Session 5: Entity Law and the Duties of Officers and Directors; Information Disclosure and Securities Markets

We will spend a session talking through issues that arise in the choice of legal entities as well as the duties of directors and officers. We will also do a brief over view of securities markets. We will start our discussion with a corporate law classic: a rare case in which directors are found to have violated the business judgment rule in the context of a sale of the company. We will then turn a second case on the sale of companies, but *Basic v. Levinson* raises securities law questions and not questions of the Delaware law of fiduciary duties.

Smith v. Van Gorkom

488 A.2d 858 (Del. 1985)

HORSEY, Justice (for the majority): This appeal from the Court of Chancery involves a class action brought by shareholders of the defendant Trans Union Corporation ("Trans Union" or "the Company"), originally seeking rescission of a cash-out merger of Trans Union into the defendant New T Company ("New T"), a wholly-owned subsidiary of the defendant, Marmon Group, Inc. ("Marmon"). Alternate relief in the form of damages is sought against the defendant members of the Board of Directors of Trans Union, New T, and Jay A. Pritzker and Robert A. Pritzker, owners of Marmon.

Following trial, the former Chancellor granted judgment for the defendant directors by unreported letter opinion dated July 6, 1982. Judgment was based on two findings: (1) that the Board of Directors had acted in an informed manner so as to be entitled to protection of the business judgment rule in approving the cash-out merger; and (2) that the shareholder vote approving the merger should not be set aside because the stockholders had been "fairly informed" by the Board of Directors before voting thereon. The plaintiffs appeal.

Speaking for the majority of the Court, we conclude that both rulings of the Court of Chancery are clearly erroneous. Therefore, we reverse and direct that judgment be entered in favor of the plaintiffs and against the defendant directors for the fair value of the plaintiffs' stockholdings in Trans Union, in accordance with Weinberger v. UOP, Inc., Del. Supr., 457 A.2d 701 (1983).

We hold: (1) that the Board's decision, reached September 20, 1980, to approve the proposed cash-out merger was not the product of an informed business judgment; (2) that the Board's subsequent efforts to amend the Merger Agreement and take other curative action were ineffectual, both legally and factually; and (3) that the Board did not deal with complete candor with the stockholders by failing to disclose all material facts, which they knew or should have known, before securing the stockholders' approval of the merger.

I.

The nature of this case requires a detailed factual statement. The following facts are essentially uncontradicted:

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Trans Union was a publicly-traded, diversified holding company, the principal earnings of which were generated by its railcar leasing business. During the period here involved, the Company had a cash flow of hundreds of millions of dollars annually. However, the Company had difficulty in generating sufficient taxable income to offset increasingly large investment tax credits (ITCs). ***

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On August 27, 1980, Van Gorkom met with Senior Management of Trans Union. Van Gorkom reported on his lobbying efforts in Washington and his desire to find a solution to the tax credit problem more permanent than a continued program of acquisitions. Various alternatives were suggested and discussed preliminarily, including the sale of Trans Union to a company with a large amount of taxable income.

Donald Romans, Chief Financial Officer of Trans Union, stated that his department had done a "very brief bit of work on the possibility of a leveraged buy-out." This work had been prompted by a media article which Romans had seen regarding a leveraged buy-out by management. The work consisted of a "preliminary study" of the cash which could be generated by the Company if it participated in a leveraged buy-out. As Romans stated, this analysis "was very first and rough cut at seeing whether a cash flow would support what might be considered a high price for this type of transaction."

On September 5, at another Senior Management meeting which Van Gorkom attended, Romans again brought up the idea of a leveraged buy-out as a "possible strategic alternative" to the Company's acquisition program. Romans and Bruce S. Chelberg, President and Chief Operating Officer of Trans Union, had been working on the matter in preparation for the meeting. According to Romans: They did not "come up" with a price for the Company. They merely "ran the numbers" at $50 a share and at $60 a share with the "rough form" of their cash figures at the time. Their "figures indicated that $50 would be very easy to do but $60 would be very difficult to do under those figures." This work did not purport to establish a fair price for either the Company or 100% of the stock. It was intended to determine the cash flow needed to service the debt that would "probably" be incurred in a leveraged buy-out, based on "rough calculations" without "any benefit of experts to identify what the limits were to that, and so forth." These computations were not considered extensive and no conclusion was reached.

At this meeting, Van Gorkom stated that he would be willing to take $55 per share for his own 75,000 shares. He vetoed the suggestion of a leveraged buy-out by Management, however, as involving a potential conflict of interest for Management. Van Gorkom, a certified public accountant and lawyer, had been an officer of Trans Union for 24 years, its Chief Executive Officer for more than 17 years, and Chairman of its Board for 2 years. It is noteworthy in this connection that he was then approaching 65 years of age and mandatory retirement.

For several days following the September 5 meeting, Van Gorkom pondered the idea of a sale. He had participated in many acquisitions as a manager and director of Trans Union and as a director of other companies. He was familiar with acquisition procedures, valuation methods, and negotiations; and he privately considered the pros and cons of whether Trans Union should seek a privately or publicly-held purchaser.

Van Gorkom decided to meet with Jay A. Pritzker, a well-known corporate takeover specialist and a social acquaintance. However, rather than approaching Pritzker simply to determine his interest in acquiring Trans Union, Van Gorkom assembled a proposed per share price for sale of the Company and a financing structure by which to accomplish the sale. Van Gorkom did so without consulting either his Board or any members of Senior Management except one: Carl Peterson, Trans Union's Controller. Telling Peterson that he wanted no other person on his staff to know what he was doing, but without telling him why, Van Gorkom directed Peterson to calculate the feasibility of a leveraged buy-out at an assumed price per share of $55. Apart from the Company's historic stock market price,[5] and Van Gorkom's long association with Trans Union, the record is devoid of any competent evidence that $55 represented the per share intrinsic value of the Company.

Having thus chosen the $55 figure, based solely on the availability of a leveraged buy-out, Van Gorkom multiplied the price per share by the number of shares outstanding to reach a total value of the Company of $690 million. Van Gorkom told Peterson to use this $690 million figure and to assume a $200 million equity contribution by the buyer. Based on these assumptions, Van Gorkom directed Peterson to determine whether the debt portion of the purchase price could be paid off in five years or less if financed by Trans Union's cash flow as projected in the Five Year Forecast, and by the sale of certain weaker divisions identified in a study done for Trans Union by the Boston Consulting Group ("BCG study"). Peterson reported that, of the purchase price, approximately $50-80 million would remain outstanding after five years. Van Gorkom was disappointed, but decided to meet with Pritzker nevertheless.

Van Gorkom arranged a meeting with Pritzker at the latter's home on Saturday, September 13, 1980. Van Gorkom prefaced his presentation by stating to Pritzker: "Now as far as you are concerned, I can, I think, show how you can pay a substantial premium over the present stock price and pay off most of the loan in the first five years. * * * If you could pay $55 for this Company, here is a way in which I think it can be financed."

Van Gorkom then reviewed with Pritzker his calculations based upon his proposed price of $55 per share. Although Pritzker mentioned $50 as a more attractive figure, no other price was mentioned. However, Van Gorkom stated that to be sure that $55 was the best price obtainable, Trans Union should be free to accept any better offer. Pritzker demurred, stating that his organization would serve as a "stalking horse" for an "auction contest" only if Trans Union would permit Pritzker to buy 1,750,000 shares of Trans Union stock at market price

[5] The common stock of Trans Union was traded on the New York Stock Exchange. Over the five year period from 1975 through 1979, Trans Union's stock had traded within a range of a high of $39 1/2 and a low of $24 1/4. Its high and low range for 1980 through September 19 (the last trading day before announcement of the merger) was $38 1/4 - $29 1/2.

which Pritzker could then sell to any higher bidder. After further discussion on this point, Pritzker told Van Gorkom that he would give him a more definite reaction soon.

On Monday, September 15, Pritzker advised Van Gorkom that he was interested in the $55 cash-out merger proposal and requested more information on Trans Union. Van Gorkom agreed to meet privately with Pritzker, accompanied by Peterson, Chelberg, and Michael Carpenter, Trans Union's consultant from the Boston Consulting Group. The meetings took place on September 16 and 17. Van Gorkom was "astounded that events were moving with such amazing rapidity."

On Thursday, September 18, Van Gorkom met again with Pritzker. At that time, Van Gorkom knew that Pritzker intended to make a cash-out merger offer at Van Gorkom's proposed $55 per share. Pritzker instructed his attorney, a merger and acquisition specialist, to begin drafting merger documents. There was no further discussion of the $55 price. However, the number of shares of Trans Union's treasury stock to be offered to Pritzker was negotiated down to one million shares; the price was set at $38—75 cents above the per share price at the close of the market on September 19. At this point, Pritzker insisted that the Trans Union Board act on his merger proposal within the next three days, stating to Van Gorkom: "We have to have a decision by no later than Sunday [evening, September 21] before the opening of the English stock exchange on Monday morning." Pritzker's lawyer was then instructed to draft the merger documents, to be reviewed by Van Gorkom's lawyer, "sometimes with discussion and sometimes not, in the haste to get it finished."

On Friday, September 19, Van Gorkom, Chelberg, and Pritzker consulted with Trans Union's lead bank regarding the financing of Pritzker's purchase of Trans Union. The bank indicated that it could form a syndicate of banks that would finance the transaction. On the same day, Van Gorkom retained James Brennan, Esquire, to advise Trans Union on the legal aspects of the merger. Van Gorkom did not consult with William Browder, a Vice-President and director of Trans Union and former head of its legal department, or with William Moore, then the head of Trans Union's legal staff.

On Friday, September 19, Van Gorkom called a special meeting of the Trans Union Board for noon the following day. He also called a meeting of the Company's Senior Management to convene at 11:00 a.m., prior to the meeting of the Board. No one, except Chelberg and Peterson, was told the purpose of the meetings. Van Gorkom did not invite Trans Union's investment banker, Salomon Brothers or its Chicago-based partner, to attend.

Of those present at the Senior Management meeting on September 20, only Chelberg and Peterson had prior knowledge of Pritzker's offer. Van Gorkom disclosed the offer and described its terms, but he furnished no copies of the proposed Merger Agreement. Romans announced that his department had done a second study which showed that, for a leveraged buy-out, the price range for Trans Union stock was between $55 and $65 per share. Van Gorkom neither saw the study nor asked Romans to make it available for the Board meeting.

Senior Management's reaction to the Pritzker proposal was completely negative. No member of Management, except Chelberg and Peterson, supported the proposal. Romans objected to the price as being too low; he was critical of the timing and suggested that consideration should be given to the adverse tax consequences of an all-cash deal for low-basis shareholders; and he took the position that the agreement to sell Pritzker one million newly-issued shares at market price would inhibit other offers, as would the prohibitions against soliciting bids and furnishing inside information to other bidders. Romans argued that the Pritzker proposal was a "lock up" and amounted to "an agreed merger as opposed to an offer." Nevertheless, Van Gorkom proceeded to the Board meeting as scheduled without further delay.

Ten directors served on the Trans Union Board, five inside (defendants Bonser, O'Boyle, Browder, Chelberg, and Van Gorkom) and five outside (defendants Wallis, Johnson, Lanterman, Morgan and Reneker). All directors were present at the meeting, except O'Boyle who was ill. Of the outside directors, four were corporate chief executive officers and one was the former Dean of the University of Chicago Business School. None was an investment banker or trained financial analyst. All members of the Board were well informed about the Company and its operations as a going concern. They were familiar with the current financial condition of the Company, as well as operating and earnings projections reported in the recent Five Year Forecast. The Board generally received regular and detailed reports and was kept abreast of the accumulated investment tax credit and accelerated depreciation problem.

Van Gorkom began the Special Meeting of the Board with a twenty-minute oral presentation. Copies of the proposed Merger Agreement were delivered too late for study before or during the meeting. He reviewed the Company's ITC and depreciation problems and the efforts theretofore made to solve them. He discussed his initial meeting with Pritzker and his motivation in arranging that meeting. Van Gorkom did not disclose to the Board, however, the methodology by which he alone had arrived at the $55 figure, or the fact that he first proposed the $55 price in his negotiations with Pritzker.

Van Gorkom outlined the terms of the Pritzker offer as follows: Pritzker would pay $55 in cash for all outstanding shares of Trans Union stock upon completion of which Trans Union would be merged into New T Company, a subsidiary wholly-owned by Pritzker and formed to implement the merger; for a period of 90 days, Trans Union could receive, but could not actively solicit, competing offers; the offer had to be acted on by the next evening, Sunday, September 21; Trans Union could only furnish to competing bidders published information, and not proprietary information; the offer was subject to Pritzker obtaining the necessary financing by October 10, 1980; if the financing contingency were met or waived by Pritzker, Trans Union was required to sell to Pritzker one million newly-issued shares of Trans Union at $38 per share.

Van Gorkom took the position that putting Trans Union "up for auction" through a 90-day market test would validate a decision by the Board that $55 was a fair price. He told the Board that the "free market will have an opportunity to judge whether $55 is a fair price." Van Gorkom framed the decision before the Board not as whether $55 per share was the highest price that could be obtained, but as whether the $55 price was a fair price that the stockholders should be given the opportunity to accept or reject.

Attorney Brennan advised the members of the Board that they might be sued if they failed to accept the offer and that a fairness opinion was not required as a matter of law.

Romans attended the meeting as chief financial officer of the Company. He told the Board that he had not been involved in the negotiations with Pritzker and knew nothing about the merger proposal until the morning of the meeting; that his studies did not indicate either a fair price for the stock or a valuation of the Company; that he did not see his role as directly addressing the fairness issue; and that he and his people "were trying to search for ways to justify a price in connection with such a [leveraged buy-out] transaction, rather than to say what the shares are worth." Romans testified:

> I told the Board that the study ran the numbers at 50 and 60, and then the subsequent study at 55 and 65, and that was not the same thing as saying that I have a valuation of the company at X dollars. But it was a way—a first step towards reaching that conclusion.

Romans told the Board that, in his opinion, $55 was "in the range of a fair price," but "at the beginning of the range."

Chelberg, Trans Union's President, supported Van Gorkom's presentation and representations. He testified that he "participated to make sure that the Board members collectively were clear on the details of the agreement or offer from Pritzker;" that he "participated in the discussion with Mr. Brennan, inquiring of him about the necessity for valuation opinions in spite of the way in which this particular offer was couched;" and that he was otherwise actively involved in supporting the positions being taken by Van Gorkom before the Board about "the necessity to act immediately on this offer," and about "the adequacy of the $55 and the question of how that would be tested."

The Board meeting of September 20 lasted about two hours. Based solely upon Van Gorkom's oral presentation, Chelberg's supporting representations, Romans' oral statement, Brennan's legal advice, and their knowledge of the market history of the Company's stock,[9] the directors approved the proposed Merger Agreement. However, the Board later claimed to have attached two conditions to its acceptance: (1) that Trans Union reserved the right to accept any better offer that was made during the market test period; and (2) that Trans Union could share its proprietary information with any other potential bidders. While the Board now claims to have reserved the right to accept any better offer received after the announcement of the Pritzker agreement (even though the minutes of the meeting do not reflect this), it is undisputed that the Board did not reserve the right to actively solicit alternate offers.

The Merger Agreement was executed by Van Gorkom during the evening of September 20 at a formal social event that he hosted for the opening of the Chicago Lyric Opera. Neither he nor any other director read the agreement prior to its signing and delivery to Pritzker.

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[9] The Trial Court stated the premium relationship of the $55 price to the market history of the Company's stock as follows: * * * the merger price offered to the stockholders of Trans Union represented a premium of 62% over the average of the high and low prices at which Trans Union stock had traded in 1980, a premium of 48% over the last closing price, and a premium of 39% over the highest price at which the stock of Trans Union had traded any time during the prior six years.

* * *

On Monday, September 22, the Company issued a press release announcing that Trans Union had entered into a "definitive" Merger Agreement with an affiliate of the Marmon Group, Inc., a Pritzker holding company. Within 10 days of the public announcement, dissent among Senior Management over the merger had become widespread. Faced with threatened resignations of key officers, Van Gorkom met with Pritzker who agreed to several modifications of the Agreement. Pritzker was willing to do so provided that Van Gorkom could persuade the dissidents to remain on the Company payroll for at least six months after consummation of the merger.

Van Gorkom reconvened the Board on October 8 and secured the directors' approval of the proposed amendments—sight unseen. The Board also authorized the employment of Salomon Brothers, its investment banker, to solicit other offers for Trans Union during the proposed "market test" period.

The next day, October 9, Trans Union issued a press release announcing: (1) that Pritzker had obtained "the financing commitments necessary to consummate" the merger with Trans Union; (2) that Pritzker had acquired one million shares of Trans Union common stock at $38 per share; (3) that Trans Union was now permitted to actively seek other offers and had retained Salomon Brothers for that purpose; and (4) that if a more favorable offer were not received before February 1, 1981, Trans Union's shareholders would thereafter meet to vote on the Pritzker proposal.

It was not until the following day, October 10, that the actual amendments to the Merger Agreement were prepared by Pritzker and delivered to Van Gorkom for execution. As will be seen, the amendments were considerably at variance with Van Gorkom's representations of the amendments to the Board on October 8; and the amendments placed serious constraints on Trans Union's ability to negotiate a better deal and withdraw from the Pritzker agreement. Nevertheless, Van Gorkom proceeded to execute what became the October 10 amendments to the Merger Agreement without conferring further with the Board members and apparently without comprehending the actual implications of the amendments.

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Salomon Brothers' efforts over a three-month period from October 21 to January 21 produced only one serious suitor for Trans Union—General Electric Credit Corporation ("GE Credit"), a subsidiary of the General Electric Company. However, GE Credit was unwilling to make an offer for Trans Union unless Trans Union first rescinded its Merger Agreement with Pritzker. When Pritzker refused, GE Credit terminated further discussions with Trans Union in early January.

In the meantime, in early December, the investment firm of Kohlberg, Kravis, Roberts & Co. ("KKR"), the only other concern to make a firm offer for Trans Union, withdrew its offer under circumstances hereinafter detailed.

On December 19, this litigation was commenced and, within four weeks, the plaintiffs had deposed eight of the ten directors of Trans Union, including Van Gorkom, Chelberg and Romans, its Chief Financial Officer. On January 21, Management's Proxy Statement for the

February 10 shareholder meeting was mailed to Trans Union's stockholders. On January 26, Trans Union's Board met and, after a lengthy meeting, voted to proceed with the Pritzker merger. The Board also approved for mailing, "on or about January 27," a Supplement to its Proxy Statement. The Supplement purportedly set forth all information relevant to the Pritzker Merger Agreement, which had not been divulged in the first Proxy Statement.

* * *

On February 10, the stockholders of Trans Union approved the Pritzker merger proposal. Of the outstanding shares, 69.9% were voted in favor of the merger; 7.25% were voted against the merger; and 22.85% were not voted.

II.

We turn to the issue of the application of the business judgment rule to the September 20 meeting of the Board.

The Court of Chancery concluded from the evidence that the Board of Directors' approval of the Pritzker merger proposal fell within the protection of the business judgment rule. *** [W]e conclude that the Court's ultimate finding that the Board's conduct was not "reckless or imprudent" is contrary to the record and not the product of a logical and deductive reasoning process.

* * * Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 Del.C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.[11] Aronson v. Lewis, Del. Supr., 473 A.2d 805, 811 (1984). In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders. The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. The rule itself "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson, supra at 812. Thus, the party attacking a board decision as uninformed must rebut the presumption that its business judgment was an informed one.

The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves "prior to making a business decision, of all material information reasonably available to them." Id.

Under the business judgment rule there is no protection for directors who have made "an unintelligent or unadvised judgment." Mitchell v. Highland-Western Glass, Del. Ch., 167 A. 831, 833 (1933). A director's duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Since a

[11] 8 Del.C. § 141 provides, in pertinent part: (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others. Such obligation does not tolerate faithlessness or self-dealing. But fulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information of the type and under the circumstances present here.

Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. Here, there were no allegations of fraud, bad faith, or self-dealing, or proof thereof. Hence, it is presumed that the directors reached their business judgment in good faith and considerations of motive are irrelevant to the issue before us.

The standard of care applicable to a director's duty of care has also been recently restated by this Court. In *Aronson, supra*, we stated:

> While the Delaware cases use a variety of terms to describe the applicable standard of care, our analysis satisfies us that under the business judgment rule director liability is predicated upon concepts of gross negligence. (footnote omitted)

473 A.2d at 812.

We again confirm that view. We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.

In the specific context of a proposed merger of domestic corporations, a director has a duty under 8 Del.C. § 251(b),[14] along with his fellow directors, to act in an informed and deliberate manner in determining whether to approve an agreement of merger before submitting the proposal to the stockholders. Certainly in the merger context, a director may not abdicate that duty by leaving to the shareholders alone the decision to approve or disapprove the agreement. Only an agreement of merger satisfying the requirements of 8 Del.C. § 251(b) may be submitted to the shareholders under § 251(c).

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[14] 8 Del.C. § 251(b) provides in pertinent part: (b) The board of directors of each corporation which desires to merge or consolidate *shall adopt a resolution approving an agreement of merger* or consolidation. The agreement shall state: (1) the terms and conditions of the merger or consolidation; (2) the mode of carrying the same into effect; (3) such amendments or changes in the certificate of incorporation of the surviving corporation as are desired to be effected by the merger or consolidation, or, if no such amendments or changes are desired, a statement that the certificate of incorporation of one of the constituent corporations shall be the certificate of incorporation of the surviving or resulting corporation; (4) the manner of converting the shares of each of the constituent corporations ... and (5) such other details or provisions as are deemed desirable.... The agreement so adopted shall be executed in accordance with section 103 of this title. <u>Any of the terms of the agreement of merger or consolidation may be made dependent upon facts ascertainable outside of such agreement, provided that the manner in which such facts shall operate upon the terms of the agreement is clearly and expressly set forth in the agreement of merger or consolidation</u>. (underlining added for emphasis)

It is against those standards that the conduct of the directors of Trans Union must be tested, as a matter of law and as a matter of fact, regarding their exercise of an informed business judgment in voting to approve the Pritzker merger proposal.

III.

*** On the record before us, we must conclude that the Board of Directors did not reach an informed business judgment on September 20, 1980 in voting to "sell" the Company for $55 per share pursuant to the Pritzker cash-out merger proposal. Our reasons, in summary, are as follows:

The directors (1) did not adequately inform themselves as to Van Gorkom's role in forcing the "sale" of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the "sale" of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency.

As has been noted, the Board based its September 20 decision to approve the cash-out merger primarily on Van Gorkom's representations. None of the directors, other than Van Gorkom and Chelberg, had any prior knowledge that the purpose of the meeting was to propose a cash-out merger of Trans Union. No members of Senior Management were present, other than Chelberg, Romans and Peterson; and the latter two had only learned of the proposed sale an hour earlier. Both general counsel Moore and former general counsel Browder attended the meeting, but were equally uninformed as to the purpose of the meeting and the documents to be acted upon.

Without any documents before them concerning the proposed transaction, the members of the Board were required to rely entirely upon Van Gorkom's 20-minute oral presentation of the proposal. No written summary of the terms of the merger was presented; the directors were given no documentation to support the adequacy of $55 price per share for sale of the Company; and the Board had before it nothing more than Van Gorkom's statement of his understanding of the substance of an agreement which he admittedly had never read, nor which any member of the Board had ever seen.

Under 8 Del.C. § 141(e),[15] "directors are fully protected in relying in good faith on reports made by officers." Michelson v. Duncan, Del. Ch., 386 A.2d 1144, 1156 (1978); aff'd in part and rev'd in part on other grounds, Del. Supr., 407 A.2d 211 (1979). The term "report" has been liberally construed to include reports of informal personal investigations by corporate officers, Cheff v. Mathes, Del. Supr., 199 A.2d 548, 556 (1964). However, there is no evidence that any "report," as defined under § 141(e), concerning the Pritzker proposal, was presented to the Board on September 20. Van Gorkom's oral presentation of his understanding of the terms of the proposed Merger Agreement, which he had not seen, and Romans' brief oral statement of his preliminary study regarding the feasibility of a leveraged buy-out

[15] Section 141(e) provides in pertinent part: A member of the board of directors ... shall, in the performance of his duties, be fully protected in relying in good faith upon the books of accounts or reports made to the corporation by any of its officers, or by an independent certified public accountant, or by an appraiser selected with reasonable care by the board of directors ..., or in relying in good faith upon other records of the corporation.

of Trans Union do not qualify as § 141(e) "reports" for these reasons: The former lacked substance because Van Gorkom was basically uninformed as to the essential provisions of the very document about which he was talking. Romans' statement was irrelevant to the issues before the Board since it did not purport to be a valuation study. ***

The defendants rely on the following factors to sustain the Trial Court's finding that the Board's decision was an informed one: (1) the magnitude of the premium or spread between the $55 Pritzker offering price and Trans Union's current market price of $38 per share; (2) the amendment of the Agreement as submitted on September 20 to permit the Board to accept any better offer during the "market test" period; (3) the collective experience and expertise of the Board's "inside" and "outside" directors; and (4) their reliance on Brennan's legal advice that the directors might be sued if they rejected the Pritzker proposal. We discuss each of these grounds seriatim:

(1)

A substantial premium may provide one reason to recommend a merger, but in the absence of other sound valuation information, the fact of a premium alone does not provide an adequate basis upon which to assess the fairness of an offering price. Here, the judgment reached as to the adequacy of the premium was based on a comparison between the historically depressed Trans Union market price and the amount of the Pritzker offer. Using market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious, premise, as the defendants' own evidence demonstrates.

The record is clear that before September 20, Van Gorkom and other members of Trans Union's Board knew that the market had consistently undervalued the worth of Trans Union's stock, despite steady increases in the Company's operating income in the seven years preceding the merger. The Board related this occurrence in large part to Trans Union's inability to use its ITCs as previously noted. Van Gorkom testified that he did not believe the market price accurately reflected Trans Union's true worth; and several of the directors testified that, as a general rule, most chief executives think that the market undervalues their companies' stock. Yet, on September 20, Trans Union's Board apparently believed that the market stock price accurately reflected the value of the Company for the purpose of determining the adequacy of the premium for its sale.

In the Proxy Statement, however, the directors reversed their position. There, they stated that, although the earnings prospects for Trans Union were "excellent," they found no basis for believing that this would be reflected in future stock prices. With regard to past trading, the Board stated that the prices at which the Company's common stock had traded in recent years did not reflect the "inherent" value of the Company. But having referred to the "inherent" value of Trans Union, the directors ascribed no number to it. Moreover, nowhere did they disclose that they had no basis on which to fix "inherent" worth beyond an impressionistic reaction to the premium over market and an unsubstantiated belief that the value of the assets was "significantly greater" than book value. By their own admission they could not rely on the stock price as an accurate measure of value. Yet, also by their own admission, the

Board members assumed that Trans Union's market price was adequate to serve as a basis upon which to assess the adequacy of the premium for purposes of the September 20 meeting.

The parties do not dispute that a publicly-traded stock price is solely a measure of the value of a minority position and, thus, market price represents only the value of a single share. Nevertheless, on September 20, the Board assessed the adequacy of the premium over market, offered by Pritzker, solely by comparing it with Trans Union's current and historical stock price.

Indeed, as of September 20, the Board had no other information on which to base a determination of the intrinsic value of Trans Union as a going concern. As of September 20, the Board had made no evaluation of the Company designed to value the entire enterprise, nor had the Board ever previously considered selling the Company or consenting to a buy-out merger. Thus, the adequacy of a premium is indeterminate unless it is assessed in terms of other competent and sound valuation information that reflects the value of the particular business.

Despite the foregoing facts and circumstances, there was no call by the Board, either on September 20 or thereafter, for any valuation study or documentation of the $55 price per share as a measure of the fair value of the Company in a cash-out context. It is undisputed that the major asset of Trans Union was its cash flow. Yet, at no time did the Board call for a valuation study taking into account that highly significant element of the Company's assets.

We do not imply that an outside valuation study is essential to support an informed business judgment; nor do we state that fairness opinions by independent investment bankers are required as a matter of law. Often insiders familiar with the business of a going concern are in a better position than are outsiders to gather relevant information; and under appropriate circumstances, such directors may be fully protected in relying in good faith upon the valuation reports of their management.

Here, the record establishes that the Board did not request its Chief Financial Officer, Romans, to make any valuation study or review of the proposal to determine the adequacy of $55 per share for sale of the Company. On the record before us: The Board rested on Romans' elicited response that the $55 figure was within a "fair price range" within the context of a leveraged buy-out. No director sought any further information from Romans. No director asked him why he put $55 at the bottom of his range. ***

The record also establishes that the Board accepted without scrutiny Van Gorkom's representation as to the fairness of the $55 price per share for sale of the Company—a subject that the Board had never previously considered. The Board thereby failed to discover that Van Gorkom had suggested the $55 price to Pritzker and, most crucially, that Van Gorkom had arrived at the $55 figure based on calculations designed solely to determine the feasibility of a leveraged buy-out.[19] No questions were raised either as to the tax implications of a cash-out merger or how the price for the one million share option granted Pritzker was calculated.

[19] As of September 20 the directors did not know: that Van Gorkom had arrived at the $55 figure alone, and

We do not say that the Board of Directors was not entitled to give some credence to Van Gorkom's representation that $55 was an adequate or fair price. Under § 141(e), the directors were entitled to rely upon their chairman's opinion of value and adequacy, provided that such opinion was reached on a sound basis. Here, the issue is whether the directors informed themselves as to all information that was reasonably available to them. Had they done so, they would have learned of the source and derivation of the $55 price and could not reasonably have relied thereupon in good faith.

None of the directors, Management or outside, were investment bankers or financial analysts. Yet the Board did not consider recessing the meeting until a later hour that day (or requesting an extension of Pritzker's Sunday evening deadline) to give it time to elicit more information as to the sufficiency of the offer, either from inside Management (in particular Romans) or from Trans Union's own investment banker, Salomon Brothers, whose Chicago specialist in merger and acquisitions was known to the Board and familiar with Trans Union's affairs.

Thus, the record compels the conclusion that on September 20 the Board lacked valuation information adequate to reach an informed business judgment as to the fairness of $55 per share for sale of the Company.

(2)

This brings us to the post-September 20 "market test" upon which the defendants ultimately rely to confirm the reasonableness of their September 20 decision to accept the Pritzker proposal. In this connection, the directors present a two-part argument: (a) that by making a "market test" of Pritzker's $55 per share offer a condition of their September 20 decision to accept his offer, they cannot be found to have acted impulsively or in an uninformed manner on September 20; and (b) that the adequacy of the $17 premium for sale of the Company was conclusively established over the following 90 to 120 days by the most reliable evidence available—the marketplace. Thus, the defendants impliedly contend that the "market test" eliminated the need for the Board to perform any other form of fairness test either on September 20, or thereafter.

Again, the facts of record do not support the defendants' argument. There is no evidence: (a) that the Merger Agreement was effectively amended to give the Board freedom to put Trans Union up for auction sale to the highest bidder; or (b) that a public auction was in fact permitted to occur. The minutes of the Board meeting make no reference to any of this. Indeed, the record compels the conclusion that the directors had no rational basis for expecting that a market test was attainable, given the terms of the Agreement as executed during the

subjectively, as the figure to be used by Controller Peterson in creating a feasible structure for a leveraged buy-out by a prospective purchaser; that Van Gorkom had not sought advice, information or assistance from either inside or outside Trans Union directors as to the value of the Company as an entity or the fair price per share for 100% of its stock; that Van Gorkom had not consulted with the Company's investment bankers or other financial analysts; that Van Gorkom had not consulted with or confided in any officer or director of the Company except Chelberg; and that Van Gorkom had deliberately chosen to ignore the advice and opinion of the members of his Senior Management group regarding the adequacy of the $55 price.

evening of September 20. We rely upon the following facts which are essentially uncontradicted:

The Merger Agreement, specifically identified as that originally presented to the Board on September 20, has never been produced by the defendants, notwithstanding the plaintiffs' several demands for production before as well as during trial. No acceptable explanation of this failure to produce documents has been given to either the Trial Court or this Court. Significantly, neither the defendants nor their counsel have made the affirmative representation that this critical document has been produced. Thus, the Court is deprived of the best evidence on which to judge the merits of the defendants' position as to the care and attention which they gave to the terms of the Agreement on September 20.

Van Gorkom states that the Agreement as submitted incorporated the ingredients for a market test by authorizing Trans Union to receive competing offers over the next 90-day period. However, he concedes that the Agreement barred Trans Union from actively soliciting such offers and from furnishing to interested parties any information about the Company other than that already in the public domain. Whether the original Agreement of September 20 went so far as to authorize Trans Union to receive competitive proposals is arguable. The defendants' unexplained failure to produce and identify the original Merger Agreement permits the logical inference that the instrument would not support their assertions in this regard. It is a well established principle that the production of weak evidence when strong is, or should have been, available can lead only to the conclusion that the strong would have been adverse. Van Gorkom, conceding that he never read the Agreement, stated that he was relying upon his understanding that, under corporate law, directors always have an inherent right, as well as a fiduciary duty, to accept a better offer notwithstanding an existing contractual commitment by the Board.

The defendant directors assert that they "insisted" upon including two amendments to the Agreement, thereby permitting a market test: (1) to give Trans Union the right to accept a better offer; and (2) to reserve to Trans Union the right to distribute proprietary information on the Company to alternative bidders. Yet, the defendants concede that they did not seek to amend the Agreement to permit Trans Union to solicit competing offers. ***

Thus, notwithstanding what several of the outside directors later claimed to have "thought" occurred at the meeting, the record compels the conclusion that Trans Union's Board had no rational basis to conclude on September 20 or in the days immediately following, that the Board's acceptance of Pritzker's offer was conditioned on (1) a "market test" of the offer; and (2) the Board's right to withdraw from the Pritzker Agreement and accept any higher offer received before the shareholder meeting. ***

(4)

Part of the defense is based on a claim that the directors relied on legal advice rendered at the September 20 meeting by James Brennan, Esquire, who was present at Van Gorkom's request. Unfortunately, Brennan did not appear and testify at trial even though his firm participated in the defense of this action. *** Several defendants testified that Brennan advised them that Delaware law did not require a fairness opinion or an outside valuation of the

Company before the Board could act on the Pritzker proposal. If given, the advice was correct. However, that did not end the matter. Unless the directors had before them adequate information regarding the intrinsic value of the Company, upon which a proper exercise of business judgment could be made, mere advice of this type is meaningless; and, given this record of the defendants' failures, it constitutes no defense here.[22]

* * *

We conclude that Trans Union's Board was grossly negligent in that it failed to act with informed reasonable deliberation in agreeing to the Pritzker merger proposal on September 20; and we further conclude that the Trial Court erred as a matter of law in failing to address that question before determining whether the directors' later conduct was sufficient to cure its initial error. * * *

-B-

We now examine the Board's post-September 20 conduct for the purpose of determining first, whether it was informed and not grossly negligent; and second, if informed, whether it was sufficient to legally rectify and cure the Board's derelictions of September 20.

(1)

First, as to the Board meeting of October 8: Its purpose arose in the aftermath of the September 20 meeting: (1) the September 22 press release announcing that Trans Union "had entered into definitive agreements to merge with an affiliate of Marmon Group, Inc.;" and (2) Senior Management's ensuing revolt.

Trans Union's press release stated:

> FOR IMMEDIATE RELEASE:
>
> CHICAGO, IL—Trans Union Corporation announced today that it had entered into definitive agreements to merge with an affiliate of The Marmon Group, Inc. in a transaction whereby Trans Union stockholders would receive $55 per share in cash for each Trans Union share held. The Marmon Group, Inc. is controlled by the Pritzker family of Chicago.
>
> The merger is subject to approval by the stockholders of Trans Union at a special meeting expected to be held sometime during December or early January.
>
> Until October 10, 1980, the purchaser has the right to terminate the merger if financing that is satisfactory to the purchaser has not been obtained, but after that date there is no such right.
>
> In a related transaction, Trans Union has agreed to sell to a designee of the purchaser one million newly-issued shares of Trans Union common stock at a cash price of $38 per share. Such shares will be issued only if the merger financing has been committed for no later than October 10, 1980, or if the purchaser elects to waive the

[22] Nonetheless, we are satisfied that in an appropriate factual context a proper exercise of business judgment may include, as one of its aspects, reasonable reliance upon the advice of counsel. This is wholly outside the statutory protections of 8 Del.C. § 141(e) involving reliance upon reports of officers, certain experts and books and records of the company.

> merger financing condition. In addition, the New York Stock Exchange will be asked to approve the listing of the new shares pursuant to a listing application which Trans Union intends to file shortly.
>
> Completing of the transaction is also subject to the preparation of a definitive proxy statement and making various filings and obtaining the approvals or consents of government agencies.

The press release made no reference to provisions allegedly reserving to the Board the rights to perform a "market test" and to withdraw from the Pritzker Agreement if Trans Union received a better offer before the shareholder meeting. The defendants also concede that Trans Union never made a subsequent public announcement stating that it had in fact reserved the right to accept alternate offers, the Agreement notwithstanding.

The public announcement of the Pritzker merger resulted in an "en masse" revolt of Trans Union's Senior Management. The head of Trans Union's tank car operations (its most profitable division) informed Van Gorkom that unless the merger were called off, fifteen key personnel would resign.

Instead of reconvening the Board, Van Gorkom again privately met with Pritzker, informed him of the developments, and sought his advice. Pritzker then made the following suggestions for overcoming Management's dissatisfaction: (1) that the Agreement be amended to permit Trans Union to solicit, as well as receive, higher offers; and (2) that the shareholder meeting be postponed from early January to February 10, 1981. In return, Pritzker asked Van Gorkom to obtain a commitment from Senior Management to remain at Trans Union for at least six months after the merger was consummated.

Van Gorkom then advised Senior Management that the Agreement would be amended to give Trans Union the right to solicit competing offers through January, 1981, if they would agree to remain with Trans Union. Senior Management was temporarily mollified; and Van Gorkom then called a special meeting of Trans Union's Board for October 8.

Thus, the primary purpose of the October 8 Board meeting was to amend the Merger Agreement, in a manner agreeable to Pritzker, to permit Trans Union to conduct a "market test." Van Gorkom understood that the proposed amendments were intended to give the Company an unfettered "right to openly solicit offers down through January 31." Van Gorkom presumably so represented the amendments to Trans Union's Board members on October 8. In a brief session, the directors approved Van Gorkom's oral presentation of the substance of the proposed amendments, the terms of which were not reduced to writing until October 10. But rather than waiting to review the amendments, the Board again approved them sight unseen and adjourned, giving Van Gorkom authority to execute the papers when he received them.[25]

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[25] We do not suggest that a board must read *in haec verba* every contract or legal document which it approves, but if it is to successfully absolve itself from charges of the type made here, there must be some credible contemporary evidence demonstrating that the directors knew what they were doing, and ensured that their purported action was given effect. That is the consistent failure which cast this Board upon its unredeemable course.

Thus, the Court of Chancery's finding that the October 8 Board meeting was convened to *reconsider* the Pritzker "proposal" is clearly erroneous. Further, the consequence of the Board's faulty conduct on October 8, in approving amendments to the Agreement which had not even been drafted, will become apparent when the actual amendments to the Agreement are hereafter examined.

The next day, October 9, and before the Agreement was amended, Pritzker moved swiftly to off-set the proposed market test amendment. First, Pritzker informed Trans Union that he had completed arrangements for financing its acquisition and that the parties were thereby mutually bound to a firm purchase and sale arrangement. Second, Pritzker announced the exercise of his option to purchase one million shares of Trans Union's treasury stock at $38 per share—75 cents above the current market price. Trans Union's Management responded the same day by issuing a press release announcing: (1) that all financing arrangements for Pritzker's acquisition of Trans Union had been completed; and (2) Pritzker's purchase of one million shares of Trans Union's treasury stock at $38 per share.

The next day, October 10, Pritzker delivered to Trans Union the proposed amendments to the September 20 Merger Agreement. Van Gorkom promptly proceeded to countersign all the instruments on behalf of Trans Union without reviewing the instruments to determine if they were consistent with the authority previously granted him by the Board. The amending documents were apparently not approved by Trans Union's Board until a much later date, December 2. The record does not affirmatively establish that Trans Union's directors ever read the October 10 amendments.

The October 10 amendments to the Merger Agreement did authorize Trans Union to solicit competing offers, but the amendments had more far-reaching effects. The most significant change was in the definition of the third-party "offer" available to Trans Union as a possible basis for withdrawal from its Merger Agreement with Pritzker. Under the October 10 amendments, a better *offer* was no longer sufficient to permit Trans Union's withdrawal. Trans Union was now permitted to terminate the Pritzker Agreement and abandon the merger only if, prior to February 10, 1981, Trans Union had either consummated a merger (or sale of assets) with a third party or had entered into a "definitive" merger agreement more favorable than Pritzker's and for a greater consideration—subject only to stockholder approval. Further, the "extension" of the market test period to February 10, 1981 was circumscribed by other amendments which required Trans Union to file its preliminary proxy statement on the Pritzker merger proposal by December 5, 1980 and use its best efforts to mail the statement to its shareholders by January 5, 1981. Thus, the market test period was effectively reduced, not extended.

In our view, the record compels the conclusion that the directors' conduct on October 8 exhibited the same deficiencies as did their conduct on September 20. ***

We conclude that the Board acted in a grossly negligent manner on October 8; and that Van Gorkom's representations on which the Board based its actions do not constitute "reports" under § 141(e) on which the directors could reasonably have relied. Further, the amended Merger Agreement imposed on Trans Union's acceptance of a third party offer conditions more onerous than those imposed on Trans Union's acceptance of Pritzker's offer on September 20. After October 10, Trans Union could accept from a third party a better offer only if it were incorporated in a definitive agreement between the parties, and not conditioned on financing or on any other contingency.

The October 9 press release, coupled with the October 10 amendments, had the clear effect of locking Trans Union's Board into the Pritzker Agreement. Pritzker had thereby foreclosed Trans Union's Board from negotiating any better "definitive" agreement over the remaining eight weeks before Trans Union was required to clear the Proxy Statement submitting the Pritzker proposal to its shareholders.

(2)

Next, as to the "curative" effects of the Board's post-September 20 conduct, we review in more detail the reaction of Van Gorkom to the KKR proposal and the results of the Board-sponsored "market test."

The KKR proposal was the first and only offer received subsequent to the Pritzker Merger Agreement. The offer resulted primarily from the efforts of Romans and other senior officers to propose an alternative to Pritzker's acquisition of Trans Union. In late September, Romans' group contacted KKR about the possibility of a leveraged buy-out by all members of Management, except Van Gorkom. By early October, Henry R. Kravis of KKR gave Romans written notice of KKR's "interest in making an offer to purchase 100%" of Trans Union's common stock.

Thereafter, and until early December, Romans' group worked with KKR to develop a proposal. It did so with Van Gorkom's knowledge and apparently grudging consent. On December 2, Kravis and Romans hand-delivered to Van Gorkom a formal letter-offer to purchase all of Trans Union's assets and to assume all of its liabilities for an aggregate cash consideration equivalent to $60 per share. The offer was contingent upon completing equity and bank financing of $650 million, which Kravis represented as 80% complete. The KKR letter made reference to discussions with major banks regarding the loan portion of the buy-out cost and stated that KKR was "confident that commitments for the bank financing * * * can be obtained within two or three weeks." The purchasing group was to include certain named key members of Trans Union's Senior Management, excluding Van Gorkom, and a major Canadian company. Kravis stated that they were willing to enter into a "definitive agreement" under terms and conditions "substantially the same" as those contained in Trans Union's agreement with Pritzker. The offer was addressed to Trans Union's Board of Directors and a meeting with the Board, scheduled for that afternoon, was requested.

Van Gorkom's reaction to the KKR proposal was completely negative; he did not view the offer as being firm because of its financing condition. It was pointed out, to no avail, that Pritzker's offer had not only been similarly conditioned, but accepted on an expedited basis. Van Gorkom refused Kravis' request that Trans Union issue a press release announcing KKR's offer, on the ground that it might "chill" any other offer. Romans and Kravis left with the understanding that their proposal would be presented to Trans Union's Board that afternoon.

Within a matter of hours and shortly before the scheduled Board meeting, Kravis withdrew his letter-offer. He gave as his reason a sudden decision by the Chief Officer of Trans Union's rail car leasing operation to withdraw from the KKR purchasing group. Van Gorkom had spoken to that officer about his participation in the KKR proposal immediately after his meeting with Romans and Kravis. However, Van Gorkom denied any responsibility for the officer's change of mind.

At the Board meeting later that afternoon, Van Gorkom did not inform the directors of the KKR proposal because he considered it "dead." Van Gorkom did not contact KKR again until January 20, when faced with the realities of this lawsuit, he then attempted to reopen negotiations. KKR declined due to the imminence of the February 10 stockholder meeting.

GE Credit Corporation's interest in Trans Union did not develop until November; and it made no written proposal until mid-January. Even then, its proposal was not in the form of an offer. Had there been time to do so, GE Credit was prepared to offer between $2 and $5 per share above the $55 per share price which Pritzker offered. But GE Credit needed an additional 60 to 90 days; and it was unwilling to make a formal offer without a concession from Pritzker extending the February 10 "deadline" for Trans Union's stockholder meeting. As previously stated, Pritzker refused to grant such extension; and on January 21, GE Credit terminated further negotiations with Trans Union. Its stated reasons, among others, were its "unwillingness to become involved in a bidding contest with Pritzker in the absence of the willingness of [the Pritzker interests] to terminate the proposed $55 cash merger."

* * *

In the absence of any explicit finding by the Trial Court as to the reasonableness of Trans Union's directors' reliance on a market test and its feasibility, we may make our own findings based on the record. Our review of the record compels a finding that confirmation of the appropriateness of the Pritzker offer by an unfettered or free market test was virtually meaningless in the face of the terms and time limitations of Trans Union's Merger Agreement with Pritzker as amended October 10, 1980. ***

* * *

Upon the basis of the foregoing, we hold that the defendants' post-September conduct did not cure the deficiencies of their September 20 conduct; and that, accordingly, the Trial Court erred in according to the defendants the benefits of the business judgment rule.

*** V.

The defendants ultimately rely on the stockholder vote of February 10 for exoneration. The defendants contend that the stockholders' "overwhelming" vote approving the Pritzker Merger Agreement had the legal effect of curing any failure of the Board to reach an informed business judgment in its approval of the merger. ***

The settled rule in Delaware is that "where a majority of fully informed stockholders ratify action of even interested directors, an attack on the ratified transaction normally must fail." Gerlach v. Gillam, Del. Ch., 139 A.2d 591, 593 (1958). The question of whether shareholders have been fully informed such that their vote can be said to ratify director action, "turns on the fairness and completeness of the proxy materials submitted by the management to the ... shareholders." Michelson v. Duncan, supra at 220. ***

Applying this standard to the record before us, we find that Trans Union's stockholders were not fully informed of all facts material to their vote on the Pritzker Merger and that the Trial Court's ruling to the contrary is clearly erroneous. We list the material deficiencies in the proxy materials:

(1) The fact that the Board had no reasonably adequate information indicative of the intrinsic value of the Company, other than a concededly depressed market price, was without question material to the shareholders voting on the merger.

Accordingly, the Board's lack of valuation information should have been disclosed. Instead, the directors cloaked the absence of such information in both the Proxy Statement and the Supplemental Proxy Statement. Through artful drafting, noticeably absent at the September 20 meeting, both documents create the impression that the Board knew the intrinsic worth of the Company. In particular, the Original Proxy Statement contained the following:

> [a]lthough the Board of Directors regards the intrinsic value of the Company's assets to be significantly greater than their book value ..., systematic liquidation of such a large and complex entity as Trans Union is simply not regarded as a feasible method of realizing its inherent value. Therefore, a business combination such as the merger would seem to be the only practicable way in which the stockholders could realize the value of the Company.

The Proxy stated further that "[i]n the view of the Board of Directors ..., the prices at which the Company's common stock has traded in recent years have not reflected the inherent value of the Company." What the Board failed to disclose to its stockholders was that the Board had not made any study of the intrinsic or inherent worth of the Company; nor had the Board even discussed the inherent value of the Company prior to approving the merger on September 20, or at either of the subsequent meetings on October 8 or January 26. ***

We find misleading the Board's references to the "substantial" premium offered. The Board gave as their primary reason in support of the merger the "substantial premium" shareholders would receive. But the Board did not disclose its failure to assess the premium offered in terms of other relevant valuation techniques, thereby rendering questionable its determination as to the substantiality of the premium over an admittedly depressed stock market price. ***

(5) The Board's Supplemental Proxy Statement, mailed on or after January 27, added significant new matter, material to the proposal to be voted on February 10, which was not contained in the Original Proxy Statement. Some of this new matter was information which had only been disclosed to the Board on January 26; much was information known or reasonably available before January 21 but not revealed in the Original Proxy Statement. Yet, the stockholders were not informed of these facts.

*** In this case, the Board's ultimate disclosure as contained in the Supplemental Proxy Statement related either to information readily accessible to all of the directors if they had asked the right questions, or was information already at their disposal. In short, the information disclosed by the Supplemental Proxy Statement was information which the defendant directors knew or should have known at the time the first Proxy Statement was issued. The defendants simply failed in their original duty of knowing, sharing, and disclosing information that was material and reasonably available for their discovery. They compounded that failure by their continued lack of candor in the Supplemental Proxy Statement. While we need not decide the issue here, we are satisfied that, in an appropriate case, a completely candid but belated disclosure of information long known or readily available to a board could raise serious issues of inequitable conduct.

The burden must fall on defendants who claim ratification based on shareholder vote to establish that the shareholder approval resulted from a fully informed electorate. On the record before us, it is clear that the Board failed to meet that burden.

* * *

For the foregoing reasons, we conclude that the director defendants breached their fiduciary duty of candor by their failure to make true and correct disclosures of all information they had, or should have had, material to the transaction submitted for stockholder approval.

VI.

To summarize: we hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer.

We hold, therefore, that the Trial Court committed reversible error in applying the business judgment rule in favor of the director defendants in this case.

On remand, the Court of Chancery shall conduct an evidentiary hearing to determine the fair value of the shares represented by the plaintiffs' class, based on the intrinsic value of Trans Union on September 20, 1980. * * * Thereafter, an award of damages may be entered to the extent that the fair value of Trans Union exceeds $55 per share.

* * *

REVERSED and REMANDED for proceedings consistent herewith.

Basic Inc. v. Levinson

485 U.S. 224 (1988)

Justice BLACKMUN delivered the opinion of the Court: This case requires us to apply the materiality requirement of § 10(b) of the Securities Exchange Act of 1934, (1934 Act), as amended, 15 U.S.C. § 78a et seq. and the Securities and Exchange Commission's Rule 10b-5, 17 CFR § 240.10b-5 (1987), promulgated thereunder, in the context of preliminary corporate merger discussions. We must also determine whether a person who traded a corporation's shares on a securities exchange after the issuance of a materially misleading statement by the corporation may invoke a rebuttable presumption that, in trading, he relied on the integrity of the price set by the market.

I

Prior to December 20, 1978, Basic Incorporated was a publicly traded company primarily engaged in the business of manufacturing chemical refractories for the steel industry. As early as 1965 or 1966, Combustion Engineering, Inc., a company producing mostly alumina-based refractories, expressed some interest in acquiring Basic, but was deterred from pursuing this inclination seriously because of antitrust concerns it then entertained. In 1976, however, regulatory action opened the way to a renewal of Combustion's interest. The "Strategic Plan," dated October 25, 1976, for Combustion's Industrial Products Group included the objective: "Acquire Basic Inc. $30 million."

Beginning in September 1976, Combustion representatives had meetings and telephone conversations with Basic officers and directors, including petitioners here, concerning the possibility of a merger. During 1977 and 1978, Basic made three public statements denying that it was engaged in merger negotiations. On December 18, 1978, Basic asked the New York Stock Exchange to suspend trading in its shares and issued a release stating that it had been "approached" by another company concerning a merger. On December 19, Basic's board endorsed Combustion's offer of $46 per share for its common stock, and on the following day publicly announced its approval of Combustion's tender offer for all outstanding shares.

Respondents are former Basic shareholders who sold their stock after Basic's first public statement of October 21, 1977, and before the suspension of trading in December 1978. Respondents brought a class action against Basic and its directors, asserting that the defendants issued three false or misleading public statements and thereby were in violation of § 10(b) of the 1934 Act and of Rule 10b-5. Respondents alleged that they were injured by selling Basic shares at artificially depressed prices in a market affected by petitioners' misleading statements and in reliance thereon.

The District Court adopted a presumption of reliance by members of the plaintiff class upon petitioners' public statements that enabled the court to conclude that common questions of fact or law predominated over particular questions pertaining to individual plaintiffs. The District Court therefore certified respondents' class. On the merits, however, the District Court granted summary judgment for the defendants. It held that, as a matter of law, any misstatements were immaterial: there were no negotiations ongoing at the time of the first statement, and although negotiations were taking place when the second and third statements were issued, those negotiations were not "destined, with reasonable certainty, to become a merger agreement in principle."

The United States Court of Appeals for the Sixth Circuit affirmed the class certification, but reversed the District Court's summary judgment, and remanded the case. 786 F.2d 741 (1986). The court reasoned that while petitioners were under no general duty to disclose their discussions with Combustion, any statement the company voluntarily released could not be "'so incomplete as to mislead.'" Id., at 746, quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (CA2 1968) (en banc), cert. denied, sub nom. Coates v. SEC, 394 U.S. 976 (1969). In the Court of Appeals' view, Basic's statements that no negotiations where taking place, and that it knew of no corporate developments to account for the heavy trading activity, were misleading. With respect to materiality, the court rejected the argument that preliminary merger discussions are immaterial as a matter of law, and held that "once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue." 786 F.2d, at 749.

The Court of Appeals joined a number of other Circuits in accepting the "fraud-on-the-market theory" to create a rebuttable presumption that respondents relied on petitioners' material misrepresentations, noting that without the presumption it would be impractical to certify a class under Federal Rule of Civil Procedure 23(b)(3). ***

II

The 1934 Act was designed to protect investors against manipulation of stock prices. Underlying the adoption of extensive disclosure requirements was a legislative philosophy: "There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy." H.R. Rep. No. 1383, 73d Cong., 2d Sess., 11 (1934). This Court "repeatedly has described the 'fundamental purpose' of the Act as implementing a 'philosophy of full disclosure.'" Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 477-478 (1977), quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

Pursuant to its authority under § 10(b) of the 1934 Act, 15 U.S.C. § 78j, the Securities and Exchange Commission promulgated Rule 10b-5.[6] Judicial interpretation and application, legislative acquiescence, and the passage of time have removed any doubt that a private cause of action exists for a violation of § 10(b) and Rule 10b-5, and constitutes an essential tool for enforcement of the 1934 Act's requirements.

The Court previously has addressed various positive and common-law requirements for a violation of § 10(b) or of Rule 10b-5. The Court also explicitly has defined a standard of materiality under the securities laws, see TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976), concluding in the proxy-solicitation context that "[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." Id., at 449. Acknowledging that certain information concerning corporate developments could well be of "dubious significance," id., at 448, the Court was care-

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[6] In relevant part, Rule 10b-5 provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> * * *
>
> "(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading....,
>
> "in connection with the purchase or sale of any security."

ful not to set too low a standard of materiality; it was concerned that a minimal standard might bring an overabundance of information within its reach, and lead management "simply to bury the shareholders in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking." Id., at 448-449. It further explained that to fulfill the materiality requirement "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Id., at 449. We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context.

III

The application of this materiality standard to preliminary merger discussions is not self-evident. Where the impact of the corporate development on the target's fortune is certain and clear, the *TSC Industries* materiality definition admits straightforward application. Where, on the other hand, the event is contingent or speculative in nature, it is difficult to ascertain whether the "reasonable investor" would have considered the omitted information significant at the time. Merger negotiations, because of the ever-present possibility that the contemplated transaction will not be effectuated, fall into the latter category.

A

Petitioners urge upon us a Third Circuit test for resolving this difficulty. Under this approach, preliminary merger discussions do not become material until "agreement-in-principle" as to the price and structure of the transaction has been reached between the would-be merger partners. See Greenfield v. Heublein, Inc., 742 F.2d 751, 757 (CA3 1984). By definition, then, information concerning any negotiations not yet at the agreement-in-principle stage could be withheld or even misrepresented without a violation of Rule 10b-5.

Three rationales have been offered in support of the "agreement-in-principle" test. The first derives from the concern expressed in *TSC Industries* that an investor not be overwhelmed by excessively detailed and trivial information, and focuses on the substantial risk that preliminary merger discussions may collapse: because such discussions are inherently tentative, disclosure of their existence itself could mislead investors and foster false optimism. The other two justifications for the agreement-in-principle standard are based on management concerns: because the requirement of "agreement-in-principle" limits the scope of disclosure obligations, it helps preserve the confidentiality of merger discussions where earlier disclosure might prejudice the negotiations; and the test also provides a usable, bright-line rule for determining when disclosure must be made.

None of these policy-based rationales, however, purports to explain why drawing the line at agreement-in-principle reflects the significance of the information upon the investor's decision. The first rationale, and the only one connected to the concerns expressed in *TSC Industries*, stands soundly rejected, even by a Court of Appeals that otherwise has accepted the wisdom of the agreement-in-principle test. "It assumes that investors are nitwits, unable to appreciate—even when told—that mergers are risky propositions up until the closing." Flamm v. Eberstadt, 814 F.2d, at 1175. Disclosure, and not paternalistic withholding of accurate information, is the policy chosen and expressed by Congress. We have recognized time and again, a "fundamental purpose" of the various Securities Acts, "was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." SEC v. Capital Gains Research Bureau, Inc., 375 U.S., at 186. The role of the materiality requirement is not to "attribute to investors a child-like simplicity, an inability to grasp the probabilistic significance of negotiations," Flamm v. Eberstadt, 814 F.2d, at 1175, but to filter out essentially useless information that a reasonable investor would not consider significant, even as part of a larger "mix" of factors to consider in making his investment decision.

The second rationale, the importance of secrecy during the early stages of merger discussions, also seems irrelevant to an assessment whether their existence is significant to the trading decision of a reasonable investor. To avoid a "bidding war" over its target, an acquiring firm often will insist that negotiations remain confidential, and at least one Court of Appeals has stated that "silence pending settlement of the price and structure of a deal is beneficial to most investors, most of the time." Flamm v. Eberstadt, 814 F.2d, at 1177.

We need not ascertain, however, whether secrecy necessarily maximizes shareholder wealth—although we note that the proposition is at least disputed as a matter of theory and empirical research—for this case does not concern the *timing* of a disclosure; it concerns only its accuracy and completeness. We face here the narrow question whether information concerning the existence and status of preliminary merger discussions is significant to the reasonable investor's trading decision. Arguments based on the premise that some disclosure would be "premature" in a sense are more properly considered under the rubric of an issuer's duty to disclose. The "secrecy" rationale is simply inapposite to the definition of materiality.

The final justification offered in support of the agreement-in-principle test seems to be directed solely at the comfort of corporate managers. A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the Securities Acts and Congress' policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be overinclusive or underinclusive. In *TSC Industries* this Court explained: "The determination [of materiality] requires delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him...." 426 U.S., at 450. After much study, the Advisory Committee on Corporate Disclosure cautioned the SEC against administratively confining materiality to a rigid formula. Courts also would do well to heed this advice.

We therefore find no valid justification for artificially excluding from the definition of materiality information concerning merger discussions, which would otherwise be considered significant to the trading decision of a reasonable investor, merely because agreement-in-principle as to price and structure has not yet been reached by the parties or their representatives.

B

The Sixth Circuit explicitly rejected the agreement-in-principle test, as we do today, but in its place adopted a rule that, if taken literally, would be equally insensitive, in our view, to the distinction between materiality and the other elements of an action under Rule 10b-5:

> When a company whose stock is publicly traded makes a statement, as Basic did, that "no negotiations" are underway, and that the corporation knows of "no reason for the stock's activity," and that "management is unaware of any present or pending corporate development that would result in the abnormally heavy trading activity," information concerning ongoing acquisition discussions becomes material *by virtue of the statement denying their existence*....
>
> * * *
>
> ... In analyzing whether information regarding merger discussions is material such that it must be affirmatively disclosed to avoid a violation of Rule 10b-5, the discussions and their progress are the primary considerations. However, once a statement is made denying the existence of any discussions, even discussions that might not have been material in absence of the denial are material because they make the statement made untrue.

786 F.2d, at 748-749 (emphasis in original).

This approach, however, fails to recognize that, in order to prevail on a Rule 10b-5 claim, a plaintiff must show that the statements were *misleading* as to a *material* fact. It is not enough that a statement is false or incomplete, if the misrepresented fact is otherwise insignificant.

C

Even before this Court's decision in *TSC Industries*, the Second Circuit had explained the role of the materiality requirement of Rule 10b-5, with respect to contingent or speculative information or events, in a manner that gave that term meaning that is independent of the other provisions of the Rule. Under such circumstances, materiality "will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity." SEC v. Texas Gulf Sulphur Co., 401 F.2d, at 849. Interestingly, neither the Third Circuit decision adopting the agreement-in-principle test nor petitioners here take issue with this general standard. Rather, they suggest that with respect to preliminary merger discussions, there are good reasons to draw a line at agreement on price and structure.

In a subsequent decision, the late Judge Friendly, writing for a Second Circuit panel, applied the *Texas Gulf Sulphur* probability/magnitude approach in the specific context of preliminary merger negotiations. After acknowledging that materiality is something to be determined on the basis of the particular facts of each case, he stated:

> Since a merger in which it is bought out is the most important event that can occur in a small corporation's life, to wit, its death, we think that inside information, as regards a merger of this sort, can become material at an earlier stage than would be the case as regards lesser transactions—and this even though the mortality rate of mergers in such formative stages is doubtless high.

SEC v. Geon Industries, Inc., 531 F.2d 39, 47-48 (1976).

We agree with that analysis.

Whether merger discussions in any particular case are material therefore depends on the facts. Generally, in order to assess the probability that the event will occur, a factfinder will need to look to indicia of interest in the transaction at the highest corporate levels. Without attempting to catalog all such possible factors, we note by way of example that board resolutions, instructions to investment bankers, and actual negotiations between principals or their intermediaries may serve as indicia of interest. To assess the magnitude of the transaction to the issuer of the securities allegedly manipulated, a factfinder will need to consider such facts as the size of the two corporate entities and of the potential premiums over market value. No particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material.

As we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information. The fact-specific inquiry we endorse here is consistent with the approach a number of courts have taken in assessing the materiality of merger negotiations. Because the standard of materiality we have adopted differs from that used by both courts below, we remand the case for reconsideration of the question whether a grant of summary judgment is appropriate on this record.

IV

A

We turn to the question of reliance and the fraud-on-the-market theory. Succinctly put:

> The fraud on the market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business.... Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements.... The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations.

Peil v. Speiser, 806 F.2d 1154, 1160-1161 (CA3 1986).

Our task, of course, is not to assess the general validity of the theory, but to consider whether it was proper for the courts below to apply a rebuttable presumption of reliance, supported in part by the fraud-on-the-market theory.

This case required resolution of several common questions of law and fact concerning the falsity or misleading nature of the three public statements made by Basic, the presence or absence of scienter, and the materiality of the misrepresentations, if any. In their amended complaint, the named plaintiffs alleged that in reliance on Basic's statements they sold their shares of Basic stock in the depressed market created by petitioners. Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones. The District Court found that the presumption of reliance created by the fraud-on-the-market theory provided "a practical resolution to the problem of balancing the substantive requirement of proof of reliance in securities cases against the procedural requisites of [Federal Rule of Civil Procedure] 23." The District Court thus concluded that with reference to each public statement and its impact upon the open market for Basic shares, common questions predominated over individual questions, as required by Federal Rules of Civil Procedure 23(a)(2) and (b)(3).

Petitioners and their *amici*: complain that the fraud-on-the-market theory effectively eliminates the requirement that a plaintiff asserting a claim under Rule 10b-5 prove reliance. They note that reliance is and long has been an element of common-law fraud, see, e.g., Restatement (Second) of Torts § 525 (1977); and argue that because the analogous express right of action includes a reliance requirement, see, e.g., § 18(a) of the 1934 Act, as amended, 15 U.S.C. § 78r(a), so too must an action implied under § 10(b).

We agree that reliance is an element of a Rule 10b-5 cause of action. Reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury. *** The modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases, and our understanding of Rule 10b-5's reliance requirement must encompass these differences.

B

Presumptions typically serve to assist courts in managing circumstances in which direct proof, for one reason or another, is rendered difficult. The courts below accepted a presumption, created by the fraud-on-the-market theory and subject to rebuttal by petitioners, that persons who had traded Basic shares had done so in reliance on the integrity of the price set by the market, but because of petitioners' material misrepresentations that price had been fraudulently depressed. Requiring a plaintiff to show a speculative state of facts, *i.e.,* how he would have acted if omitted material information had been disclosed, or if the misrepresentation had not been made would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.

*** The presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.[24] It has been noted that "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game?" Schlanger v. Four-Phase Systems Inc., 555 F.Supp. 535, 538 (SDNY 1982). Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the

[24] Fischel, Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus.Law. 1, 4, n. 9 (1982) (citing literature on efficient-capital-market theory). We need not determine by adjudication what economists and social scientists have debated through the use of sophisticated statistical analysis and the application of economic theory. For purposes of accepting the presumption of reliance in this case, we need only believe that market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices.

market price may be presumed. Commentators generally have applauded the adoption of one variation or another of the fraud-on-the-market theory. An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

C

The Court of Appeals found that petitioners "made public, material misrepresentations and [respondents] sold Basic stock in an impersonal, efficient market. Thus the class, as defined by the district court, has established the threshold facts for proving their loss." 786 F.2d, at 751. The court acknowledged that petitioners may rebut proof of the elements giving rise to the presumption, or show that the misrepresentation in fact did not lead to a distortion of price or that an individual plaintiff traded or would have traded despite his knowing the statement was false.

Any showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance. For example, if petitioners could show that the "market makers" were privy to the truth about the merger discussions here with Combustion, and thus that the market price would not have been affected by their misrepresentations, the causal connection could be broken: the basis for finding that the fraud had been transmitted through market price would be gone.[28] Similarly, if, despite petitioners' allegedly fraudulent attempt to manipulate market price, news of the merger discussions credibly entered the market and dissipated the effects of the misstatements, those who traded Basic shares after the corrective statements would have no direct or indirect connection with the fraud. Petitioners also could rebut the presumption of reliance as to plaintiffs who would have divested themselves of their Basic shares without relying on the integrity of the market. For example, a plaintiff who believed that Basic's statements were false and that Basic was indeed engaged in merger discussions, and who consequently believed that Basic stock was artificially underpriced, but sold his shares nevertheless because of other unrelated concerns, e.g., potential antitrust problems, or political pressures to divest from shares of certain businesses, could not be said to have relied on the integrity of a price he knew had been manipulated.

V

In summary:

1. We specifically adopt, for the § 10(b) and Rule 10b-5 context, the standard of materiality set forth in TSC Industries, Inc. v. Northway, Inc., 426 U.S., at 449.

[28] By accepting this rebuttable presumption, we do not intend conclusively to adopt any particular theory of how quickly and completely publicly available information is reflected in market price. Furthermore, our decision today is not to be interpreted as addressing the proper measure of damages in litigation of this kind.

2. We reject “agreement-in-principle as to price and structure” as the bright-line rule for materiality.

3. We also reject the proposition that “information becomes material by virtue of a public statement denying it.”

4. Materiality in the merger context depends on the probability that the transaction will be consummated, and its significance to the issuer of the securities. Materiality depends on the facts and thus is to be determined on a case-by-case basis.

5. It is not inappropriate to apply a presumption of reliance supported by the fraud-on-the-market theory.

6. That presumption, however, is rebuttable.

7. The District Court’s certification of the class here was appropriate when made but is subject on remand to such adjustment, if any, as developing circumstances demand.

The judgment of the Court of Appeals is vacated, and the case is remanded to that court for further proceedings consistent with this opinion.

It is so ordered. ***