increasing investment bankers' desire to accommodate an entrenched management's wishes. After all, bankers' indemnification protections are frequently negotiated with management. It is conceivable that entrenched management might be more willing to give pliant investment bankers greater protections against *Schneider* liability in exchange for an informal agreement to favor a friendly bidder. Of course, such collusion could take place anyway, but auctioneers' *Schneider* liability gives entrenched management another bargaining advantage.

81. *See* Rosenbloom, *supra* note 55, at 591-92.

82. In particular, public company auctioneers conflicts would be reduced if they were compensated only with a percentage of the sale price of the company and prohibited from acting in other roles in the transaction.

83. The SEC has greatly expanded its disclosure requirements in this area. Rosenbloom, *supra* note 55, at 585-89; Fiflis, *supra* note 54, at 4-6.

costs.[84]

As a policy matter, *Schneider*'s agency model of the corporation—directors as agents of shareholders, and investment bankers as agents of directors—could be justified as an attempt to keep directors faithful to the corporation in a "final period" situation.[85] In the final period of the corporation's life, directors may act opportunistically to benefit themselves. Society could make directors liable under agency principles to attempt to prevent this conduct, which would also make auctioneers liable to shareholders (as agents of an agent) under agency principles.

Even if this agency liability would have beneficial effects on director conduct, which is unclear,[86] there are strong policy arguments against extending agency liability to auctioneers. For example, *Schneider*'s duplicative enforcement regime creates a potentially serious conflict of interest. If investment bankers are going to be held directly liable to shareholders for the outcome of an auction, are they going to allow the board of directors to decide who will be the buyer of the corporation?[87] Do we want investment bankers to determine who comes to the auction, how long the auction runs, what the auction rules are and who wins?[88] A myriad of these conflicts could arise, including questions about which bid is highest, or who should be eligible to bid. The *Schneider* test transforms the relationship between a board and its banker into a potentially adversarial one.

The problems created by the *Schneider* decision extend much further though. *Schneider* changes the legal status of directors. If directors are viewed as agents during a sale of the corporation this has serious implications for their liability and behavior. For example, under

84. *See* Alfred F. Conard, *A Behavioral Analysis of Directors' Liability for Negligence,* 1972 DUKE L.J. 895.

85. Final period problems arise whenever a corporation is being sold to a new owner because directors and managers have less incentive to be faithful to employees when their jobs will no longer exist. Thus, in this end game, directors and managers have greater reason to act opportunistically and engage in hidden self-dealing.

86. As noted above, shareholders already have a direct action against directors for breaching their fiduciary duties in selling a corporation. This would be the same claim that a seller would make against a common law auctioneer. *See supra* Section III.A. The principal difference would be that under the corporate law standard, directors are only liable for gross negligence in conducting the sale, *see* Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985), whereas the common law standard is simple negligence. See *supra* Section III. This change does not seem likely to have much effect on director behavior, especially after indemnification and insurance coverage are taken into account. *See* Conard, *supra* note 84.

87. Rosenbloom, *supra* note 54, at 577.

88. *Id.* at 579.

corporate law principles, directors conduct auctions in the manner they decide is in the best interests of the shareholders. Agency law would require directors to follow the shareholders' *instructions* about how to conduct the auction. Giving shareholders complete discretion over how to conduct the auction and how to determine which bid to accept creates another serious potential conflict of interest. Some shareholders may choose to sacrifice other shareholders' interests. Nor is it clear which shareholders the board should be listening to. What if there is no consensus among shareholders about how to sell the company? Equally importantly, are all shareholders to be given the same voice, or should long term shareholders' votes be given more weight than arbitrageurs?

Making directors the agents of shareholders would also destroy the limited liability protections afforded by the corporate form. The shareholders, as principals, would be liable for the agents' misdeeds that are committed in the conduct of the principal's business. Shareholders could thus be liable for a wide variety of directors' misdeeds, such as potential fraudulent conveyance claims in leveraged buyouts.

More importantly for our purposes, the case opens a new door for shareholders to sue advisors for simple negligence.[89] *Schneider* removes a major impediment to shareholder suits against advisors/auctioneers: under previous Delaware law, plaintiffs had to prove that the auctioneer knowingly participated in a breach of the directors' fiduciary duties to the shareholders. If directors are agents of the shareholders instead of fiduciaries, then the advisors become agents of agents and are therefore liable to their principals (the RJR shareholders) for acts of simple negligence.

Under *Schneider*, advisors/auctioneers could be sued by any bidder, in its capacity as a stockholder of the company, claiming that the auctioneer failed to run a fair auction—for example, that the auctioneer negligently valued its bid; improperly deprived it of information; deprived it of a chance to re-bid; or otherwise tilted the playing field.[90] These bidder suits would impair auction conduct, as auctioneers worry more about bidders' claims than about maximizing revenues.

It is also clear from our description of general auctioneer liability[91] that *Schneider* is inconsistent with the legal regime that governs noncorporate auctioneers' relationships with bidders. For example, in

89. *See also supra* note 53 (discussion of other types of suits against any advisors to the board).

90. This claim against the advisors would piggy-back on suits against the board of directors for breach of its fiduciary duty to run a fair auction. *See, e.g.*, Samjens Partners I v. Burlington Indus., Inc., 663 F. Supp. 614, 624 (S.D.N.Y. 1987) (board has a fiduciary duty to its shareholders to conduct auction fairly).

91. See *supra* Section III.A for this discussion.

other types of auctions, auctioneers have no duties to third parties, such as disappointed bidders.[92] Sellers are generally prohibited from bidding on the goods that they are auctioning. Because the principal cannot compete with the bidders, the principal has strong incentives to design the auction to maximize its expected revenues. *Schneider* could distort these incentives because it fails to discriminate between those buyers/bidders who are also shareholders, and who could under agency law be considered principals of the auctioneer with all the rights and remedies of principals, and buyers/bidders who have no relationship to the seller, who would have little or no legal recourse against the auctioneer under agency law.

IV. An Economic Analysis of Increased Auctioneer Liability

The purpose of this section of the paper is to make predictions concerning *Schneider*'s effect on corporate auctions. We focus on the prices charged by auctioneers for their services; on the indemnifications offered by boards to auctioneers; on the means-of-payment used by corporate acquirors to buy other companies at auction; on the prices auctioned companies can be expected to receive; and on the net effect on selling company shareholders. To accomplish this, we first look into the effect of increased liability on the prices for auctioneer's services and on the nature of any indemnification contracts offered to the auctioneers. This analysis relies on a principal/agent model. We predict that *Schneider* will cause indemnification contracts between selling companies and auctioneers to broaden so as to cover any new legal liability. Given our prediction that all of the increased legal liability will end up being borne directly by the selling corporation through wider auctioneer indemnification clauses, we then analyze the effect this development will have on auction prices for the selling company. This analysis relies on auction theory; accordingly, we give a brief review of the necessary theoretical components before applying the theory to auctions of companies with increased potential legal liability.

A. Effects on Auctioneers' Prices, Indemnification Contracts, and Auctioneer Due Diligence

Under *Schneider*, corporate auctioneers face increased legal liability and, therefore, increased expected costs of doing business. If the auctioneers are not indemnified for their increased legal liability, there will be two immediate effects: first, the prices for auctioneer services

92. *See supra* note 39 and accompanying text.

will increase; and second, auctioneers will take what actions they can (optimally) to improve their performance and reduce their expected legal liability.

The conventional economic view of the negligence standard is that it demands that defendants engage in a weighing of the costs and benefits of preventive measures. Additional precautions should be taken when the burden of the precaution is less than or equal to the probability of an injury occurring times the size of the injury if one occurs.[93] The shift from aiding and abetting liability to the *Schneider* negligence standard will increase the probability of a finding that an injury has occurred. This will cause firms to take additional precautions to reduce their potential liability.

Some of these precautions could accrue as benefits to the selling company shareholders if they improve the auction process (for example, improved industry self-regulation may lead to fewer conflicts of interest or better standardized valuation techniques). Yet, the tremendous size of the potential liability, over $1 billion in the *Schneider* case, combined with the possibility of jury error in assessing what the proper level of precautions should have been, could lead auctioneers to take excessive precautions. Furthermore, in those areas where auctioneers must exercise judgment, such as how many bidders to invite or what projections to use, the threat of increased liability will not produce an improved auction process, but rather litigation avoidance behavior.

In weighing the net effect of the changed legal regime on selling company shareholders, we begin by determining the elements of the price increase for auctioneer services due to *Schneider*. We identify five separate components to this increase: increased settlement costs, increased costs due to litigation avoiding behavior, increased legal fees, risk premiums in auctioneer fees, and an "auction uncertainty premium." The increase in price is then compared to the benefits to selling company shareholders. Here we find two components of benefits—proceeds from successful lawsuits and potential improvements in auction quality. We present two arguments as to why the price increase will likely outweigh any increase in benefits provided; we will first describe in general terms these two arguments and then analyze them in depth.[94]

93. Judge Learned Hand is generally credited for this formulation of the negligence standard. *See* United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947).

94. We should note at this point that we are assuming well-functioning auction markets in the sense that bidders respond rationally to changes in the legal regime. This does not mean that we assume away all market imperfections; it just means that the response to the one change that we focus on is rational. Although the auction-theoretie literature always assumes rational behavior, and empirical evidence from real-world data

Our first argument as to why the price increase must outweigh any incremental benefits relies on a qualitative evaluation of the price increase relative to any benefits. We argue that the price increase will be large because of risk aversion of the auctioneers and the tremendous amount of risk being borne (e.g., $1 billion of potential damages in *Schneider*).[95] Conversely, we argue that the incremental benefits will be small because the incentives will be for auctioneers to minimize legal liability, not to maximize auction efficiency, and because in what will be a major area of litigation—valuation of non-cash bids—there is relatively little that auctioneers can do to improve the *ex post* accuracy of their advice.[96]

Our second argument as to why the price increase must outweigh any incremental benefit is in a sense just a formalization of our first argument, but it also highlights what may be the essence of the issue. If directors act in the interests of shareholders (a large assumption that we return to address), then they will contract for an economically efficient level of quality and care from their advisors. If shareholders could commit themselves to not sue *ex post* if the advice given is incorrect, then advisors would be willing to enter a contract that asked and paid for the efficient level of advice. Under *Schneider*, however, shareholders cannot commit themselves to not sue even if the advisors fulfilled the *ex ante* terms of the deal. Indeed, it should be expected that shareholders will sue whenever the expected benefits of bringing a case exceed the costs, and

often confirms this, experimental auction work has turned up violations of the theoretical predictions. For a review of the evidence, see Robert G. Hansen & John R. Lott, Comment, *The Winner's Curse and Public Information in Common Value Auctions*, 81 AM. ECON. REV. 347 (1991).

95. *See* Christopher D. Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 52-53 n.202. To say that the investment bank is risk averse, means that it is willing to pay more to avoid a loss than the true expected value of the loss. Dale H. Oesterle, *Limits on a Corporation's Protection of its Directors and Officers from Personal Liability*, 1983 WIS. L. REV. 513, 523 n.23. If the banker is forced to bear this risk, and the banker is risk averse, then it will demand an increase in its fees greater than the expected value of the loss to compensate it for assuming this risk. *Id.* If the banker could buy insurance against this risk, which it cannot presently do, the insurance company would charge at least the amount of the expected loss plus a reasonable profit margin. *Id.* This insurance would be unlikely to cover acts of willful misconduct by the auctioneer though unless the auctioneer continued to bear some financial responsibility for any possible misconduct. *Id.* at 523-24. Furthermore, as the size of the expected losses increased, fewer corporations would purchase insurance, rendering it increasingly difficult to estimate total future losses and insure these risks. *Id.* at 524.

96. Some commentators argue that *Schneider* yields an additional benefit of forcing corporate advisors to monitor directors. *See* Fiflis, *supra* note 54, at 41-47. *See infra* notes 111-17 and accompanying text.

this will occur in many instances when the advice was *ex ante* good but *ex post* incorrect. To protect themselves in such a situation, advisors will necessarily provide more than the efficient level of quality and care. This means that the costs of additional quality exceed the benefits. If we are correct in these arguments, we should then expect to see selling companies avoid the net cost of *Schneider* by indemnifying their auctioneers. After further analysis of *Schneider*'s net cost, we return to discuss current and expected indemnification arrangements.

To substantiate our arguments on the net cost of *Schneider*, we begin by analyzing the necessary increase in auctioneer prices if *Schneider* is the operative legal standard. The five components of this price increase relative to the costs incurred under a pre-*Schneider* regime are:

(A1) Increased costs due to the direct settlement costs[97] of the expected number and size of lawsuits arising out of a given deal;
(A2) Increased costs due to actions taken by the auctioneer to reduce legal liability;
(A3) Litigation costs;
(A4) A risk premium since the auctioneers are likely to be risk averse and their net fees are now being made very stochastic;[98] and
(A5) What we term an "auction uncertainty premium" that arises if auctioneer prices are themselves set through an auction process.[99]

Let us now view this situation from the selling corporation's shareholders' viewpoint. The *Schneider* decision gives selling company shareholders a cause of action against the auctioneer for simple negligence in conducting an auction of the shareholders' property. The benefits of this new legal regime for the shareholders will be two-fold:

(S1) Direct settlements from *Schneider* lawsuits; and
(S2) Any net benefits deriving from actions taken by the

97. By settlement costs, we mean both out-of-court settlements and court judgments. Litigation costs are considered separately.

98. Net fees—fees minus settlements and litigations costs—are stochastic because settlements and litigation costs are uncertain. Auctioneers are assumed to be risk-averse in that they prefer a certain payment of x over an uncertain lottery that has expected value of x. Risk aversion is a reasonable assumption here because many advisors are private corporations or partnerships where the owners are not well-diversified.

99. See *infra* notes 132-33 and accompanying text for elaboration of this point.

auctioneer to reduce their legal liability.[100]

In comparing the costs and benefits of the *Schneider* legal regime to shareholders, one first notices that (S1) and (A1) cancel one another; what shareholders expect to receive from *Schneider* lawsuits they must also expect to pay in increased prices for auctioneer services. Thus, the comparison of costs versus benefits simplifies to weighing the costs A2 through A5 against the net benefit S2.

First, we present a qualitative argument concerning the relative size of these costs and benefits. We should expect A4 to be relatively large because of the size of the potential liability auctioneers assume. A $1 billion settlement—which could conceivably emerge from *Schneider*—would be enough to wipe out the equity of even the largest public investment banks.[101] When one considers the effect of such a liability on smaller investment banks, consulting firms, and law firms, one must conclude that these entities would effectively be prohibited from participating in the auction market.[102] Second, cost A5—the auction uncertainty premium—will also be significant, because auctioneers will likely differ greatly in their estimates of what the *Schneider* liability in any given case will be. As we establish below, this heterogeneity creates a sort of market power in the auction context and therefore gives bidders an opportunity strategically to increase prices.[103]

Now consider the potential incremental benefits to the selling company's shareholders. We have already noted that the incentive for auctioneers is to minimize legal liability, rather than maximize auction efficiency.[104] For example, to protect themselves from suits by disgruntled bidder/shareholders, we expect auctioneers to exclude fewer bidders from participation in final rounds of bidding and to be even more complete in their disclosure of relevant information about the selling company. Yet both of these actions may lower the expected price received for the selling company, for they result in more widespread

100. We qualify this as a "net" benefit for it is not clear that actions taken by advisors will be in the interests of running a more efficient auction for the shareholders' benefit.

101. Auctioneers may also withdraw their services entirely from small or financially risky firms. *See, e.g.*, Reiner H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 891-92 (1984).

102. One could even envision syndication of the risk taking place, much as investment banks syndicate the financial risk of securities underwritings. But such syndication also comes at a significant cost.

103. In this auction, bidders are selling a service so that higher prices make the buyer of the service, the corporation, worse off. See *infra* notes 132-33 and accompanying text for further discussion of why heterogeneity creates market power in auctions.

104. *See supra* notes 90-91 and accompanying text.

knowledge of potentially sensitive information.[105]

Second, suppose that some of the actions taken by auctioneers to reduce their legal liability actually do serve to enhance the auction process. How much room is there for improvement? Consider the issue of valuation of non-cash bids, one which would certainly be a ripe area for shareholder litigation. The amount of uncertainty in a security valuation that is unresolvable—at least, unresolvable without tremendous resources—is necessarily very large, for a valuation depends upon forecasts of market-based discount rates and forecasts of company-specific performance.[106] In fact, it is safe to say that any *ex ante* valuation will turn out *ex post* to be wrong.[107] This does not imply that all valuations are equally poor, for it is possible to reduce a significant amount of uncertainty through a careful and unbiased analysis. But even after doing all they can reasonably do to reduce uncertainty, auctioneers will be left with inaccurate valuations that will give rise to *Schneider* lawsuits. Selling company shareholders pay a large price increment in return for a marginal improvement in auctioneer advice.[108]

Indeed, the *Schneider* case itself presents a good example of the results created by applying a negligence standard to the complex valuation problems faced by auctioneers. Both bids received by the RJR Special Committee included enormous dollar value amounts of complex securities that were designed to allow RJR's current shareholders to participate in the potential future benefits of a healthy corporation. The size of these

105. See Hansen, *supra* note 25, for further elaboration of why it is efficient to restrict both bidders and disclosure when selling a company. It is doubtful that a jury would ever find an auctioneer guilty of negligence for inviting too many bidders, for the cost of that action is necessarily difficult to quantify.

106. For a description of several common valuation methodologies used by investment bankers and their dependence on certain assumptions, see Arthur H. Rosenbloom & Arthur H. Aufses III, *On Understanding Investment Banker Liability*, 4 INSIGHTS, Apr. 1990, at 3-4. Even if we have investment bankers independently verify every piece of information they are given by the company, a tremendously expensive process, these estimates may be of lower quality than company estimates. *See* Rosenbloom, *supra* note 55, at 578.

107. *See* Oesterle & Norberg, *supra* note 3, at 255 nn.155-56. The RJR valuation exercise is an outstanding example of this problem; the subsequent market value of the securities issued in that buy-out greatly exceeded the Special Committee's investment advisors' ex ante estimates.

108. Other actions that might improve the quality of auctioneer services, such as investment banker self-regulation and greatly expanded disclosure requirements, *see* Rosenbloom, *supra* note 55, at 591-92, could be implemented by the industry and the SEC independently of the legal liability standard for auctioneers. These changes could reduce technical mistakes and failures to take proper care by providing better standards for the industry and exposing shoddy work to the public. The SEC has been very active in this area. *Id.* at 585-89.

security issuances dwarfed anything ever issued before. When coupled with the complex terms of the securities in the RJR deal, this made it impossible for the auctioneers to value the securities with any real certainty. The investment bankers' valuations of the securities were by necessity based on assumptions about the trading value of the securities. These assumptions will be, at most, only marginally improved by telling the bankers that they will be sued for mistakes found in after-the-fact valuations. A more likely effect of increased liability for valuation mistakes is that auctioneers will become too cautious in soliciting bids. Many will seek all cash bids, instead of potentially higher bids involving a mix of cash and securities,[109] because of their fear of being sued for improper valuation of the bids.[110]

Some commentators would counter our arguments here by saying that an increased threat of a shareholder suit forces corporate advisors to act as monitors of director conduct.[111] In other words, the argument is that auctioneer/advisors act as "gatekeepers,"[112] and that it would be worthwhile for shareholders to pay for this service through increased auctioneers' fees and, perhaps, less efficient auctions. The idea of using auctioneers to better regulate director conduct has appeal: auctioneers are outsiders with independent reputations that have influence in shaping how the directors conduct the auction, and they are likely to have little to gain

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109. *See infra* notes 136-38 and accompanying text.

110. The potential inhibiting effect of heavy personal liability on the willingness of actors to engage in innovative or high risk behavior has been discussed in a variety of contexts. *See, e.g.*, Oesterle, *supra* note 95, at 514 n.3 (discussing director and officer liability).

111. Retaining an investment banker to act as an auctioneer can serve as a monitoring device against management misconduct when the bankers diligently perform their job and offer their market reputations as "hostages" for the quality of their work. *See* Robert J. Giurffra, Jr., Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 126 (1986). On the other hand, if management corrupts the investment banker auctioneer, inducing it to act in management's self-interest, then employing the auctioneer will serve to insulate further managers from shareholder scrutiny. *Id.* at 127-130; Oesterle & Norberg, *supra* note 3 at 211-12 (when shareholders and managers' interests diverge in a sale of the corporation, investment bankers may serve only to "hoodwink" shareholders by offering ostensibly fair valuations to support management's self-interested behavior). It appears from some litigated cases that investment bankers are not acting as open-minded experts, but rather as producers of made-to-order opinions that support management's pre-established positions. *Id.* at 211. *See also* Lucian A. Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They And What Can Be Done About It?*, 1989 DUKE L.J. 27.

112. *See* Kraakman, *supra* note 101, at 889; Reiner H. Kraakman, *Gatekeepers: The Anatomy of Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 54 n.3 (1986) [hereinafter Kraakman, *Gatekeepers*]; Stone, *supra* note 95, at 47.

and much to lose from covering up the directors' misdeeds.[113] Imposing gatekeeper liability is costly though—as we have just argued—since investment bankers will demand compensation for assuming these duties. This demand will penalize innocent clients and encourage the entry into the market of low-quality competitors. Investment bankers may also refuse to accept high risk cases, precisely the group of firms most in need of their services.[114] It may also be easy for management to select investment bankers that are corrupt or willing to assume personal liability for a price,[115] although this will be more difficult with diversified investment banking firms that have widespread client bases and well-known reputations,[116] and to fire bankers that try to stop abuses.

We also note that Delaware law already imposes gatekeeper liability on investment banker auctioneers with respect to director misconduct because auctioneers have a duty not to aid and abet director misconduct.[117] In short, imposing an additional "gatekeeper" duty would result in little, if any, improvement in director performance. Misconduct involving both the special committee and the auctioneer, such as an agreement to award the company to a favored bidder, could be attacked by shareholders under the existing aiding and abetting legal standard. Nor would this type of intentional misconduct by auctioneers be covered by existing indemnification agreements.

The second argument as to why the costs of increased auctioneer liability must exceed the benefits begins by recognizing that the market for corporate auctioneers, like most markets, provides a trade-off between increased quality of advice and the price paid. It would be naive to think that the market for auctioneer services is one where quality either does not matter or cannot be varied. In fact, reputation of advisors is a key component of competition among corporate advisors such as investment banks,[118] and there are well-established quality tiers—that is, a corporation chooses its level of advice quality by choosing among well-recog-

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113. Kraakman, *supra* note 101, at 890-91.

114. Kraakman, *Gatekeepers*, *supra* note 112, at 75-78.

115. Kraakman, *supra* note 101, at 891-92.

116. Kraakman, *Gatekeepers, supra* note 112, at 71-72, 96-97.

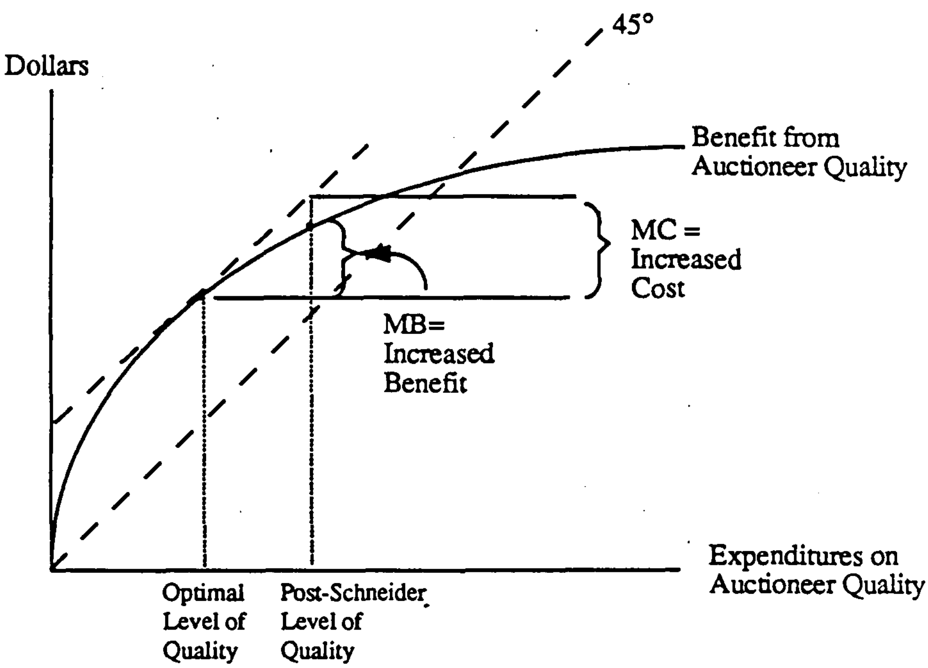
117. *See id.* at 74 n.66, 84 n.93.

118. *See, e.g,* James R. Booth & Richard L. Smith II, *Capital Raising, Underwriting and the Certification Hypothesis*, 15 J. FIN. ECON. 261 (1986). These authors argue that the reputation of investment banks serve to certify the value of initial public offerings.

nized tiers of advisors.[119] And once an advisor is chosen, that advisor can also offer a trade-off between advice quality and price by, among other things, varying the time spent and number of professionals used on the case.

Assuming for now that directors work in the shareholders' interests, then they will, in the absence of *Schneider*, choose that quality of advice which just balances A2 and S2, the marginal costs and marginal benefits of increased auctioneer advice quality.[120] Figure 1 makes this point graphically.

Figure 1
Auctioneer Quality, Pre- and Post-*Schneider*



119. For a general description of the tiers of investment banks, see SAMUEL HAYES III ET AL., COMPETITION IN THE INVESTMENT BANKING INDUSTRY (1983). In one article that argues investment bankers' reputations serve to certify the value of new securities offerings, it is also shown that bankers doing a poor job of pricing their issues tend to lose market share in subsequent periods. *See* Randolph P. Beatty & Jay R. Ritter, *Investment Banking, Reputation, and the Underpricing of Initial Public Offerings*, 15 J. FIN. ECON. 213 (1986).

120. Following our definition of negligence, *see supra* text accompanying note 93, this level of quality is the only one which, theoretically, should not be considered negligent. Thus, the non-negligent level of quality is the efficient level, and directors who act in the shareholders' interests will want to purchase that amount.

Shareholders are wealthiest when the optimal level of quality is chosen.[121] This is not, of course, a level of quality that ensures no mistakes *ex post*, and therein lies the problem. Under *Schneider*, any mistake that becomes obvious *ex post* will provide material for a shareholders' suit that the level of care taken was negligent. It seems unlikely that a jury will be able perfectly to determine whether a mistake was due to negligence or simply to the turn of events, so that advisors who provide an *ex ante* optimal care level will find themselves successfully sued for negligence. Shareholders also cannot commit themselves *ex ante* to not bring such opportunistic suits. The obvious thing for advisors to do then, under *Schneider*, is to increase the quality of advice so as to minimize the grounds for any lawsuits. But since the quality level without *Schneider* should be the optimal level, any increase is inefficient, that is, it imposes greater costs than benefits on shareholders.

Recognizing the agency problem between directors and shareholders raises two additional issues. Directors might further their own interests at the expense of shareholders by contracting for an inefficient level of advice quality or by employing advisors who will deliberately present biased advice that helps the directors directly (e.g., that ensures a favored bidder will win). Concerning quality of advice, it would seem that directors are most likely to choose too-high a quality level, for this reduces their potential liability to shareholders. If this is the case, our points of above still hold. Concerning the hiring of deliberately biased advisors, we concede that *Schneider* can make such a practice riskier for advisors and might therefore reduce the occurrence of such breaches of fiduciary duty obligations. As in our above discussion of the "gatekeeper" role of advisors, we would question whether this benefit of *Schneider* outweighs its obvious costs, and we would also note that Delaware law already allows shareholders to sue advisors who aid and abet directors who violate their fiduciary duties.

If we are right in our assessment of the costs and benefits of *Schneider* to selling company shareholders, then we should find that the

121. We are essentially arguing that the level of care to be taken in providing auctioneer services is a choice that can be made *ex ante*, that is, before the auctioneer is hired. The reason for this is that auctioneers compete with one another by *committing* themselves to different levels of quality. Auctioneers that deviate from their reputed quality will be punished by fewer transactions in the future (that is, as bidders and directors observe the low level of quality, they will decide to use a different advisor in the future). *See, e.g.*, Randall Smith, *Deal-Shock: Wasserstein Falls in the Ranking*, WALL ST. J., Feb. 11, 1991, at C1 (auctioneer that was found potentially personally liable for aiding and abetting breach of directors' fiduciary duties in improperly conducting an auction of a major American corporation estimates that it has cost his firm 10-15% of its business).

selling corporation will choose to indemnify its advisors against the simple negligence suits that will arise from *Schneider*. Instead of passively accepting a court decision that imposes a net cost on them, selling corporations will contract around the regime change through indemnification agreements. We have also argued that any improvements in the conduct of the auction from increased liability are likely to be de minimus, while the real costs of increased liability are high. Thus, society should not stop the parties from freely contracting for indemnification. To understand how these indemnification agreements are likely to work, we will briefly review how current indemnification practices operate.[122]

Investment bankers and other advisors performing services for companies often request that the company agree to indemnify them for any losses that they suffer in the course of performing the services.[123]

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122. As mentioned above, *supra* note 43 and accompanying text, the standard Sotheby's contract gives Sotheby's complete direction on how the auction is to be conducted and limits the ability of sellers to sue Sotheby's over disagreements on procedure. This practice is consistent with what we argue above.

123. Historically, investment bankers have sought indemnification rather than other equivalent forms of protection from legal liability, such as *ex ante* waivers by the corporation of its right to sue, or separate insurance policies, to cover these risks. State corporate laws authorize corporations to enter into binding agreements to indemnify its agents in future controversies. *See* Oesterle, *Personal Liability Protection*, *supra* note 95, at 543-45 (discussing standards for indemnifying officers and directors of the corporation). These agreements do not, however provide complete protection for auctioneers. If the client corporation goes bankrupt, this could render the indemnification agreement unenforceable. There are also limitations on the coverage of indemnification. *See infra* notes 129-30 and accompanying text.

Waivers would avoid most of the litigation expense associated with enforcing the *Schneider* standard. Agency and trust law principles suggest that waivers of the corporation's right to sue for negligent, or even grossly negligent conduct, are enforceable. Oesterle, *supra* note 95, at 554, 572. However, granting an ex ante waiver lays the corporation open to criticism by its shareholders for giving up its right to judicial recourse against misconduct, which may explain their infrequent usage. *Id.* at 572. A more limited version of the waiver would allow bankers to restrict damages to the amount of compensation that the banker received for its auctioneer services. Coffee, *supra* note 62, at 6.

Alternatively, the target corporation is statutorily authorized in most states to purchase insurance policies that insure it against the risk of misconduct of its agent, the auctioneer. Oesterle, *supra* note 95, at 550. These agreements will be enforceable if they are restricted to claims of negligent or grossly negligent behavior. *See id.* at 550-51, 561 (claiming that the judicial trend is to enforce policies that cover even intentional misconduct by the insured so as to insure that injured parties receive full compensation). Insurance would have the advantage of introducing the insurer as a monitor of auctioneer conduct and could be used to spread the risks of large judgments against auctioneers.

Insurance has the disadvantage of tying the target corporation to the decisions of a third party, the insurance company, that may not offer the amount of coverage desired, Indemnification shifts potential legal liabilities from the advisors onto the hiring corporation.[124] In the case of corporate auctions, the selling company indemnifies the auctioneer.[125] Standard engagement letters between selling corporations and investment bankers include broad indemnification provisions, such as "[t]he Company agrees to indemnify and hold Investment Banker harmless against any and all losses, claims, damages, liabilities, or expenses, joint or several, to which Investment Banker may become subject arising from or in connection with the services."[126] Typically, there is also a clause stating that the indemnification holds only if the advisor is not finally adjudged to have committed "willful misfeasance or gross negligence" in performing its duties.[127] The breadth of the exclusions contained in the indemnification letter is a matter for negotiation between the company and its advisor.[128]

While existing indemnification provisions may not cover simple negligence suits stemming from *Schneider*, there is already evidence that indemnification agreements are being re-drafted specifically to cover the new liability.[129] Such indemnification is generally legally permissi-

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or may charge extremely high premiums for the coverage. *Id.* at 570. For example, insurance premiums for professionals such as accountants and lawyers that act as advisors to savings and loan associations are projected to increase by amounts ranging from 15% to 30% over the next year because of the increased incidence of lawsuits against these advisors. Sherry R. Sontag, *Soured Deals Snag More Professionals,* NAT'L L.J., Feb. 4, 1991, at 31. For a further discussion of the problems of using insurance to offset tort liability, see Silicano, *supra* note 53, at 1948-50.

For an excellent discussion of the interplay between the currently permitted strategies of indemnification, insurance and waiver, see generally Oesterle, *supra* note 95, at 561-66.

124. Indemnification agreements may shift the impact of liability from the advisors to the corporation. Oesterle, *supra* note 95, at 513 n.1. The risk of large personal debts from litigation over their official actions leads investment bankers to demand protection or compensation from the target corporation against these potential liabilities. *See id.* at 518.

125. Giuffra, *supra* note 111, at 140; 1 MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS & FREEZEOUTS at 8-5 (1991). Indemnification is also widespread for officers and directors of corporations. Clifford G. Holderness, *Liability Insurers as Corporate Monitors,* 10 INT'L REV. L. ECON. 115, 116 n.6 (1990) (99% of corporations surveyed indemnified directors and officers).

126. 2 LIPTON & STEINBERGER, TAKEOVERS & FREEZEOUTS at C-22 (1990) (form of engagement letter with respect to takeover defense).

127. *Id.*

128. Giuffra, *supra* note 111, at 140 n.122.

129. While investment bankers traditionally have obtained indemnifieation from the company, if the Special Committee is indeed to be deemed the "agent" for the shareholders in this eontext, consideration should be given by counsel to investment bankers to seeking additional protections in the engagement letter to be binding both upon the company and its shareholders (e.g., choice of forum clause, waiver of trial by jury).

ble.[130]

Of course, the story on *Schneider*'s impact cannot end here; with indemnification, the legal liability is merely retained by the selling corporation. This will in turn influence the price that the selling corporation can be expected to fetch at auction—for the purchaser of the selling corporation will in the end be the entity which bears the cost of any payments from *Schneider* litigation. To analyze the effect on auction prices, we turn to auction theory.

B. Effects on Auction Prices When the Selling Corporation Indemnifies the Auctioneer

If the purchaser ends up with the financial liability arising from *Schneider* cases, how will this be reflected in bids for the selling corporation? A first approximation would be that bids would be reduced by the expected financial liability assumed by the purchaser. This implies that selling corporations are made worse off by *Schneider* only to the extent of litigation costs, for settlement payments are a wash: Bids are reduced by expected settlements, but those expected settlements are received by selling corporation shareholders.

Auction theory, however, implies that the expected price for the selling company will fall by *more* than the expected financial liability of *Schneider* suits, even if bidders are risk neutral. We state this formally as Proposition 3 below. For now, we will attempt to give an intuitive understanding of the result: Under the *Schneider* legal regime, bidders for a corporation must realize that they are buying a potential financial

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Herbert M. Wachtell et al., *Investment Banker Liability to Shareholders in the Sale-of-Control Context*, N.Y. L.J., Mar. 1990, at 1, 4. *See also* ROSENBLOOM, *supra* note 55, at 595-96 (suggesting expanded indemnification rights, contribution undertakings limited to amount of fees paid, waiver of jury trial and forum restrictions).

130. Statutory authorization of indemnification against agent's liabilities arising out of suits by, or in the name of, the corporation is generally limited: If the agent is successful in defending the suit, or settles the case without a finding of liability, the corporation is obligated to pay its reasonable expenses; however, if the agent is adjudged liable in the suit to the corporation, then the corporation may not indemnify the agent under the terms of the statute. *See, e.g.*, MODEL BUSINESS CORP. ACT § 8.51, 8.56 (1989). Contractual agreements respecting indemnification, on the other hand, are not limited by these restrictions and may provide much broader protections subject only to the limitation that the indemnification offered may not be inconsistent with public pelicy. *Id.* at § 8.56 (3) cmt.; *see also* Hibbert v. Hollywood Park, Inc., 457 A.2d 339, 344 (Del. 1983) (stating that Delaware corporation could grant indemnification broader than statute provided). To the extent that auctioneers cannot be indemnified against these liabilities, we would expect them to raise the price for their services to compensate themselves for the increased risk of liability.

liability arising out of *Schneider* lawsuits, as well as the corporation itself. Thus, rational bidders must reduce the amount they are willing to pay for this "package" of corporation and legal liability together. But the actual dollar amount of any *Schneider* liability will be unknown to any bidder ex ante, so the overall financial uncertainty associated with the package is higher than that of the corporation value itself.[131] But for reasons detailed below, uncertainty is anathema to auction prices; with greater uncertainty, bidders will naturally lower their bids (partly to protect themselves from losses, and partly out of opportunism—there is a good chance that other bidders will think the package is worth much less). For this reason, the expected value of the auction price will decline by more than just the expected value of the *Schneider* liability.

To investigate this further, consider an auction where n bidders compete via sealed-bids for the right to purchase an item of uncertain value. Suppose as a first case that all bidders have the same information on the item's value, so that the expected value of the item is the same to all bidders. Call this expected value E(v). Then in a sealed-bid auction the Nash equilibrium bid strategy is for all bidders to submit a bid of E(v): although this bid gives no expected profit to any bidder, to deviate unilaterally from the strategy (bid something other than E(v)) would entail either a certainty of winning but at a loss, or it would entail losing for

131. More formally, let A be a bidder's estimate of asset value and let L be the bidder's estimate of *Schneider* legal liability being assumed. Then the joint value is A - L and the variance of this is

$$\text{var}(A - L) = \text{var}(A) + \text{var}(L) - 2\,\text{cov}(A,L)$$

Thus, the variance of the joint value is definitely greater than var(A) if cov(A,L) is negative or positive and not too large. It is not at all clear that estimates of asset value and liability should be anything other than independent of one another; and if anything one would suspect negative covariance: if A is estimated to be high, then a bidder could infer that the sale price of the company will also be high. In this case, one could also reasonably infer that L will be low, for the selling company shareholders have received a high price and will be either unlikely to sue or will receive lower damage payments if a suit is brought and won. This makes cov(A,L) negative and increases the risk of the package. In the formal proof of our result below, we assume only that cov(A,L) = 0.

A related issue concerns the possibility of auction *price* and L being related to one another. A high price paid might be an effective "bribe" to shareholders, i.e., paying a high price results in a low L. This introduces a new aspect to bid strategy, and one would expect higher bids as a result. Our result concerning lower total payments to shareholders still remains, though. Bidders will only raise their bid if by doing so the expected liability falls by more than the increase in expected payment. But if that is so, the action makes shareholders on net worse off. In our discussion, therefore, we ignore the possibility of L being affected by bid price.

sure.[132] Thus, with homogeneous information, the seller can, through an auction, extract the expected value of the item for sale.

What if bidders have different value estimates—for example, if bidders' value estimates are viewed as independent draws from a probability distribution whose mean equals the item's true value? In this case bidders will, in equilibrium, generally find it optimal to bid less than their estimated values and, as a result, the expected price to the seller will be less than the item's expected value. In a sense, uncertainty and heterogeneous information creates an opportunity for bidders to "shave" strategically their bids because by lowering their bid below their estimated value, the bidders will not be reducing their probability of winning by one as was the case with homogeneous information.

To take an example to illustrate this point, suppose that one bidder estimates the item for sale to be worth $100 million. In the case when all bidders thought this—and everybody knew what everybody else thought—then the only reasonable bid would be $100 million. But if other bidders are likely to have valuations different from $100 million, the economics of an optimal bid change: Suppose this one bidder now places a bid of $99 million. Unlike the case with homogeneous value estimates, the bidder's probability of winning with a $99 million bid will not drop to zero. Indeed, the chance of winning with $99 million bid will probably be quite close to the chance of winning with a $100 million bid, for the bidder only incrementally loses in those cases when one of his competitors would have bid something between $99 and $100 million. Traded off against this cost, however, is the fact that upon winning the bidder pays $1 million less. Generally such a tradeoff will be beneficial, so all bidders end up bidding *less* than their expected value.

This is a basic result of auction theory: When selling an item of uncertain value, the expected selling price will be less than the item's expected value, and the bidders will have positive expected profit. We state this more formally as Proposition 1.[133]

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132. A Nash equilibrium bidding strategy is defined as follows. First, let b(E(v)) represent a function that maps any bidder's value estimate to a bid. Then b(E(v)) constitutes a (symmetric) Nash equilibrium if b(E(v)) gives the optimal (expected profit maximizing) bid for any one bidder when all other bidders are believed to also employ b(E(v)). In other words, in a Nash equilibrium there can be no incentive for any bidder to unilaterally defect—that is, to switch to a different bid function.

The equilibrium in the text is a *weak* equilibrium in that there are other bids besides E(v) that give bidders the same expected profit (which is of course zero). Of course, if all bidders were to bid something other than E(v), there would be an incentive for any one bidder to change his strategy.

133. For a formal model that yields these results, see Douglas K. Reece, *Competitive Bidding for Offshore Petroleum Leases*, 9 BELL J. ECON. 369 (1978).

Proposition 1

Consider an auction of an item which has value v, assumed to be the same for all bidders. If v is unknown *ex ante* to the bidders, but the bidders have value estimates which are identically and independently distributed according to a probability function F(v), then if all bidders follow Nash equilibrium bidding strategies, and bids are in cash, the following will hold:

(i) The expected selling price will be less than E(v), the expected value of the auctioned item; and

(ii) Each bidder has positive expected profit from participating in the auction.

Since the seller receives less than the expected value, a natural course of research would be to investigate actions that a seller can take to improve the situation. One possible action is suggested by our above example: When all bidders had the *same* value estimates, the seller could extract all of the item's expected value. Thus, it would appear that making bidders' information less disparate would increase the expected selling price. One common way of reducing disparity is to provide all bidders with some common piece of pertinent information, such as a value estimate done by an appraiser. In private auctions, real estate appraisals and environmental clean-up cost estimates are normally provided to all serious bidders. This common information gives all bidders a similar basis for estimating the value of these corporate assets. Proposition 2 states an important relationship between information and expected selling prices.[134]

Proposition 2

In auctions of the type described in Proposition 1, provision of additional information to all bidders concerning the value of the item will increase the expected selling price.

Using Propositions 1 and 2, we can now determine the effect on auction prices for companies when auctioneers are indemnified for negligence in conducting the auction. As we pointed out above, indemnifying the advisor means that the auction winner ends up assuming the financial liability from any (old) shareholder suits. Thus, we can now think of the sale of the company as consisting of the sale of two parts: (1) the company; and (2) the financial liability from shareholder suits.

134. This result is proved in Paul R. Milgrom & Robert J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 ECONOMETRICA 1089 (1982). McAfee & Mcmillan, *supra* note 1, at 722 provide a re-statement.

Our question asks how the inclusion of (2) in the auction will affect the selling price.

Let E(c) be the expected financial cost of shareholder suits emerging from the auction. Suppose we sold this liability at a separate hypothetical auction. Clearly, the price in this auction would have to be *negative*, for the purchaser is assuming a liability. Assuming that the actual liability is of uncertain value, and that bidders would differ in their assessments of that value, the expected selling price should be *less* than (-E(c)), the expected value of the item being sold. In such an auction the seller would have to pay *more* than the expected cost to get a bidder to assume the liability.

This suggests that bundling financial liability from shareholder suits with the sale of the company itself will reduce the expected selling price by more than the expected cost of the financial liability. In this case, selling company shareholders would be made worse off, for although they receive proceeds from shareholder suits, their expected price falls by even more (and this is even before the deadweight loss of litigation costs are taken out).

Proof of this result is a bit more complex because the company and the liability are auctioned together; the discussion above assumes two separate auctions. We state our result as Proposition 3 and then prove it using both Propositions 1 and 2.

Proposition 3[135]

Let E(p) be the expected price received in an auction of the company itself, and let E(c) be the expected settlement cost of shareholder suits. If E(p*) is the expected price in an auction of the company and the shareholder suit liability, then

135. **Proof**

E(p*) is the expected selling price for the company and the liability given uncertainty over both the company's value and the amount of the liability. Suppose that we now provide perfect information on the liability. Then the expected selling price in this case, denoted E(p**), will be

$$E(p^{**}) = E(p) - E(c)$$

In any given auction, the expected price will be E(p)-c, where c is the actual liability for that auction. Taking expectations over all auctions—with different liability costs—gives us the expression above. This also assumes independence between the amount of the liability and the company's asset value.

However, from Proposition 2, we know that providing additional information raises the expected selling price. Thus,

$$E(p^{*}) < E(p^{**})$$
$$\Rightarrow E(p^{*}) < E(p) - E(c)$$

QED

$$E(p^*) < E(p) - E(c)$$

The result: *Schneider* will, assuming indemnification of advisors, result in lower expected net proceeds for selling company shareholders (net proceeds being selling price plus any proceeds from shareholder suits). *Schneider* therefore makes selling company shareholders worse-off.

C. Secondary Effects of Schneider *on Corporation Auctions*

In this section we point out one other damaging effect that *Schneider* is likely to have on corporate auction markets: a reduction in the use of non-cash methods of payment. It is, after all, the valuation of a non-cash bid versus a cash bid that lies at the heart of the *Schneider* decision. Cash bids are inherently easier to value and to compare to one another, so there will be a natural tendency for auctioneers and directors desirous of minimizing litigation to state a preference for all-cash bids. Non-cash bids, however, because of their contingent-pricing aspects, are desirable from both the seller's and the buyer's points of view.[136] Propositions 4 and 5 state the two major results concerning non-cash bidding methods:

Proposition 4[137]

If the value of bids depends, at least in part, on the unobserved value of the selling company, then the seller's expected revenue will be higher than if the bids were not contingent upon unobserved value.

Proposition 5[138]

There is a greater likelihood of exchange if bids can be made contingent upon unobserved value than if they cannot.

Examples of bids whose value are contingent upon the selling company's value would include any form of stock or debt of the acquiring company for the value of the acquiring company's securities, which will end up being dependent upon the selling company's value, as well as the value of any synergies created by the merger. Sometimes one sees more explicit contingent-pricing methods—for example, new issues of stock in a newly-created corporation (made up mostly of the selling company), or future payments that depend explicitly on some measure of

136. There may be other reasons to prefer non-eash bids, not the least of which are tax considerations (in some instances the acceptance of securities by the selling shareholders will allow them to postpone any capital gains tax).

137. For a more formal treatment, see McAfee & Macmillan, *supra* note 1.

138. *See* Robert G. Hanscn, *A Theory for the Choice of Exchange Medium in Mergers and Acquisitions*, 60 J. BUS. 75 (1987).

earnings.[139]

The intuition for Proposition 4 can be best seen through an example. As we have already argued, a selling company will expect to receive less than its expected value if it sells itself at auction.[140] This assumes, however, all-cash bids. Suppose instead that the selling company requires bids to be in the form of a percentage of the selling company's future earnings. Then equilibrium results in all bidders offering 100% of future earnings: A bid of anything less leaves a bidder with an expected gain, hence he should be willing to bid more. Since all bidders would think similarly, equilibrium calls for all bidders to offer 100% of future earnings. But in this case, the selling company will end up with 100% of its expected value (although it receives payment over time). The use of a contingent payment method has in essence eliminated all variation in bids, and, again, it is variation in bids that allows bidders the opportunity to lower strategically their bids. Less extreme forms of contingent payments—accepting stock or other securities; retaining a royalty interest—will exhibit the same price-increasing effect, but to a lesser degree. Of course, it must be recognized that the use of contingent payment methods do not come out without cost: The seller ends up bearing more of the risk concerning what true value really is, and some contingent payment methods are prone to moral hazard problems (e.g., earnings-based methods are subject to acquiring companies' accounting manipulation of earnings).

Proposition 5 can be viewed as an implication of Proposition 4; sellers will be more likely to sell their items if they expect to receive a higher price for them, as is the case with contingent payments. There is another effect behind Proposition 5, however, besides just a price-increasing effect. Contingent payment methods can often help to resolve differences in belief between the buyer and the seller. For example, an acquiring company might believe that a selling company's prospects are less rosy than does the selling company itself. With such a difference in opinion over the status of the company's prospects, there may be no cash price at which a mutually agreeable exchange can be effected. Yet trade might be effected through a non-cash payment method: A contingent payment method will give the seller more value if he is right about the company's prospects while at the same time will make the buyer give up less value if he is right about the company's prospects. In more popular terms, using a contingent payment method such as giving the selling

139. *See, e.g.*, Braunschweiger v. American Home Shield Corp., No. 10755, 1989 WL 128571, at *4 (merger consideration included contingent payment right securities where the value of the security depended on the company's future earnings).

140. *See supra* Proposition 1.

company shares in the new company allows the selling shareholders to participate in future earnings of the selling company, and this might induce those shareholders to part with the company, even if they are very optimistic about its future. According to Proposition 5, then, non-cash bids are an efficiency-enhancing device; they help to promote mutually beneficial exchange.

Post-*Schneider* we should expect to see sellers and auctioneers preferring all-cash bids so as to reduce potential litigation risks. In any structured auction—for instance, the sale of a private company—it would be possible for the selling company to state that only cash bids will be considered.[141] From Propositions 4 and 5, this restriction will reduce the seller's expected price and reduce the efficiency of the corporate auction market, yet the move will be in sellers' interests given the change in liability regimes.

V. CONCLUDING REMARKS

The argument against *Schneider*'s increased liability for auctioneers is really threefold: First, the decision establishes poor legal precedent; second, current incentives are already sufficient to promote quality auctioneering services; and third, *Schneider* is unlikely to change the quality of auctioneer services and will increase other auction costs.

While we can understand a concern for management, directors, and advisors colluding (either explicitly or implicitly) against shareholders, this concern, in part, is already addressed through the Delaware "aiding and abetting" standard, does not justify creating such an expensive safety net for shareholders.

Opening the door for direct suits against corporate advisors for simple negligence will create tremendous increased costs, and only minimal benefits, to shareholders. If some form of direct action by shareholders against investment bankers is needed to stop financial advisers from favoring management-backed bidders, then we would favor eliminating indemnification and insurance agreements in exchange for capping investment banker liability at the amount of their (quite considerable) fees.[142] We agree with an earlier study of director liability that for liability to work efficiently, there must be "a scaling down of the

141. In public company auctions, the directors could, under Delaware law, refuse to accept a nominally higher bid including securities. *See supra* note 30 and accompanying text.

142. Coffee makes a somewhat similar recommendation for contractual provisions between the company and its investment bankers. He suggests that the two parties agree to "eliminate consequential damages and restrict the [banker's] liability to return of the compensation it received from the corporation." Coffee, *supra* note 62, at 6.

limits of liability . . . simultaneously with elimination of indemnification and insurance."[143] Otherwise, as it stands today, *Schneider* reduces the revenues generated in corporation auctions to the detriment of the selling companies shareholders without creating significant benefits.

143. Conard, *supra* note 84, at 919.