

1-1-1989

Commentary on Understanding Pennzoil v. Texaco: Rational Bargaining and Agency Problems

Stephen M. Bundy
Berkeley Law

Follow this and additional works at: <http://scholarship.law.berkeley.edu/facpubs>



Part of the [Law Commons](#)

Recommended Citation

Stephen M. Bundy, *Commentary on Understanding Pennzoil v. Texaco: Rational Bargaining and Agency Problems*, 75 Va. L. Rev. 335 (1989),
Available at: <http://scholarship.law.berkeley.edu/facpubs/1502>

This Article is brought to you for free and open access by Berkeley Law Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Berkeley Law Scholarship Repository. For more information, please contact jcera@law.berkeley.edu.

COMMENTARY ON "UNDERSTANDING *PENNZOIL v. TEXACO*": RATIONAL BARGAINING AND AGENCY PROBLEMS

Stephen M. Bundy*

PROFESSORS Mnookin and Wilson's analysis of the multi-billion dollar lawsuit between Pennzoil and Texaco is an imaginative contribution to the study of "bargaining in the shadow of the law."¹ This Commentary examines the authors' answer to the question of why Texaco and Pennzoil took so long to settle their dispute after the jury entered its verdict. In passing, it also considers their explanation of why the stock market apparently discounted the combined value of Pennzoil and Texaco by over \$3 billion while the case was pending.

For Mnookin and Wilson, the parties' failure to settle soon after the jury verdict in *Pennzoil Co. v. Texaco, Inc.*² presents a challenge to economic theory. As they see it, "there is little reason to think that the parties or their lawyers had radically different assessments of the probabilities of possible outcomes." What is more, "for shareholders the costs of the continuing litigation were enormous." Mnookin and Wilson conclude that with the parties in substantial agreement on the outcome and extraordinary costs in prospect, "[t]he relevant economics literature suggests that the parties to the dispute should have settled quickly for some amount that permitted them to share the avoidable extra costs of the litigation." Yet the litigation was not settled for more than two years, after multiple appeals and a costly bankruptcy filing by Texaco.

The authors attribute this apparent departure from profit-maximizing rationality to a conflict of interest on the part of Texaco's board of directors. Mnookin and Wilson contend that from the directors' perspective continued litigation was preferable, not because it benefited shareholders, but because it

* Acting Professor of Law, School of Law (Boalt Hall), University of California at Berkeley. Thanks for helpful comments on an earlier draft are due to Dick Buxbaum, David Caron, Jesse Choper, John Dwyer, Mel Eisenberg, Tom Jorde, Paul Mishkin, Andrea Peterson, Robert Post, Dan Rubinfeld, and Jan Vetter. I am responsible for any remaining errors.

¹ The term "bargaining in the shadow of the law" is, of course, borrowed from Professor Mnookin's own pioneering study, Mnookin & Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 Yale L.J. 950 (1979).

² No. 84-05905 (Dist. Ct. Harris County, Tex. Dec. 4, 1985), *aff'd in part*, 729 S.W.2d 768 (Tex. Ct. App. 1987), *cert. dismissed*, 108 S. Ct. 1305, *appeal dismissed on agreement of the parties*, 748 S.W.2d 631 (Tex. Ct. App. 1988).

was the directors' only hope of avoiding ruinous liability for breach of their duty of care in connection with the Getty acquisition and Pennzoil's suit. Although this thesis is presented with apparent modesty, the authors do not suggest or endorse any other explanation of the parties' failure to settle. By negative implication, then, they contend that the Texaco board's alleged conflict of interest is the best single explanation of that failure.

This Commentary offers an alternative thesis. *Pennzoil v. Texaco* would have been hard to settle even in the absence of information asymmetries or agency problems. The outcome on appeal was difficult to predict, the stakes were vast, and the expected costs of continued litigation, insofar as they can now be determined, were initially relatively moderate. Based on their prior dealings, each party had reason to distrust the other, and that distrust probably impeded negotiations. There is thus substantial evidence that the parties' failure to settle may have resulted from management conduct calculated to maximize expected returns to shareholders.

Other evidence, however, indicates that agency problems may have impeded settlement. Because of differences in their use of and relationship with outside counsel, the parties may have expected different outcomes on appeal. Management biases may have increased the difference between the parties' expected outcomes and caused the parties' managers to overvalue continued litigation. These biases apparently resulted principally from the respective managers' sense of honor, their sense of right and wrong, their desire to preserve a reputation for competence, and their mutual personal animosity. The Texaco board's fear of personal liability to shareholders may also have impeded settlement, but it was probably not the most important and almost certainly not the only such impediment.

The limited available information does not permit a confident determination of whether agency problems impeded settlement. If they did not, then *Pennzoil v. Texaco* is an important example of a neglected class of cases—those in which prodigiously expensive litigation is in the interest of both parties and, perhaps, in the interest of the legal system as well. On this view, the intervention of the bankruptcy judge to force settlement may well have been misguided. If agency problems did impede settlement, the question is how such problems might best be controlled in the future. This Commentary argues that for large corporations engaged in complex litigation a promising approach is to increase the legal capacity of senior management by improving in-house counsel.

The Commentary proceeds in three stages. Part I is a brief summary of the "law and economics" account of settlement. Part II uses that framework to test the authors' thesis against the available evidence and to develop my

alternative thesis.³ Part III considers some ways of mitigating the kinds of agency problems that may have impeded settlement.

I. THE THEORY OF SETTLEMENT

The process that determines whether and when a legal dispute will settle has two elements: evaluation and bargaining.

A. Evaluation

The dominant theoretical account of settlement assumes that no disputant will contest a claim unless he believes that the value of doing so is superior to that of available alternatives.⁴ In the simplest version of this account, plaintiff and defendant each compare the consequences of settlement with those of litigation to judgment. Neither will wish to go forward unless his expected net gain from continued litigation is greater than his expected net gain from settlement.⁵ Where the plaintiff's expected gain from litigating to

³ Mnookin and Wilson have capably summarized the basic chronology of events in the Pennzoil-Texaco dispute, and I rely on the reader's familiarity with that chronology. For additional information on the case, I have principally relied on S. Coll, *The Taking of Getty Oil* (1987) and T. Petzinger, *Oil and Honor* (1987). Unfortunately, neither provides a full account of the parties' settlement negotiations.

⁴ Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. Legal Stud. 399, 417-20 (1973); Priest & Klein, *The Selection of Disputes for Litigation*, 13 J. Legal Stud. 1, 4 (1984).

⁵ Each party calculates the expected outcome at judgment as the product of (1) his estimate of the probability of a finding of liability and (2) his estimate of the present value of the judgment if liability is found. To determine his expected gain from litigation to judgment, the plaintiff must subtract his expected costs of litigation from the expected outcome; to this amount he must add the expected costs of settlement that he will avoid by continuing to litigate. Defendant, on the other hand, calculates his net gain from litigation to judgment by adding his expected costs of litigation to his expected outcome at judgment and then subtracting his avoided settlement costs from that total.

The factors that each disputant must consider in predicting the outcome are more complex than indicated by this simple statement. First, in even the simplest case, the calculation of probable outcomes includes a range of different findings on the liability issue, a range of different damage awards, and a range of possible costs. See H. Raiffa, *The Art and Science of Negotiation* 70-77 (1982). Second, each variable is potentially linked to others. See Posner, *supra* note 4, at 418-20. For example, an increase in the expected judgment may induce greater expenditure on the case. Perloff & Rubinfeld, *Settlements in Private Antitrust Litigation*, in *Private Antitrust Litigation: New Evidence*, New Learning 149, 160-61 (L. White ed. 1988). Third, each disputant's estimates are strategic, in that they depend importantly on a prediction of what the opponent will do. Fourth, evaluations are incremental and subject to ongoing revision. Although the simplified model emphasizes the choice between settlement and trial, decisions more commonly focus on smaller increments of benefit and cost. At each stage, the litigant must decide whether to accept the best offer presently available from the opponent or to go one step further. For each additional step, the advantage, if any, is a

judgment is less than the defendant's expected loss, there is a positive "settlement gap"—a range of values between the parties' estimated outcomes in which a settlement will leave both parties better off. The larger that gap is, the greater the likelihood of settlement. Conversely, if that gap is small or negative (because plaintiff's expected gain from judgment is higher than defendant's expected loss) then settlement is correspondingly unlikely.⁶

This model suggests that several factors affect the likelihood of settlement. First, settlement is less likely to the extent that plaintiff assigns a higher probability than does the defendant to the possibility that plaintiff will win on the issue of liability⁷—a state of affairs sometimes characterized as "excessive optimism."⁸ Second, informational asymmetries and biases are likely to produce greater differences in the parties' expectations and hence are more likely to prevent settlement in "close" or "hard" cases in which both sides have good reasons for optimism.⁹ Third, large stakes magnify the effect of excessive optimism because small differences in the parties' expected outcomes produce large disparities in the expected value of the claim.¹⁰ Fourth, when litigation costs are high, settlement is more likely. Fifth, when either party places a special premium on avoiding judgment because of its precedential or reputational effects, settlement is more likely. Conversely, if either party affirmatively values judgment, settlement is less likely.¹¹

B. Bargaining

The existence of a positive settlement gap does not ensure that settlement will occur.¹² The parties must initiate discussions, make or solicit an acceptable offer, and reach agreement. Both know that if neither does any of these things, the case will go to judgment without any exploration of possible preferable outcomes. But both also know that bargaining is risky. In particular, it may convey to the opponent useful information about the course of any future litigation or about one's willingness to settle. To avoid that risk, a

marginal improvement in his ability to predict the outcome, to persuade his opponent of his resolve, or to assess his opponent's resolve. See Cooter, Marks & Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 *J. Legal Stud.* 225, 232-33 (1982); Miller, *An Economic Analysis of Rule 68*, 15 *J. Legal Stud.* 93, 114 (1986).

⁶ See Perloff & Rubinfeld, *supra* note 5, at 173-75.

⁷ Posner, *supra* note 4, at 419 n.29.

⁸ Cooter, Marks & Mnookin, *supra* note 5, at 225.

⁹ Priest & Klein, *supra* note 4, at 15-16.

¹⁰ Posner, *supra* note 4, at 419 & n.29. This result assumes, of course, that the parties are risk neutral.

¹¹ Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 *UCLA L. Rev.* 4, 29-30 (1983); Perloff & Rubinfeld, *supra* note 5, at 156, 174.

¹² See Cooter, Marks & Mnookin, *supra* note 5.

party may make no offers, or may make only offers falling outside the settlement gap.

Even when a party makes an offer that the offeree realizes would, if accepted, make him better off than litigation to judgment, settlement need not occur. If the offeree believes that the probability of further concessions is sufficiently large and that the expected improvement in the offer is sufficiently substantial, he may rationally refuse the pending offer, despite the risk that there will be no better offer and that the case will go to judgment. In some such cases, the risked event occurs and the case goes to trial.¹³

This account suggests conditions under which a positive settlement gap will likely lead to settlement. First, trust or fellow feeling should increase the likelihood of agreement, because in cases in which the parties believe that disclosures are less likely to be exploited by the opponent, they are more willing to run the risk of bargaining.¹⁴ Second, when the parties are familiar with each other, they are less likely to mistake the opponent's expectations, preferences, and likely course of action. Familiarity thus should reduce the risk that the parties will bluff themselves out of a mutually profitable settlement.¹⁵

II. *PENNZOIL V. TEXACO* REINTERPRETED

Against this background, Mnookin and Wilson's thesis can be summarized as follows. First, the parties' expected outcomes probably were in substantial agreement. Second, litigation costs were high. Accordingly, the settlement gap was large and settlement should have followed promptly. The reason it did not was the disloyalty of Texaco's board, which wrongfully assigned a higher value to continued litigation than a disinterested analysis would have warranted. In effect, the directors' conflict of interest created an asymmetry in the parties' stakes and thus prevented settlement. My interpretation is different. First, for some considerable time after the jury verdict the settlement gap was probably negative, but primarily for reasons other than the Texaco board's fear of liability. Second, at all relevant times, mutual distrust, misunderstanding, and personal antagonism impeded the parties' bargaining.

¹³ Id. at 226.

¹⁴ Cf. D. Lax & J. Sebenius, *The Manager as Negotiator: Bargaining for Cooperation and Competitive Gain* 154-60 (1986) (discussing the risks involved in cooperative negotiation strategies).

¹⁵ Cooter, Marks & Mnookin, *supra* note 5, at 236-37.

*A. Was There A Settlement Gap?**1. Different Predictions*

In contrast to Mnookin and Wilson, I believe that there is considerable evidence that the parties expected different outcomes. The Pennzoil-Texaco appeal presented three basic questions: Could Texaco win outright on the ground that Pennzoil's claim was invalid as a matter of law? Could Texaco obtain a new trial, either on all issues or on the issues of actual or punitive damages? Could Texaco obtain a reduction on appeal of actual or punitive damages? Several types of information were relevant to these questions. First, there was the bulky trial court record. Second, there was the reported substantive law of the United States, New York, and Delaware and the reported procedural law of Texas and ultimately of the United States Supreme Court. Finally, there was knowledge of the predilections and prejudices of the relevant courts concerning a wide range of subjects, including oral contracts, large oil companies, Wall Street lawyers and investment bankers, huge jury verdicts,¹⁶ the competence and probity of the Texas judiciary,¹⁷ and the obligation of a state court to apply the laws of other states faithfully in cases arising under those laws.

An initial reason why the parties may have expected different outcomes is that the case was "close," in the sense that each party had good reasons for optimism.¹⁸ Texaco had several strong legal arguments for a directed verdict or for a new trial, although none was absolutely compelling. On the other hand, Pennzoil had in its favor the exceptionally deferential standard of review applied by Texas courts in reviewing judgments rendered on jury

¹⁶ The verdict was some 90 times larger than the largest judgment ever previously sustained on appeal. T. Petzinger, *supra* note 3, at 14.

¹⁷ The alleged corrupting effect of contributions to Texas judicial campaigns was at issue in the case. Shortly after the first of the two trial judges was assigned to the case, Pennzoil's lead trial lawyer, Joseph Jamail, made an exceptionally large contribution to the judge's campaign. *Id.* at 282. Texaco claimed that the judge's acceptance of this contribution required his removal from the case. *Id.* at 288-91. Jamail was also the largest or second largest contributor to the campaigns of five of the nine justices of the Texas Supreme Court. *Id.* at 456. In mid-1986 a Texas Senate committee was to begin public hearings on that court's "inner workings," when lobbyists, acting on Jamail's behalf, succeeded in having the probe "swept behind the closed doors of the Texas Judicial Conduct Commission." *Id.*

¹⁸ The term "close" is used here without any implication that the case was close in terms of what the Texas courts *should* have done. I believe the Texas courts should have reversed the trial court judgment and ordered judgment for Texaco. Their failure to do so was wrong, and the failure of the Texas Supreme Court even to hear Texaco's appeal on the merits, in the face of a weak and somewhat disingenuous opinion from the Court of Appeals, was a grave injustice.

verdicts.¹⁹ The critical variable, then, was the attitude of the Texas courts toward the issues and persons involved in the appeal and toward their national audience.

Recent work by Priest and Klein suggests that when the "true" value of a case lies close to the line between victory and defeat on the liability issue (what they call the "decision standard"), even very small differences in the parties' estimates of the single most probable resolution of that issue can produce quite large differences in the parties' estimates of the probability that plaintiff will prevail.²⁰ Because different estimates of the single most probable resolution can occur even if the parties' estimates of the outcome are based on the same information and are unbiased, Pennzoil and Texaco might have expected quite different outcomes on appeal even under relatively favorable circumstances. But the theory also predicts that in "close" cases informational differences and biases that tend to make both parties optimistic will cause relatively greater increases in the difference between the parties' estimated probabilities of plaintiff's success and hence relatively greater decreases in the probability of settlement.²¹ Thus, in the Pennzoil-Texaco dispute, even modest differences in the parties' information or in their perception of that information may have produced relatively substantial differences in their estimates of the probable outcome on appeal.

The case's complexity may also have caused Pennzoil and Texaco to disagree about the outcome. At least during the early stages of the appeal, there were probably important gaps in each party's understanding, due not to any failure of competence or loyalty, but rather to the difficulty of obtaining a comprehensive, accurate evaluation of a complex legal dispute involving a large record, numerous issues of law, multiple jurisdictions, and teams of lawyers of varying abilities operating under extraordinary deadline pressure.²² There is evidence that the able lawyers on both sides did not fully understand their cases in the trial court. They continued to learn during the appeal, and some important arguments were not well understood or well presented until late in the case.²³ If the parties were biased toward opti-

¹⁹ See *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768, 864 (Tex. Ct. App. 1987), cert. dismissed, 108 S. Ct. 1305, appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988).

²⁰ Priest & Klein, *supra* note 4, at 15-16.

²¹ *Id.*

²² See T. Petzinger, *supra* note 3, at 419-21.

²³ For example, the potentially decisive questions of the lawfulness of the alleged Pennzoil-Getty contract under the federal securities laws and of Texaco's standing to raise that issue are treated only superficially in the parties' post-trial briefs. See *Texaco Inc.'s Memorandum in Support of Its Motion for Judgment and Motion for Judgment Notwithstanding the Verdict* at 69-74, *Pennzoil Co. v. Texaco, Inc.*, No. 84-05905 (Dist. Ct. Harris County, Tex. Dec. 4, 1985), *aff'd in part*, 729 S.W.2d. 768 (Tex. Ct. App. 1987), cert. dismissed, 108 S. Ct. 1305,

mism, this learning lag may have allowed that bias relatively greater free play.

Apart from the closeness and complexity of the case, informational differences may also have contributed to different expectations. In the early stages of the appellate process, the parties may have had different information because of their choice of and relationship with appellate counsel. Pennzoil was represented at trial and on appeal by the same counsel—Joseph Jamail, Baker & Botts, and W. James Kronzer.²⁴ Jamail was a close friend of Hugh Liedtke, the chairman and chief executive of Pennzoil.²⁵ He had easy access to Pennzoil's senior management and they had confidence in him.²⁶ Pennzoil's president, Baine Kerr, was a former partner in Baker & Botts,²⁷ and the firm also had a close, long-term relationship with Pennzoil's internal

appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988). In the Texas Court of Appeals, the briefs show improved research, analysis, and argument. See Brief of Appellant Texaco Inc. at 66-68, *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Ct. App. 1987) (No. 01-86-00216-CV), cert. dismissed, 108 S. Ct. 1305, appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988); Brief of Appellee Pennzoil Co. at 224-34, *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Ct. App. 1987) (No. 01-86-00216-CV), cert. dismissed, 108 S. Ct. 1305, appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988); Reply Brief of Appellant Texaco Inc. at 86-92, *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Ct. App. 1987) (No. 01-86-00216-CV), cert. dismissed, 108 S. Ct. 1305, appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988). There is an even greater improvement in the briefs submitted to the Texas Supreme Court. See Application for a Writ of Error at 105-21, *Texaco, Inc. v. Pennzoil Co.*, No. C-6432 (Tex. Sup. Ct. June 15, 1987), cert. dismissed, 108 S. Ct. 1305, appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988); Appendix of SEC Authorities in Support of Application for a Writ of Error, *Texaco, Inc. v. Pennzoil Co.*, No. C-6432 (Tex. Sup. Ct. June 15, 1987), cert. dismissed, 108 S. Ct. 1305, appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988); Pennzoil's Reply to Texaco's Application for Writ of Error at 97-140, *Texaco, Inc. v. Pennzoil Co.*, No. C-6432 (Tex. Sup. Ct. Aug. 3, 1987), cert. dismissed, 108 S. Ct. 1305, appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988); Texaco's Reply to Pennzoil's Reply Brief at 8-44, *Texaco, Inc. v. Pennzoil Co.*, No. C-6432 (Tex. Sup. Ct. Sept. 1, 1987), cert. dismissed, 108 S. Ct. 1305, appeal dismissed on agreement of the parties, 748 S.W.2d 631 (Tex. Ct. App. 1988). This learning in the course of the lawsuit undoubtedly produced a sharper sense in both parties of the plausible range of decisions.

So too, in its initial papers in the federal court action, Pennzoil did not argue that its exercise of bond and lien rights under Texas law was not state action. See Brief of Pennzoil in Opposition to Texaco's Motion for a Preliminary Injunction at 35 n.5, *Texaco, Inc. v. Pennzoil Co.*, 626 F. Supp. 250 (S.D.N.Y.) (No. 85 Civ. 9640-CLB), aff'd in part, 784 F.2d 1133 (2d Cir. 1986), rev'd, 481 U.S. 1 (1987). Yet Pennzoil prominently featured that defense in the Court of Appeals and in the Supreme Court. See, e.g., Brief for Appellant at 13-15, *Pennzoil Co. v. Texaco, Inc.*, 481 U.S. 1 (1987) (No. 85-1798).

²⁴ S. Coll, *supra* note 3, at 399-400; T. Petzinger, *supra* note 3, at 357.

²⁵ T. Petzinger, *supra* note 3, at 137.

²⁶ *Id.* at 137, 266-67.

²⁷ S. Coll, *supra* note 3, at 249.

legal department.²⁸ The working relationship among Jamail, Baker & Botts, and Kronzer was reportedly cordial and effective.²⁹ These lawyers were intimately familiar with the trial court record and with the legal issues to the extent that they had been developed in the trial court. Most important, they had extensive experience with and knowledge of the Texas state judiciary. In the case of Jamail and Kronzer, in particular, this experience and knowledge was reputedly extraordinary.³⁰

Texaco's situation was different. Prior to the case, Texaco's Texas trial counsel had no professional or personal contact with Texaco.³¹ Even before the jury verdict, trial counsel often dealt with senior management through the hierarchical structure of Texaco's in-house legal department.³² After a jury verdict twenty-five times greater than their "likely worst case" scenario and five times greater than their estimated "complete runaway,"³³ Texas trial counsel was discredited.³⁴ Principal responsibility for Texaco's appeal passed to firms that had not been extensively involved in the trial. Several of these firms had not previously represented Texaco, and two of them were based in New York City.³⁵ Most of the lawyers handling the appeal were initially unfamiliar with the trial court record, the legal issues, and the workings of the Texas courts.³⁶ Moreover, although Texas trial counsel were available for consultation, the new lawyers reportedly had low regard for them, believing that they had made numerous tactical and strategic errors.³⁷ The Texas lawyers reportedly were in turn resentful of the New York lawyers.³⁸ Apparently, there was antagonism even among Texaco's New York counsel, antagonism which on occasion resulted in failures to share information.³⁹ Finally, Texaco management reportedly failed to appoint lead counsel or otherwise to establish clear lines of authority and communication among its new lawyers.⁴⁰

²⁸ T. Petzinger, *supra* note 3, at 136-37.

²⁹ S. Coll, *supra* note 3, at 399-400.

³⁰ T. Petzinger, *supra* note 3, at 265 (Jamail); *id.* at 358 (Kronzer).

³¹ See *id.* at 280.

³² S. Coll, *supra* note 3, at 428.

³³ *Id.* at 408.

³⁴ T. Petzinger, *supra* note 3, at 416.

³⁵ See Stewart, *Who's In Charge of Texaco's Team? Me! No, Me! No . . .*, *Wall St. J.*, Dec. 6, 1985, at 3, col. 4.

³⁶ T. Petzinger, *supra* note 3, at 420.

³⁷ *Id.*; see also Stewart, *supra* note 35 (reporting dissension within the Texaco legal team over which of four major law firms was in charge).

³⁸ T. Petzinger, *supra* note 3, at 420.

³⁹ *Id.*; Stewart, *supra* note 35, at 17, col. 3.

⁴⁰ Stewart, *supra* note 35, at 17, col. 3.

It seems quite plausible that during the initial stages of the appeal Texaco's lawyers had less complete information than did Pennzoil's lawyers and that Texaco had poorer lines of communication with its lawyers than did Pennzoil. If so, Texaco's information may well have differed significantly from Pennzoil's.⁴¹ Although the passage of time probably allowed Texaco's new counsel to catch up in knowledge of the record and of the applicable law, the displacement of Texas counsel (and conceivably the acumen and personal connections of Pennzoil's counsel) may have prevented Texaco from ever achieving full informational parity concerning the likely behavior of the Texas courts.⁴²

On each side bias also appears to have contributed to "excessive optimism." For the management of each company, the natural tendency to overestimate the strength of its own position⁴³ was reinforced by the strongly held belief that its cause was absolutely just and its opponent's morally bankrupt. Pennzoil executives believed that Texaco had "stolen" Pennzoil's share of Getty Oil.⁴⁴ For their part, Texaco executives and lawyers believed that the decision of the jury was "absurd"⁴⁵ and an "outrageous travesty" of justice,⁴⁶ that Pennzoil had "stolen" the trial through a combination of corruption and trickery,⁴⁷ and that their own conduct had been lawful and honorable in all respects.⁴⁸ It is only a short step from the conviction that a result is morally required to the conclusion that it is likely

⁴¹ For example, Petzinger reports that although Pennzoil's lawyers were aware from the outset of Pennzoil's bond and lien rights under Texas law and of the terrific leverage conferred on them by those provisions, it took Texaco's lawyers several weeks to appreciate the gravity of the threat. See T. Petzinger, *supra* note 3, at 421, 424-25.

⁴² For example, although Texaco's Texas lawyers unanimously opposed the filing of the federal request for an injunction because of the low probability that it would succeed and because of its potentially adverse effect on Texaco's appeal in the Texas courts, Texaco's New York lawyers prevailed and the action was filed. *Id.* at 419-20, 440. The best possible outcome of the federal court action was to spare Texaco from having to file for bankruptcy while it prosecuted its appeal, and the *ex ante* probability of achieving even that limited goal must have been low. It seems unlikely that the New York lawyers would have recommended such a course of action unless they were convinced that the risk of harmful retaliation against Texaco by the Texas courts was lower than Texas counsel had predicted. The one-sided decision of the Texas Court of Appeals and the otherwise almost inexplicable refusal of the Texas Supreme Court to hear Texaco's appeal suggest that expectation was unduly optimistic. It is also possible, however, that Texaco's New York lawyers recommended the federal court action on the assumption that even under the best of circumstances there was no chance of meaningful relief on direct appeal, short of United States Supreme Court review.

⁴³ See H. Raiffa, *supra* note 5, at 75.

⁴⁴ T. Petzinger, *supra* note 3, at 16, 235-36.

⁴⁵ S. Coll, *supra* note 3, at 474.

⁴⁶ T. Petzinger, *supra* note 3, at 413.

⁴⁷ *Id.* at 21.

⁴⁸ S. Coll, *supra* note 3, at 450.

to occur. The location of each party's management in a community that largely shared its views of the rights and wrongs of the case⁴⁹ and each party's principal reliance for advice on lawyers located in its own community may well have helped to maintain their biases.⁵⁰

Shared moral outrage may have been compounded by egotism.⁵¹ *Pennzoil v. Texaco* was an unusual corporate lawsuit in that the senior managers of both parties were personally involved in the disputed transaction, testified under stinging cross examination at trial, and were subjected to vigorous personal attacks in arguments to the jury.⁵² It must have been difficult for those men to avoid viewing the trial court judgment as reflecting their personal vindication or condemnation by the judicial system, or to give even partial credit to the other party's point of view.

It would be naive to treat management's expressions of moral or personal outrage as unambiguous evidence of harmful bias. It is often a rational bargaining strategy for a loyal agent to feign an irrational or disloyal attachment to values not shared by his principal, particularly when the opposing negotiator cannot readily communicate with the principal.⁵³ In addition, as managers of an enterprise under unusual stress, *Texaco's* senior executives may rationally have believed that the need to reinforce employee morale required vigorous denunciations of the Texas judgment. But even making allowances for those factors, it appears that moral and personal considerations played some role in the relevant management decisions.

⁴⁹ Although newspapers in the Northeast were generally highly critical of the trial court judgment, Texas newspapers were more supportive. *Id.* at 474; T. Petzinger, *supra* note 3, at 412, 437-38.

⁵⁰ See Ross & Anderson, *Shortcomings in the Attribution Process: On the Origins and Maintenance of Erroneous Social Assessments*, in *Judgment under Uncertainty: Heuristics and Biases* 129, 143 (D. Kahneman, P. Slovic & A. Tversky eds. 1982) ("[E]xposure to a biased sample of people and behavior does not demand that we err in our estimates concerning the relevant populations, but it does make such errors likely.").

⁵¹ Commenting on the prospects for settlement, Boone Pickens warned that "'personal feelings are something that CEOs don't have the luxury of letting get in the way of a deal.'" Frazier & Petzinger, *Eight Wise Men Offer Eight Ideas to End the Texaco-Pennzoil Fight*, *Wall St. J.*, Jan. 17, 1986, at 21, col. 4. A noted personal injury lawyer recommended that *Texaco* management put its "'egos in the closet'" or get "'some alter-egos.'" *Id.*

⁵² T. Petzinger, *supra* note 3, at 308-11 (testimony of Baine Kerr, president of *Pennzoil*); *id.* at 328-41 (testimony of Hugh Liedtke, chairman of *Pennzoil*); *id.* at 341-45 (testimony of John McKinley, chairman and chief executive of *Texaco*); *id.* at 386-88 (testimony of Alfred DeCrane, president of *Texaco*).

⁵³ See T. Schelling, *The Strategy of Conflict* 142-43 (1960); Meltsner & Schrag, *Negotiating Tactics for Legal Services Lawyers*, 7 *Clearinghouse Rev.* 259, 262 (1973).

2. *High Stakes*

The trial court's judgment, including interest, was \$11.12 billion,⁵⁴ over five times the highest financial stakes ever in a litigated appeal.⁵⁵ In consequence, modest differences in the parties' expected outcomes on liability translated into very large differences in the expected value of the judgment. For example, if Texaco's estimated probability that Texaco would win its appeal was 0.60, and if Pennzoil's estimate of that probability was 0.40, then the parties' estimated values of the claim, before costs, would have differed by over \$2.2 billion.⁵⁶ It is not surprising that a contemporary account of the settlement negotiations stated that "the sheer size of this judgment tends to overwhelm efforts for an amicable solution."⁵⁷

3. *Moderate Costs of Litigation*

The available information on litigation costs, although incomplete, suggests that initially those costs were moderate relative to the amount in controversy. In ordinary civil cases, the principal litigation cost is attorneys' fees,⁵⁸ which are often relatively large in proportion to the stakes involved.⁵⁹ In this case, however, although the fees paid by both parties during the state appellate process were large in absolute terms—perhaps \$200 million total—they were small in relation to the size of the stakes.⁶⁰ If the parties' expected

⁵⁴ T. Petzinger, *supra* note 3, at 15.

⁵⁵ The largest judgment prior to Pennzoil's was \$1.8 billion; that judgment was ultimately set aside on appeal. See *MCI Communications Corp. v. American Tel. & Tel. Co.*, 708 F.2d 1081 (7th Cir.), cert. denied, 464 U.S. 891 (1983).

⁵⁶ This example, like others that follow, abstracts from the complexity of the real appeal by treating it as if the amount of the judgment was fixed and would not change on appeal and as if the only liability issue was whether Pennzoil would win outright or Texaco would win outright. It ignores the complexities introduced by the possibility that the appeal might have resulted in a reduction of the compensatory or punitive damages award or in an order for a new trial. Moreover, the probabilities used in the example, although intended to be within the range of plausibility, are not otherwise warranted for historical accuracy.

⁵⁷ Petzinger, Stewart & Sullivan, *High Stakes Poker: Texaco and Pennzoil*, With Truce Expiring, *Again Talk of Settling*, *Wall St. J.*, Mar. 14, 1986 at 1, col. 6.

⁵⁸ Trubek, Sarat, Felstiner, Kritzer & Grossman, *The Costs of Ordinary Litigation*, 31 *UCLA L. Rev.* 72, 91-92 (1983).

⁵⁹ See *id.* at 110-12 (finding a median recovery-to-fee ratio of 2.15 for lawyers charging hourly rates).

⁶⁰ Cutler and Summers report that Texaco announced its expenditure for legal fees for the two years following judgment in the trial court as \$55 million. See Cutler & Summers, *The Costs of Conflict Resolution and Financial Distress: Evidence from the Texaco-Pennzoil Litigation*, 19 *RAND J. Econ.* 157, 166-67 (1988). In addition, following the bankruptcy filing, Texaco paid an estimated \$3.5 million monthly for the bankruptcy expenses of the company and the creditor committees. *Id.* at 167. Although Pennzoil's reported fees were in the range of \$400 million, it appears that most of that figure represented contingent fees that were payable to trial counsel and that did not increase significantly during the appeal. *Id.* It

outcomes differed significantly, costs of this magnitude would not have bridged the resulting negative settlement gap. Using our earlier example, if Texaco estimated the probability that Texaco would win its appeal as 0.60 and Pennzoil estimated that probability as 0.40, then the parties' estimated values of the claim, before costs, would have differed by over \$2.2 billion, far more than the increase in fees paid to lawyers during the state court appeals.

No doubt other significant costs were in prospect, but their magnitude remains uncertain. Mnookin and Wilson note that by late 1987 the stock market had discounted the combined value of Texaco and Pennzoil by over \$3 billion. That discount, they contend, probably represented a rational estimate of the present value of future losses from "a protracted and costly bankruptcy reorganization" of Texaco and can be treated as a measure of the costs of continued litigation. But although the authors persuasively demonstrate that prolonged reorganizations may destroy value and that by late 1987 prolonged reorganization of Texaco was a real possibility, they fail to provide plausible estimates of the expected probability of prolonged reorganization or of its expected cost sufficient to justify the observed market discount. The need for such evidence is illustrated by the following examples. If by late November 1987 the market could rationally have assigned a 0.50 probability to reorganization,⁶¹ then to calculate the \$3.4 billion loss in present value measured by Cutler and Summers, the market would have had to assign to reorganization a present expected cost of at least \$5 billion,⁶² about four times Texaco's 1985 net income and seven times its 1986 net income.⁶³

therefore seems plausible to assume total out of pocket fees for both sides of about \$200 million over the course of the two years between trial and settlement.

⁶¹ It is difficult to see how the market could have thought that the risk of a destructive reorganization was as great as 0.50. Mnookin and Wilson assume that the worst case would occur only if (1) the parties did not settle prior to a decision in the United States Supreme Court, (2) Texaco lost in the United States Supreme Court, and (3) a prolonged and costly reorganization ensued. The appropriate probability for each of these events must have been considerably less than 1 (the authors themselves state that the probability of a Texaco loss in the Supreme Court may have been as low as 0.50), and their product much less than 1.

⁶² This estimate depends on several simplifying assumptions. First, the alternative outcomes are (a) a settlement shortly before decision in the United States Supreme Court, (b) a settlement shortly after decision in the United States Supreme Court, whether or not that decision favored Texaco, and (c) a decision against Texaco in the United States Supreme Court, followed by a protracted and costly reorganization. In all three scenarios, it is assumed that the market could anticipate legal fees of \$500 million incurred up to the Supreme Court decision. These costs are therefore treated as having a probability of 1. It is assumed that alternatives (a) and (b) would not otherwise have been very costly—only 10% of the remaining \$2.9 billion discount is allocated to them. The remaining \$2.61 billion of the discount is treated as attributable to alternative (c). Thus, if the market believed that the probability of alternative (c) was 0.50, it must have assumed that the cost of that alternative was about \$5.2 billion.

⁶³ See Texaco, Inc., 1986 Annual Report 1 (1987).

Assuming a 0.25 probability of reorganization, the present expected cost would have been \$10 billion. These are large numbers indeed. I conclude that the authors have not demonstrated that the possibility of reorganization fully explains the observed discount.⁶⁴

The authors' failure to account for all of the observed discount in the market value of the two companies compels reconsideration of the suggestion of Cutler and Summers that "the market inefficiently valued the claims of the two companies."⁶⁵ Is there indeed reason to believe that the market overestimated the costs of continued litigation in *Pennzoil v. Texaco*? The efficient capital markets hypothesis makes two broad claims: "all relevant information will be available to the market, and . . . the market rapidly digests all such information as soon as it becomes available."⁶⁶ Assuming this hypothesis is valid in the ordinary case,⁶⁷ there are two distinctive features of *Pennzoil v. Texaco* that may have prevented the market from accurately reflecting the parties' expected litigation costs. First, available information about the case may have been skewed by the exigencies of the parties' adversarial relationship. Second, such information was novel and exceptionally costly to evaluate.

One reason for believing that information reaching the market ordinarily permits accurate valuation of a firm is that firms often have substantial economic incentives to disclose to investors both good and bad news about their operations and prospects.⁶⁸ But adherents of this view recognize that disclo-

⁶⁴ The market must have anticipated that reorganization might also have positive consequences. Mnookin and Wilson point out that in reorganization Texaco management lost some control over the decision whether to settle Pennzoil's claim. It also apparently lost some ability to block various major corporate transactions intended to increase value for shareholders. On the authors' analysis, this weakening of Texaco management benefited both Texaco and Pennzoil shareholders.

⁶⁵ Cutler & Summers, *supra* note 60, at 169.

⁶⁶ Gordon & Kornhauser, *Efficient Markets, Costly Information and Securities Research*, 60 N.Y.U. L. Rev. 761, 786, 838 (1985). The semi-strong form of the hypothesis makes the more modest claim that publicly available information of obvious interest to investors is fully reflected in the price of the stock. Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 555 (1984); see Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. Legal Stud. 165, 190 (1988); Note, *The Efficient Capital Markets Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 Stan. L. Rev. 1031, 1044-50 (1977).

⁶⁷ For recent criticisms of the hypothesis, see Gordon & Kornhauser, *supra* note 66; Shiller, *Fashions, Fads and Bubbles in Financial Markets*, in *Knights, Raiders and Targets: The Impact of the Hostile Takeover* 54, 58-60 (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988); Shubik, *Corporate Control, Efficient Markets and the Public Good*, in *Knights, Raiders and Targets: The Impact of the Hostile Takeover* 31 (J. Coffee, L. Lowenstein & S. Rose-Ackerman eds. 1988).

⁶⁸ Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669, 680-85 (1984).

sure may not be optimal in situations where "a firm must withhold information in order to avoid giving commercially valuable secrets to rivals."⁶⁹ Litigation and settlement negotiations are two such situations. As a matter of legitimate self-protection and advancement, a negotiating litigant often must conceal or misrepresent both his preferences and his estimates of the outcome and of the costs of the dispute.⁷⁰ Such tactics may involve appearing ill-informed, stupid, or disloyal. The litigant expects that his opponent will understand that he is being misled to a degree, but that, on balance, the opponent will entertain a less favorable view of the outcome and of the litigant's preferences than he would otherwise have done and will therefore offer more or demand less in settlement. In their negotiations, Texaco and Pennzoil undoubtedly concealed from each other and from the public their unbiased estimates of outcomes and costs, their reservation prices, and their bargaining strategies. Information reaching the market may therefore have suggested a greater likelihood of continued litigation than in fact existed, and may have led the market to anticipate litigation costs higher than those expected by the parties.

There is also good reason to doubt that the market completely or rapidly assimilated available information about the case. That process would not have been costless. Court records and case reports are "semi-public" information that must be sought out and studied. Such information is the special preserve of "the community of market professionals," including analysts and arbitrageurs.⁷¹ These actors devote themselves to acquiring and evaluating such information, and their trading permits that information to be rapidly assimilated into share prices.⁷²

To see why the market may not have processed information about *Pennzoil v. Texaco* very effectively, consider how professional analysts function in the ordinary case. The typical large corporation is followed by a number of experts. Each expert knows a good deal about the fundamental principles of business and finance, the company's lines of business, and the industry in which it operates. In most cases, he will have developed models of both the company and the industry. The flow of information is relatively routine and predictable. There are quarterly bursts of news; otherwise, the analyst receives information a bit or two at a time and enters it into firm and industry models. Because the typical bit of information has only modest

⁶⁹ Id. at 674.

⁷⁰ A striking account of how a corporate litigant's negotiating position was severely prejudiced by an unguarded disclosure of its reservation price to a third party is reported in G. Stern, *The Buffalo Creek Disaster: The Story of the Survivors' Unprecedented Lawsuit* 247-63 (1976).

⁷¹ Gilson & Kraakman, *supra* note 66, at 571.

⁷² Id.; Note, *supra* note 66, at 1054-55.

significance and does not call for rethinking of the models, the analyst can evaluate it quickly and at low cost.

Now consider *Pennzoil v. Texaco*. When Pennzoil's claim mushroomed overnight to \$11 billion, it probably overwhelmed the market mechanisms that ordinarily lead to rapid assimilation of information. The accumulated expertise of the analyst community was rendered largely irrelevant. Proper analysis called for a lawyer, or more realistically several lawyers, drawn from different jurisdictions and expert in litigation, federal securities law, and bankruptcy. Those lawyers had to create from scratch an evaluation of the case involving a huge amount of new information. Finally, that evaluation had to be relayed to and understood by the analyst and integrated into a dramatically restructured version of each company's financial model. The acquisition, processing, and verification of information about the case must therefore have been unusually costly, so that some professionals were reluctant to undertake it, and unusually time consuming, so that those who did undertake it did not begin to trade on their information with their customary speed. Recent theoretical and empirical work suggests that when presented with novel information that is costly to evaluate, the market does not respond with the promptness characteristic of efficiency.⁷³

The thesis that the high cost of information in *Pennzoil v. Texaco* was partially responsible for the persistent discount in the market value of the companies is strengthened if one considers that securities analysis may be in some measure a public good. Professional information gatherers who trade for their own account may find that leaks and price decoding permit other traders a "free ride" on their investment in information.⁷⁴ Those who provide securities analysis to clients are correspondingly limited in what they can charge by their clients' reduced ability to take full advantage of that information in the marketplace.⁷⁵ Because those who gather and analyze information cannot always recover the full economic value of their services, such services may be underprovided. If this is so, many market professionals may have despaired of recovering the tremendous investment required to prepare and update a high-quality evaluation of *Pennzoil v. Texaco*.⁷⁶ If some decided not to make that investment, a sub-optimal level of market

⁷³ Gilson & Kraakman, *supra* note 66, at 626 & n.205 (citing studies showing "some level of inefficiency" in the market's response to "new, and therefore more costly, information").

⁷⁴ Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 *Va. L. Rev.* 717, 725-26 (1984); Easterbrook & Fischel, *supra* note 68, at 681.

⁷⁵ Coffee, *supra* note 74, at 725-27.

⁷⁶ It is striking that Salomon Brothers advised its clients, "'The legal issues and options . . . are enormously complex and beyond our ability to analyze sensibly for investors.'" Getschow & Moffett, *In the Texaco Case, Judge's Countenance is of the Essence*, *Wall St. J.*, Dec. 9, 1985, at 1, col. 4.

research with respect to both companies may have caused them to trade at a discount.⁷⁷

These considerations strongly suggest that the market's \$3.4 billion discount was not an accurate measure of the expected costs of continued litigation between Pennzoil and Texaco as of late 1987.⁷⁸ But even if that discount accurately reflected expected litigation costs at that time, it cannot serve as the measure of expected costs at the time of the jury verdict in late 1985 or in 1986. Cutler and Summers indicate that over two-thirds of the litigation-related loss in the combined value of the two companies occurred after the trial court judgment was affirmed by the Texas Court of Appeals in February 1987.⁷⁹ If it is proper to take the combined market value of the two companies as reflecting the parties' expected litigation costs, then immediately after the verdict, when the parties' expected outcomes on appeal were in all probability most strongly divergent, their cost estimates were far lower than those relied on by Mnookin and Wilson.

A number of inferences can be drawn from the available information about costs. Legal fees for the two years following the trial court judgment were relatively low. Other costs were certainly significant, but are not now readily quantifiable. The expected costs of continued litigation, including the costs of bankruptcy, changed over time. They were probably low during the year following the trial court judgment, but increased in 1987 when the Texas Court of Appeals affirmed most of the trial court judgment and the United States Supreme Court vacated the injunction that had prevented Pennzoil from exercising its bond and lien rights. Although the expected costs of bankruptcy were higher in this later period, they were probably never as high as the authors suggest.

⁷⁷ Again, empirical evidence suggests that firms that are "informationally naked" or that lack a following of analysts often trade at a discount. Gilson & Kraakman, *supra* note 66, at 571 n.69 (quoting Arbel & Strebel, Pay Attention to Neglected Firms!, *J. Portfolio Mgmt.*, Winter 1983, at 37, 40).

⁷⁸ This account also suggests that Cutler and Summers are wrong to contend that a demonstration that the market misvalued Texaco and Pennzoil would provide "strong *general* grounds for doubting the rationality of market valuations." Cutler & Summers, *supra* note 60, at 169 (emphasis added). For if Pennzoil and Texaco were misvalued because the available public information was (1) skewed by litigation and settlement bargaining and (2) unusually costly to evaluate, there are no necessary implications for the accuracy of market valuations in cases lacking those features.

⁷⁹ Cutler & Summers, *supra* note 60, at 161 table 1. For the market value of the combined companies, the total of one-day losses associated with litigation events and with the bankruptcy was \$3.4 billion. Of that cumulative loss, only about \$0.78 billion, representing about 23% of the total loss, occurred prior to February 1987.

4. Asymmetric Stakes and Agency Problems

Corporate executives acting as disinterested fiduciaries ought to be indifferent between a judgment with a net expected value to shareholders of \$1 and a settlement with the same net value. It seems possible, however, that the biases of Texaco's management caused them to value judgment more highly than settlement.⁸⁰ Mnookin and Wilson attribute this to the fears of Texaco's directors that they would be held liable for failing "to make 'appropriately informed decisions' (1) to acquire Getty . . . , (2) to indemnify the various Getty interests as part of the transaction, and (3) to allow the Pennzoil litigation ever to reach a Texas jury." They argue that Texaco's directors chose between settlement and continued litigation of *Pennzoil v. Texaco* "in the shadow" of the Delaware business judgment rule as interpreted in *Smith v. Van Gorkom*.⁸¹ That decision, Mnookin and Wilson claim, created a significant probability that Texaco's directors would be held liable to shareholders for "gross negligence" and required to pay damages equal to the amount ultimately paid by Texaco to Pennzoil. For purposes of argument, the authors conservatively estimate that probability as 0.10.⁸² If the directors chose settlement, the authors assume, Texaco's payment to Pennzoil would have an expected value of \$3 billion. If the directors chose continued litigation, that payment would have an expected value of \$5.5 billion, reflecting a 0.50 probability of an adverse judgment of \$11 billion. Plainly, settlement was superior for shareholders. But for the directors, both alternatives led to liability far in excess of the limits of Texaco's directors and officers (D & O) liability policy: \$300 million in the case of settlement⁸³ and \$550 million in the case of continued litigation.⁸⁴ Mnookin and Wilson contend that because there was an expected wipeout for the directors at both branches of this decision tree the directors would have preferred continued litigation, which yielded a fifty percent chance of avoiding liability altogether.

This account depends on four doubtful assumptions: (1) the directors believed that the risk of liability was as high as the authors suggest; (2) the directors expected to pay in settlement the expected value of any judgment against them; (3) a self-interested decision by the Texaco directors to continue the litigation would not have increased their financial exposure to Tex-

⁸⁰ See *supra* notes 43-53 and accompanying text.

⁸¹ 488 A.2d 858 (Del. 1985).

⁸² The authors state that in assigning a probability of 0.10 they are "taking a reasonably expansive view of the business judgment rule despite *Smith v. Van Gorkom*."

⁸³ The expected value of a 10% chance of being held liable for a \$3 billion settlement payment.

⁸⁴ The expected value of a 10% chance of being held liable for a judgment with an expected value of \$5.5 billion.

aco shareholders; and (4) Texaco directors considered only monetary sanctions in deciding whether to settle.

Mnookin and Wilson overstate the risk of liability for Texaco's directors under the Delaware business judgment rule as applied in *Smith v. Van Gorkom*.⁸⁵ That case involved the decision of the board of directors of Trans Union Corporation to accept a merger proposal at a premium of roughly fifty percent over market price.⁸⁶ As the Delaware Supreme Court read the record, the following facts were salient. The decision to sell was made at a two-hour board meeting. No outside directors had been given notice of the subject of the meeting. The board decided to accept the offer after a brief oral presentation by Van Gorkom, the chairman and chief executive officer, without asking how the offered price had been negotiated, seriously questioning senior management, commissioning or reviewing any study of the adequacy of the offered price, or reserving the right to seek a better price.⁸⁷ These precautions were forgone even though there was no "crisis or emergency" that might have justified less searching inquiry.⁸⁸ On these facts the court held the directors "grossly negligent" in failing to obtain "all material information reasonably available to them" before accepting the offer.⁸⁹ Later efforts by the board to inform itself could not undo the damage done by this initial unwise commitment.⁹⁰

Much is wrong with *Van Gorkom*. The Delaware Supreme Court's reconstruction and reversal of the lower court's findings is strained and unpersuasive. Moreover, the decision was rendered by a 3-2 majority and was immediately subjected to heavy criticism, as Mnookin and Wilson acknowledge. Its precedential authority is therefore uncertain. But if the case is good law on the stated facts, *Van Gorkom* at most establishes that in the absence of exigent circumstances, a board of directors violates its duty of care when it agrees to sell a corporation for the first price offered by the first

⁸⁵ 488 A.2d 858 (Del. 1985).

⁸⁶ See *id.* at 869 n.9 (premium of 48% over last closing price).

⁸⁷ Although several directors testified that they had insisted that the merger agreement include a provision allowing Trans Union to seek a higher price, and that senior management agreed to insist on one, the court found that the board had "no rational basis" for believing that such a "market test" was part of the deal. *Id.* at 878, 880.

⁸⁸ *Id.* at 874. Had the board conducted such inquiries, it would have learned that the merger price had been calculated by Van Gorkom without any consultation with senior management, that it had been proposed by Van Gorkom to the offeror, and that it had been accepted by the offeror without any dickering. The board would also have learned of the nearly unanimous view of senior management that "the timing of the offer was wrong and the offer inadequate." *Id.* at 877. These facts would presumably have suggested that the offered price was not necessarily the best available.

⁸⁹ *Id.* at 872-75.

⁹⁰ *Id.* at 881-88.

bidder without either (1) having performed a reasonable inquiry to determine whether a better price can be obtained or (2) reserving the right to seek a better price.

After examining the available evidence, I doubt that Texaco's board was advised that there was any serious likelihood that its decisions to risk Pennzoil's suit or to take it to trial would be found "grossly negligent" under the Delaware business judgment rule, even as applied in *Van Gorkom*. First, when made, neither decision appeared as important to Texaco as the Trans Union board's decision to sell was to Trans Union. Second, when it decided to risk Pennzoil's suit and indemnify the Getty interests, the Texaco board, unlike the Trans Union board, was faced with tight deadlines.⁹¹ Even so, it made more searching inquiries than did the Trans Union board.⁹² Third, and most important, the issue on which the Texaco board was required to obtain "reasonably available" information was Texaco's legal exposure to Pennzoil. That question could only be evaluated sensibly by lawyers, and the Texaco board sought the advice of widely respected, disinterested legal counsel. At the time of the acquisition, the board consulted with its in-house counsel and with one of the two leading mergers and acquisitions firms in the nation.⁹³ Before and during trial, the board was personally advised by one of the most respected litigation firms in Texas.⁹⁴ So far as can be determined, those experts all informed the board that Texaco faced little risk of substantial liability on Pennzoil's claim, let alone the catastrophic liability that ultimately resulted.⁹⁵ Even with the benefit of hindsight, this advice seems reasonable.

When a board of directors is charged with failing to acquire sufficient information on a doubtful or complex question of law, it is normally a complete defense that it reasonably relied on the advice of counsel.⁹⁶ Given that the legal questions presented were complex and that the Texaco board con-

⁹¹ T. Petzinger, *supra* note 3, at 203.

⁹² S. Coll, *supra* note 3, at 348, 352, 354-56; T. Petzinger, *supra* note 3, at 203.

⁹³ S. Coll, *supra* note 3, at 355.

⁹⁴ See *id.* at 450 (Texaco's trial counsel attended board meeting during trial).

⁹⁵ See *id.* at 355, 408.

⁹⁶ *Pool v. Pool*, 22 So. 2d 131, 133 (La. Ct. App. 1945); *Gilbert v. Burnside*, 13 A.D.2d 982, 983, 216 N.Y.S.2d 430, 432 (1961), *aff'd*, 11 N.Y.2d 960, 183 N.E.2d 325, 229 N.Y.S.2d 10 (1962); *Hawes & Sherrard, Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 Va. L. Rev. 1, 41-49 (1976). Similarly, the American Law Institute has stated that

if the only issue in a duty of care litigation relates to the propriety of a director's reliance on an accounting firm, and if the director (i) acted in good faith, (ii) reasonably believed that the accounting firm merited confidence when it was delegated responsibility, and (iii) reasonably believed that his continuing reliance on it was warranted, then the director will have a complete defense and will have fulfilled his duty [of care].

sulted widely respected lawyers who were unanimous in their views, this defense probably would have prevailed even if the directors had done nothing more to inform themselves.⁹⁷ In fact, however, they did do more; they delegated their vice chairman to attend the entire trial and to report to senior management on a daily basis.⁹⁸ His reports on the case apparently paralleled those of trial counsel.⁹⁹ These efforts contrast vividly with the two-hour deliberation of the Trans Union board.

All this does not establish that the Texaco board believed that it ran no risk of liability. Delaware law might conceivably be read differently. Moreover, the facts that Texaco expected would emerge in discovery may have looked different from those contained in published accounts relied on here. But based on what we presently know, Texaco's directors had a very strong case for summary judgment or a directed verdict. There was also a substantial likelihood that a duty of care claim would be dismissed short of any adjudication on the merits, either on account of failure to satisfy the demand requirements applicable to shareholder derivative suits or on the basis of a recommendation of a special committee appointed by the board.¹⁰⁰ An

Principles of Corporate Governance: Analysis and Recommendations § 4.02 comment c (Tent. Draft No. 4, 1985) [hereinafter *Corporate Governance*]. Although the American Law Institute's comment refers to accountants, in context it is absolutely clear that the same rule would apply to reliance on attorneys. This rule is said to be "consistent with the law as it would be interpreted in most jurisdictions." *Id.* at comment a. In *Smith v. Van Gorkom*, the Delaware Supreme Court recognized a defense of this kind, stating 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." 488 A.2d 858, 881 n.22 (Del. 1985). The defense was held unavailable in that case, however, because counsel's advice did not tend to establish the adequacy of the merger price, the issue on which the board's inquiry was held deficient. Here, in contrast, counsel's advice went to the heart of the Texaco board's inquiry.

Counsel for the board must have been well aware of the importance of the defense of reliance on counsel, because the Delaware Chancery Court had recently cited it as one ground for approving the settlement, on terms very favorable to the directors, of a shareholders' derivative action against Texaco's board. See *Good v. Texaco, Inc.*, No. 7501, 1985 WESTLAW 11536 at 52 (Del. Ch. Feb. 19, 1985), *aff'd sub nom. Polk v. Good*, 507 A.2d 531 (Del. 1986).

⁹⁷ See *Corporate Governance*, *supra* note 96, § 4.02 comment i ("In general, independent verification or inquiry would be required only if suspicious circumstances or other unusual facts suggest that it would be appropriate to do so.").

⁹⁸ S. Coll, *supra* note 3, at 450.

⁹⁹ *Id.*

¹⁰⁰ In order to prosecute a derivative action, shareholders of a Delaware corporation must make demand on the board of directors, unless demand on the board is excused as futile. *Zapata Corp. v. Maldonado*, 430 A.2d 779, 786 (Del. 1981). Where demand is required, a refusal by the board to prosecute the claim terminates the action, subject only to judicial review of the board's decision under the relatively relaxed standards of the business judgment rule. Demand is excused only where the complaint alleges "particularized facts" sufficient to raise a "reasonable doubt" that "the directors are disinterested and independent" or that "the challenged transaction was otherwise the product of a valid exercise of business judgment."

accurate estimate of the likelihood of an adverse ruling on the merits was thus far lower than the 0.10 figure that Mnookin and Wilson propose.

A second assumption implicit in Mnookin and Wilson's analysis is that to settle a derivative suit or class action, defendants must pay the expected value of the claim. Much evidence suggests, however, that such suits normally settle for far less than their expected value at judgment. Such settlements occur because, although the class and class counsel often have very different interests, class plaintiffs are unable to monitor their counsel. In the absence of effective monitoring, class counsel can trade a substantial part of the expected class recovery for a larger, quicker, or more certain fee payment.¹⁰¹ A number of observers have argued that the procedural protections that attend class settlements are inadequate to prevent settlements of this kind.¹⁰² Texaco's board and its counsel knew that collusive settlements were possible. Shortly before the duty of care claims were filed, Texaco's board settled a derivative claim that appeared to have "substantial settlement value"¹⁰³ on terms that provided "no direct monetary compensation to either Texaco or its shareholders" and a fee of \$700,000 for class counsel.¹⁰⁴

Aronson v. Lewis, 473 A.2d 805, 814 (Del. 1983). It is far from clear that Texaco's shareholders could have established the futility of demand. See Pogostin v. Rice, 480 A.2d 619, 625 (Del. 1984); *Aronson*, 473 A.2d at 815.

Even if the shareholders established the futility of demand, the Texaco board could still have appointed a special committee, composed of persons who did not participate in the challenged decisions, to determine whether continued prosecution of the claims was in Texaco's best interest. If the special committee recommended dismissal, that recommendation would be subject to judicial review to determine (1) whether the special committee was independent, acted in good faith, and conducted a reasonable investigation and (2) whether, in the court's "independent business judgment," the case should be dismissed. *Zapata Corp.*, 430 A.2d at 788-89. On the present record, it seems unlikely that a Delaware court would have rejected a recommendation to dismiss. See *Kaplan v. Wyatt*, 484 A.2d 501, 519 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (Del. 1985).

¹⁰¹ Some examples of this phenomenon, together with an economic analysis of its causes, are presented in Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, *Law & Contemp. Probs.*, Summer 1985, at 5, 23-33.

¹⁰² See *Allegheny Corp. v. Kirby*, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting), *aff'd* by an equally divided court en banc, 340 F.2d 311 (2d Cir. 1965), cert. dismissed sub. nom. *Holt v. Allegheny Corp.*, 384 U.S. 28 (1966); Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 *Colum. L. Rev.* 669, 679-80, 714-20 (1986); Coffee, *supra* note 101, at 26-27.

¹⁰³ Coffee, *supra* note 101, at 30.

¹⁰⁴ *Good v. Texaco, Inc.*, No. 7501, 1985 WESTLAW 11536 at 44 (Del. Ch. Feb. 19, 1985), *aff'd* sub nom. *Polk v. Good*, 507 A.2d 531 (Del. 1986). In *Good*, a derivative suit, the Chancellor found that the directors stood a "better than even chance of establishing" their defense. *Id.* at 54. Possible damage awards ranged from about \$40 million (for 26.5 million shares repurchased at a premium of \$1 5/8 over the latest market price) to \$400 million (requested by some plaintiffs who used the lower market price of several weeks earlier as the

Once the authors' initial assumptions are relaxed, it seems likely that Texaco's directors were advised that the duty of care claims against them would almost certainly be settled within the limits of Texaco's D & O liability insurance policy. Suppose that Texaco had D & O liability coverage with a limit of \$100 million.¹⁰⁵ If the board was told that there was a 0.05 chance of liability for the full amount of a \$3 billion settlement with Pennzoil, the expected value of the shareholders' claim was \$150 million. Given the dynamics of shareholder litigation, that claim might have been settled for considerably less than \$100 million. If one assumes, more plausibly, that the directors were advised that the risk of liability was 0.03 or less, then the expected value of the claim was at most \$90 million and the case could surely have been settled within policy limits.¹⁰⁶

This alternative scenario undercuts the authors' conclusion that self-interested Texaco directors would not have settled with Pennzoil for less than the expected value of Pennzoil's claim. To begin with, if the risk of liability on the duty of care claim was sufficiently low, the amount of Texaco's settlement payment to Pennzoil would have determined whether that claim could have been settled within policy limits. Suppose again that the policy limit was \$100 million and that the probability of liability was 0.03. Using the authors' figures, if Texaco settled for \$3 billion, the expected value of the shareholders' claim was \$90 million; if Texaco litigated to judgment, the expected loss was \$5.5 billion, and the expected value of the claim was \$165 million. A self-interested director would surely have believed that the probability of settling the \$90 million claim within policy limits was much higher, not least because the bitter "fight to the finish" leading to the \$11 billion judgment would have increased public interest in the consequent shareholder litigation, thereby making it more difficult to arrange a "sweet-

baseline). See *id.* at 26-27, 57. Normally a litigant with a claim of that magnitude against him and only a "better than even chance" of prevailing is not able to settle by paying the opponent's fees. There is more direct evidence of collusion. Plaintiffs' counsel played down the value of the claim by offering their "professional opinion" that the plaintiff class would lose at trial. *Id.* at 34. Defendants agreed as a condition of the settlement to support class counsel's fee request in its entirety. *Id.* at 36.

¹⁰⁵ The Wyatt Company reports that in 1987 the median policy limit for Fortune 100 industrial companies responding to its survey was \$70 million and that the third quartile policy limit was \$100 million. The Wyatt Company, *Directors and Officers & Fiduciary Survey 1987*, at 62 (1988). Given that Texaco ranked in the top ten Fortune 100 industrials, it seems reasonable to assume that its D & O policy also fell in that upper range.

¹⁰⁶ The example in the text is somewhat oversimplified, in that it ignores the possibility that Texaco's insurer might have resisted making payment under the policy on the basis of a claimed misstatement in the policy application. See Comment, *Void Ab Initio: Application Fraud as Grounds for Avoiding Directors' and Officers' Liability Insurance Coverage*, 74 *Calif. L. Rev.* 929 (1986).

heart" settlement.¹⁰⁷ Such directors may therefore have been strongly motivated to settle.¹⁰⁸

This scenario also compels rejection of the authors' assumption that "the odds of the director being held liable in a derivative suit [would not have been] much affected by whether the [*Pennzoil v. Texaco*] case [was] resolved by settlement or by a courtroom loss." If the Texaco board failed to settle the Pennzoil-Texaco suit on favorable terms because of their fear of personal liability, that further breach of the duty of loyalty and the resulting damages could have been pleaded in an amended complaint in the duty of care action or in a separate action.¹⁰⁹ If the interests of shareholders and management differed as sharply as the authors suggest, that claim may well have had a higher expected value than the duty of care claim.¹¹⁰ Moreover, unlike the duty of care claim, the duty of loyalty claim probably was not covered by Texaco's D & O policy and hence posed a greater threat to the directors' personal wealth.¹¹¹

Finally, to portray the Texaco board as motivated solely by the threat of financial sanctions, as the authors implicitly do, is probably false to the character of the people involved. One need not idealize corporate executives to think that their motives are complex. Certainly the desire for personal financial gain is very important. But corporate executives are also motivated to some extent by the desire to do their moral duty, whether by maximizing shareholder wealth or by advancing wider social goals, and by the desire to be known for their competence and probity. Like the large law firm leaders

¹⁰⁷ Cf. Coffee, *supra* note 101, at 27 n.68 ("[T]he classic 'sweetheart' settlement would be the settlement whose terms would least likely be reported widely.").

¹⁰⁸ That incentive would have been even greater if, as seems probable, the self-interested director was risk averse with respect to large losses of personal wealth. *Id.* at 19.

¹⁰⁹ The theory would be that, in failing to settle, the directors "advance[d] [their] pecuniary interest" by using their power to control the settlement decision "in a manner that . . . cause[d] reasonably foreseeable harm to the corporation." Principles of Corporate Governance: Analysis and Recommendations § 5.04(a)(1) (Tent. Draft No. 5, 1986). Under Delaware law an action whose only significant effect is to "protect the directors against a perceived threat of personal liability . . . to the ultimate detriment of shareholders" violates the directors' duty of loyalty. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184-85 (Del. 1986).

¹¹⁰ Mnookin and Wilson's figures can be used to illustrate the point. Assume that a shareholder can demonstrate that the board turned down an offer of \$3 billion at a time when it estimated the expected value of Pennzoil's judgment at \$5.5 billion. If the risk of liability was as high as 0.1, then the expected value of the duty of loyalty claim would be \$250 million.

¹¹¹ Such policies typically contain an exclusion for any claim "[b]ased upon or attributable to gaining any personal profit or advantage to which the insureds are not legally entitled." W. Knepper & D. Bailey, *Liability of Corporate Officers and Directors* § 21.12 (4th ed. 1988); Coffee, *supra* note 101, at 19 & n.46.

that Professor Mnookin has studied,¹¹² such executives are selected in part, at least, because they are so motivated. These motives probably moderated any bias against settlement resulting from fear of personal liability to shareholders. At best, then, that fear probably produced only a modest drag on the settlement process.¹¹³

That is not to say that the parties' agents may not have had a strong distaste for settlement. Moral outrage, concern for reputation, anger, and unreflective egotism all may have caused the Texaco board (and, perhaps, the Pennzoil board) to devalue the settlement option. When James Kinnear, Texaco's new chief executive officer, said, "If it takes the last breath in me, I intend to get vindication,"¹¹⁴ he clearly was not talking about minimizing his personal liability. Equally clearly, he was not talking about maximizing shareholder wealth. There is evidence that Texaco management viewed settlement as a capitulation to judicially sanctioned "terrorism"¹¹⁵ and as an admission of wrongdoing.¹¹⁶ Because public statements of this kind were undoubtedly intended, at least in part, to shape Pennzoil's expectations and

¹¹² See Gilson & Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 *Stan. L. Rev.* 313, 376-80 (1985).

¹¹³ Apart from their account of *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), the only evidence the authors cite in support of their thesis is the inclusion in the settlement of provisions releasing Texaco's directors and officers from claims arising from the Getty transactions. Although these releases obviously evidenced the directors' desire to close the books on the shareholders' litigation, they are weak evidence that the directors were so worried about personal liability that they intentionally delayed a settlement, particularly since the settlement proceedings indicated that those claims posed no serious threat to the directors. In the face of a strong challenge to the releases by Carl Icahn—a well-financed and highly motivated stockholder represented by loyal counsel—the Bankruptcy Court concluded that the claims against the directors were not "a valuable property right of the Texaco estate." *In re Texaco, Inc.*, 84 Bankr. 893, 904 (Bankr. S.D.N.Y. 1988). Among the evidence relied on for this conclusion was a report by two law firms retained by Texaco to investigate the Getty acquisition. This report advised "that Texaco's officers and directors could not be held responsible for any claims asserted in the derivative actions." *Id.* at 899.

Rather than challenge the releases, the lawyers representing the class claimants settled their clients' duty of care claims and abandoned their objections to the releases before the confirmation hearing. Although class counsel had previously argued (as do Mnookin and Wilson) that those claims were worth "at least as much as Texaco must pay to Pennzoil if the settlement is approved [i.e., \$3 billion]," *id.* at 897, the *only* payment under the settlement with respect to those claims was an allowance of up to \$5 million in fees to class counsel, to be paid by Texaco's liability carrier. The nonmanagement defendants also agreed to pay up to \$5 million in additional fees. *Id.* at 898. As argued above, the Texaco directors knew that a cheap buyout of class counsel was a probable outcome even if the derivative suits had continued.

¹¹⁴ T. Petzinger, *supra* note 3, at 467.

¹¹⁵ *Id.* at 458.

¹¹⁶ S. Coll, *supra* note 3, at 408.

to boost employee morale, they need to be taken with a grain of salt. Even making such allowances, however, it appears that Texaco management's distaste for settlement and its reciprocal hunger for vindication in the appellate courts may have helped to prolong the litigation.

5. *Changes Over Time*

Although immediately after the jury verdict in the trial court there probably was not a positive settlement gap, the parties' evaluations undoubtedly changed as the dispute progressed. As the parties learned more about the case and as Texas appellate courts successively passed judgment, the parties' expectations about the likelihood of reversal probably converged, in part perhaps because Texaco's informational disadvantages concerning the Texas courts did not extend to the United States Supreme Court. As the odds against reversal lengthened, there was increased risk that continued litigation would lead to reorganization and to a corresponding increase in expected litigation costs. The passage of time may have moderated the parties' anger and sense of injustice. Thus, by mid-1987 it was considerably more probable that there was a positive settlement gap.

B. *Bargaining Problems: Distrust and Misunderstanding*

Even if there was a positive settlement gap during the early stages of the Texaco appeal, there were serious obstacles to effective bargaining. Negotiating was ultimately the responsibility of the senior executives of the two companies. Feelings between those executives had apparently never been cordial. The hotly contested Getty transaction, followed by a trial in which each side assailed the competence and probity of its opponent, hardened these negative views. The sketchy published accounts of the negotiations disclose several occasions on which one party expressed the view that the opposing party's management was unusually rapacious¹¹⁷ or on which one party openly questioned the other's good faith.¹¹⁸ To some extent, this mutual distrust was justified. In the battle for control of Getty and in the resulting litigation, no quarter had been asked or given. Consistent with their fiduciary obligations, both managements may have concluded that an open negotiating style would harm their shareholders. But it is also possible that bias, anger, and mutual antagonism poisoned the bargaining climate, thereby harming shareholders.

¹¹⁷ See, e.g., T. Petzinger, *supra* note 3, at 425 ("[W]e can count on Pennzoil to be as ruthless as the law permits.").

¹¹⁸ For example, the chairman of Pennzoil was reported to have said that negotiating with Texaco was like "trying to frisk a wet seal." *Id.* at 436.

In addition, each management appears to have poorly understood the positions and preferences of the other. On several occasions, representatives of one party pronounced themselves "stunned" at the conduct of the other.¹¹⁹ Several offers were rejected without even a counteroffer.¹²⁰ The combination of lack of trust and lack of knowledge may have continued to impede settlement in 1987, when it may have been apparent to both parties that a settlement gap existed.

III. LESSONS OF THE LITIGATION

My interpretation is necessarily tentative. Although the case is exceptionally well documented, there are still gaps in the data.¹²¹ In consequence, both Mnookin and Wilson and I have had to reconstruct the parties' expectations, preferences, and strategies using formal models and informed speculation. We can offer only tentative accounts that generally describe the parties' estimates of outcomes and costs, the way those estimates changed over time, and some agency problems that may have impeded settlement. Neither study is very precise about the magnitude of and changes in the parties' estimates, the effect of agency problems, or the reasons for the ultimate settlement.

Without better data, no account can plausibly claim to be definitive. The available evidence, however, does not support Mnookin and Wilson's claim that the case failed to settle earlier principally because of the self-interested efforts of the Texaco directors to minimize their own personal liability. The better view is more complex and more ambiguous. There is substantial evidence that settling the case would have been difficult for disinterested fiduciaries. The liability issue was close, the stakes were gargantuan, the initial costs of further litigation were moderate, and the parties had reason to distrust each other. Each management could plausibly have concluded that incurring the costs of the initial state court appeal was in the interest of its shareholders. Indeed, the evidence does not rule out the possibility that loyal directors could have drawn a similar conclusion in mid- or late 1987

¹¹⁹ See, e.g., S. Coll, *supra* note 3, at 476 (rejection by Texaco of Pennzoil's \$4 billion settlement offer); T. Petzinger, *supra* note 3, at 445 (rejection of Texaco's settlement proposal, which provided that it would take over Pennzoil).

¹²⁰ T. Petzinger, *supra* note 3, at 429 (Texaco's offer of \$50 million in return for Pennzoil's promise not to exercise liens while case was on appeal); *id.* at 431 (first post-trial settlement offer); *id.* at 444-45 (takeover proposal).

¹²¹ Unlike the vast majority of disputes resolved "in the shadow of the law," the Pennzoil-Texaco dispute produced a full public record of the proceedings at trial and on appeal. Even more unusual, there are reports detailing portions of the parties' settlement negotiations. Finally, the terms of the settlement are public. On the other hand, we know very little, for example, about the parties' litigation costs (other than attorneys' fees) and almost nothing about the relative risk aversion of the parties' agents.

and that the Bankruptcy Court's intervention to compel settlement may have harmed Texaco shareholders. There is also substantial evidence, however, that informational asymmetries and management bias may have impeded settlement.

The possible agency problems identified in my account—those that resulted from imperfect relations with outside counsel and from bias on the part of senior managers—probably are present in many corporate suits. What lessons does this case teach about possibilities for reducing such agency problems? The present law of directors' liability would not sanction directors for failure to manage outside counsel effectively or for acting out of anger or the desire for vindication, unless such behavior rose to the level of "gross negligence."¹²² It seems clear that under such a standard neither Pennzoil nor Texaco management could have been sanctioned for its conduct of the settlement negotiations. If this deferential standard is justified in other settings, it would seem to be especially well justified here. It is often difficult to decide whether negotiating conduct giving the appearance of unwarranted optimism or bias is part of a rational bargaining strategy or the real thing. There is therefore a risk that hindsight review will discourage disinterested profit-maximizing behavior. Moreover, many qualities that produce the sort of bias that was apparently present here—a sense of honor, a sense of right and wrong, and a desire to preserve one's reputation—cause directors to adhere to standards of loyalty in circumstances where cheating would go undetected or unsanctioned. Sanctions against directors who stray modestly from the path of profit maximization on account of those characteristics would tend to produce a breed of directors who are pure rational calculators immune to anger, shame, or moral outrage. I suspect that, given the shaky state of external regulation of corporate affairs, such directors would be far more dangerous to shareholders than the more complex people that they would replace.

There is no easy fix for the kinds of agency problems that apparently arose in *Pennzoil v. Texaco*. For both parties, the case directly involved the conduct of senior management and had a massive effect on the corporations' finances and long-term strategies. In such cases, the corporation is deprived of a fundamental device for controlling agency problems—shifting responsi-

¹²² Duty of care liability would be determined under the principles discussed by Mnookin and Wilson and *supra* notes 81-90 and accompanying text. For a case suggesting that unconscious disloyalty may give rise to a breach of the duty of care, see *Abrams v. Allen*, 297 N.Y. 52, 74 N.E.2d 305 (1947), in which an allegation that a board knowingly permitted one director to "vent his personal bias, animus and hatred" in the formation and direction of the corporation's labor policies was held to state a cause of action. *Id.* at 55, 74 N.E.2d at 306.

bility for evaluation or bargaining to more senior, disinterested managers.¹²³ To their credit, the managers of Texaco and Pennzoil recognized the value of detachment and allowed negotiations to be carried on by lower level employees and investment bankers.¹²⁴ But in a dispute of such importance, management could not responsibly delegate final settlement authority to those agents.

How might management have gone further in shedding its biases? One important source of detachment in litigation is the corporation's outside lawyer, whose conduct is not in issue and who is trained to take a detached view.¹²⁵ In the traditional vision, such lawyers have sufficient professional competence to determine what is going to happen, sufficient moral courage and independence to deliver any bad news, and sufficient credibility to make the news acceptable and to promote action on it. The extent to which outside counsel should and do fulfill that role is controversial.¹²⁶ It appears, however, that such intervention might have been desirable here.

Pennzoil v. Texaco is one of an increasingly important class of matters in which outside counsel is less likely to play a strong role in informing and checking senior management. The distinguishing characteristic of such matters is that they cannot be handled by a single outside firm.¹²⁷ As *Pennzoil v. Texaco* shows, the need for multiple firms may arise for any or all of three reasons: the matter may be too big to be staffed by a single firm; it may involve the laws and the courts of several jurisdictions; or it may call for knowledge of a number of specialties not available in a single firm. The case also demonstrates how such matters may impair the traditional attorney-client relationship. Such matters pose new problems of communication. Where multiple firms are involved, it is less likely that they will know the needs and preferences of the client.¹²⁸ Moreover, multiple law firms may

¹²³ Fama & Jensen, Separation of Ownership and Control, 26 J. L. & Econ. 301, 310-11 (1983). This strategy may be implemented as part of day-to-day management, or in an ad hoc alternative dispute resolution procedure such as a minitrial. See generally S. Goldberg, E. Green & F. Sander, Dispute Resolution 271-78 (1985) (describing the role of senior management in minitrial procedures).

¹²⁴ See S. Coll, *supra* note 3, at 473-74.

¹²⁵ Eisenberg, Private Ordering Through Negotiation: Dispute-Settlement and Rulemaking, 89 Harv. L. Rev. 637, 663 (1976).

¹²⁶ See Gordon, The Independence of Lawyers, 68 B.U.L. Rev. 1 (1988).

¹²⁷ The most celebrated examples of such matters are the government and private antitrust litigations involving IBM and AT&T. Increasingly, however, businesses such as communications and financial services companies, which operate in complex regulatory environments, face mergers and acquisitions and nonlitigation problems that have this character.

¹²⁸ Gordon, *supra* note 126, at 53.

present senior management with conflicting opinions, as they reportedly did to Texaco.

The use of multiple firms also creates greater potential for opportunistic behavior. Firms that see no prospect of a long-term relationship may be tempted to maximize short-term gains at the expense of the client. Firms with long-term relationships may wish to block out potential competitors for that role. The reported reaction of Texaco's regular outside counsel to the hiring of additional firms suggests that something like that occurred here. Professional independence may also be compromised if outside lawyers jockey for position by providing senior management with the advice that they think it wants to hear.

These agency problems create tremendous demands on corporate management, and particularly on inside counsel. Senior management cannot reasonably be expected to evaluate the advice received from multiple lawyers and to formulate a successful strategy to control opportunism among outside counsel. What is required is inside counsel with loyalty to management, but with the professional acumen and standing to make an independent assessment of the advice of competing outside counsel, to formulate an overall strategy, and to deliver to management news that it does not want to hear. In some cases, these problems can be resolved by appointing a single outside firm as lead counsel, a course reportedly urged on Texaco.¹²⁹ Even that decision, however, requires considerable professional acumen on the part of inside counsel.¹³⁰ To perform these roles, inside counsel must be the professional equal of any of the outside lawyers and the superior of most of them. Traditionally, in-house counsel have not approached this level of competence and professional standing. In recent years, however, well-managed corporations faced with complex multijurisdictional problems have begun to hire lawyers of unusual professional distinction as general counsel or for other senior management positions.¹³¹

Texaco appears to have suffered from the problems of poor communication, lack of cooperation, and conflicting legal advice that can arise in complex multijurisdictional matters. Moreover, its senior management may have needed the detachment that independent counsel could have provided.

¹²⁹ See Stewart, *supra* note 35.

¹³⁰ For a description of how Nicholas Katzenbach established a hierarchy of authority among IBM's outside counsel in its antitrust litigation, see J. Stewart, *The Partners* 84-85 (1982).

¹³¹ The preeminent case is IBM's hiring of Nicholas Katzenbach. But other major corporations have recently taken this step, among them Capital Cities Communications (Stephen Weisswasser), Chemical Bank (Richard Simmons), Citicorp (Hans Angermuller), General Electric (Ben Heinemann, Jr. and Phillip Lacovara), General Motors (Elmer Johnson), Philip Morris (Murray Brimg), and Standard Oil of California (Charles Renfrew).

But in this case, inside counsel may not have been up to the task. Inside counsel had been actively involved in the events giving rise to the lawsuit and had testified in the case. Independence thus appears to have been lacking. It is more difficult to judge whether lack of capacity contributed to whatever informational asymmetry or bias occurred. The situation would severely have tested the competence and independence of any lawyer. Nonetheless, the scanty available evidence does suggest that Texaco lacked the internal capacity to evaluate and direct its outside counsel in this kind of dispute. One lesson of the lawsuit may be that large corporations would be well advised to acquire such capacity.

To close on a note of agreement: the interpretations of *Pennzoil v. Texaco* presented in this symposium suggest that there may be an important class of corporate disputes in which agency problems not amounting to violations of the business judgment rule unduly prolong litigation.¹³² My interpretation further suggests that in some cases there may be no easy way to solve those problems through reform of corporate law or management practice. In such cases, the argument for judicial intervention in support of settlement seems strong, because settlement would benefit the shareholders of both companies while preserving the resources of the judicial system. But can courts identify such cases with confidence? If they can, are they justified in using coercive techniques to bring about settlement? Mnookin and Wilson's statement that the intervention of the Bankruptcy Court to compel settlement was "useful" suggests that their preliminary answer to both questions is affirmative. Although I am less certain, I view it as a virtue of our competing interpretations that they may inform further study of these issues.

¹³² Of course, such failures may also lead to premature settlement. See Fiss, *Against Settlement*, 93 Yale L.J. 1073, 1078-79 (1984); see also *supra* text accompanying notes 101-03 (agency problems may lead to settlement against the interests of class-action plaintiffs).

