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"COMPLY OR EXPLAIN"—A FLEXIBLE MECHANISM TO COUNTERVAIL BEHAVIORAL BIASES IN M&A TRANSACTIONS

GERRIT M. BECKHAUS*

ABSTRACT:

Mergers and acquisitions (M&A) are a common phenomenon of great importance in today's business world. However, the majority of them fail to achieve the aspired objectives. These failures can be attributed to various circumstances, inter alia decision-makers' vulnerability to behavioral biases due to the complexity, uncertainty, and time pressure characteristic of M&A transactions. Such biases often lead to predictable irrational behavior resulting in momentous misjudgments. Despite numerous psychological studies proving that people systematically tend to make irrational decisions under uncertainty, neither the transactional practice nor its current legal framework address this problem. Instead, the present law shields decision-makers from potential liability through the business judgment rule leaving shareholders largely unprotected in order to preserve the freedom of good faith business decisions.

While upholding this freedom the article suggests the implementation of a best practice framework containing feasible strategies—several of which are developed in the article—against irrational behavior. This framework shall be enforced through a "comply or explain" mechanism imposing liabilities for nonobservance. "Comply or explain," meaning that companies may choose whether to comply with the framework's recommendations but have to publicly explain their reasons for non-compliance, is a regulatory approach adopted by several European corporate governance codes. Contrary to common legislative "one size fits all" mechanisms, it ensures maximum flexibility and minimizes interference with the business judgment itself.

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INTRODUCTION

Mergers and acquisitions (M&A)[1] are a common phenomenon of great importance in today's business world. M&A are typically motivated by synergetic, strategic, and efficiency-oriented considerations, aiming at increasing competitiveness, growth, and profitability.[2] Other reasons include assumed inefficiencies within the target company causing it to be undervalued.[3] Particularly large corporate mergers will quite often determine the involved companies' success in the near future, if not, their entire existence. Failure can have devastating consequences for the companies' employees, shareholders, and business partners. Hence, M&A involve significant risks. Despite what is at stake and in contrast to what one would expect based on the large number of M&A transactions, the aspired objectives are not achieved in many cases. Respective studies have concluded that only 30% to 50% of all M&A transactions prove to be a success in retrospect,[4] though these studies are not based on a uniform

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1 While the term mergers and acquisitions is predominantly understood broadly to capture all forms of buying, selling, dividing and combining different companies or similar entities, the following will focus on the acquisition of a company or its shares mainly from the buyer's perspective.

2 STEVEN M. BRAGG, MERGERS & ACQUISITIONS—A CONDENSED PRACTITIONER'S GUIDE 1-4 (2009); RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE 873 *passim* (9th ed. 2009); PATRICK A. GAUGHAN, MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS 14-15, 125-79 (5th ed. 2011); STEPHAN A. JANSEN, MERGERS & ACQUISITIONS – UNTERNEHMENSAKQUISITIONEN UND -KOOPERATIONEN – EINE STRATEGISCHE, ORGANISATORISCHE UND KAPITALMARKTTHEORETISCHE EINFUEHRUNG 135-36 (5th ed. 2008) (Ger.); STEPHEN A. ROSS, RANDOLPH W. WESTERFIELD & JEFFREY F. JAFFE, CORPORATE FINANCE 802 (7th ed. 2005); Randall Schuler & Susan Jackson, *HR Issues and Activities in Mergers and Acquisitions*, 19 EUR. MGMT. J. 239, 240 (2001).

3 BREALEY ET AL., *supra* note 2, at 875-76; TIMOTHY J. GALPIN & MARK HERNDON, THE COMPLETE GUIDE TO MERGERS AND ACQUISITIONS – PROCESS TOOLS TO SUPPORT M&A INTEGRATION AT EVERY LEVEL 5 (2d ed. 2007); Gaughan, *supra* note 2, at 15, 174-75.

4 *See* Vicki Bogan & David Just, *What Drives Merger Decision Making Behavior? Don't Seek, Don't Find, and Don't Change Your Mind*, 72 J. ECON. BEHAVIOR & ORG. 930, 930-32 (2009); ROBERT F. BRUNER, APPLIED MERGERS AND ACQUISITIONS 30 (2004); ROBERT F. BRUNER, DEALS FROM HELL: M&A LESSONS THAT RISE ABOVE THE ASHES *passim* (2009); Don de Camara & Punit Renjen, *The Secrets of Successful Mergers: Dispatches from the Front Lines*, 25 J. BUS. STRATEGY 10, 10 (2004); J. ROBERT CARLETON & CLAUDE S. LINEBERRY, ACHIEVING POST-MERGER SUCCESS: A STAKEHOLDER'S GUIDE TO CULTURAL DUE DILIGENCE, ASSESSMENT, AND INTEGRATION 13 (2004); JANSEN, *supra* note 2, at 336; Sara B. Moeller, Frederike P. Schlingemann & René M. Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave,* 60 J. FIN. 757 *passim* (2005); Jeffery S. Perry & Thomas J. Herd, *Mergers and Acquisitions: Reducing M&A Risk Through Improved Due Diligence*, 32 STRATEGY & LEADERSHIP 12, 13 (2004); DAVID M. SCHWEIGER, M&A INTEGRATION – A FRAMEWORK FOR EXECUTIVES AND MANAGERS 4 (2002); *see also* Marc J. Epstein, *The Determinants and Evaluation of Merger Success*, 48 BUS. HORIZONS 37, 37-41 (2005).

standard[5] with regard to what constitutes success.

The significant number of failed M&A transactions can be attributed to various circumstances. Distinguishing between "hard" and "soft" factors, the former include easily measurable elements or quantifiable variables such as lack of potential synergies, high transaction costs or legal obstacles.[6] The latter, the so-called "soft factors," are comprised essentially of psychological aspects—those factors which are difficult to ascertain but are no less significant.[7] Also among them are insufficient personal, cultural and organizational integration, and deficient planning processes.[8]

Technical mistakes by the participants and decision-makers' misjudgments are the main causes for the aforementioned aspects. While it is comparably easy to countervail technical incapacities, for instance in the planning process, contractual design, or in the evaluation of legal issues by implementing control mechanisms, avoiding misjudgments is significantly more difficult. Evaluating the prospects of success of an M&A transaction constitutes a highly complex process, influenced by a variety of data and interdependent circumstances and considerable reliance on predictions.[9] Moreover, the information regarding the target company is commonly incomplete. Against this background, it seems virtually impossible to qualify an assessment of potential synergies or certain integration efforts as right or wrong.

Obtaining further data about the target company or regulating risks through specific contractual design are common recommendations to decrease the danger of misjudgments with far-reaching consequences.[10] However, insights from psychology regarding human behavior in perceiving information and decision-making are widely disregarded, though these considerations have found their way into the economic and legal discourse through behavioral economics and behavioral law. A vast

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[5] Olimpia Meglio & Annette Risberg, *The (Mis)measurement of M&A Performance – A Systematic Narrative Literature Review*, 27 SCANDINAVIAN J. MGMT. 418 *passim* (2011).

[6] Robert G. Eccles, Kersten L. Lanes & Thomas C. Wilson, *Are You Paying Too Much for That Acquisition? – The Key is Knowing What your Top Price Is – and Having the Discipline to Stick to It*, HARV. BUS. REV. 136, 138 et. seqq. (July-Aug. 1999); ROSS ET AL., *supra* note 2, at 807-08; Schuler & Jackson, *supra* note 2, at 241.

[7] *See generally* Camara & Renjen, *supra* note 4, at 11.

[8] Ronald N. Ashkenas, Lawrence J. DeMonaco & Suzanne C. Francis, *Making the Deal Real: How GE Capital Integrates Acquisitions*, 76 HARV. BUS. REV., Jan. 1998, at 165, 172-175; Marc J. Epstein, *The Drivers of Success in Post-Merger Integration*, 33 ORGANIZATIONAL DYNAMICS 174, 175-79 (2004); GALPIN & HERNDON, *supra* note 3, at 3-4; Schuler & Jackson, *supra* note 2, at 241.

[9] ROSS ET AL., *supra* note 2, at 796.

[10] *See generally* JANSEN, *supra* note 2, at 276; Perry & Herd, *supra* note 4, at 12-18.

number of studies have proven that people systematically tend to act irrationally in decision-making processes under uncertainty with regard to perceiving and processing information as well as the decision-making itself.

In this article, I argue that decision-makers'—directors' and officers'—predictable irrational behavior in different phases of a transaction are a significant factor contributing to momentous misjudgments in M&A transactions and thus to their low success rates. Nonetheless, transactional practices, as well as the current legal framework, fail to address this problem. The present law rather shields decision-makers from a potential liability through the business judgment rule leaving shareholders, who are—besides employees—typically harmed the most by failed M&A transactions, largely unprotected. The underlying rationale for this approach is the protection of the freedom of good faith business decisions that should not be scrutinized by courts. While essentially upholding this freedom and avoiding a *re*biasing instead of a debiasing, this article suggests the implementation of a best practice framework that contains certain general strategies against irrational behavior and is to be enforced through a "comply or explain" mechanism imposing liabilities for nonobservance. The specific area of M&A is chosen for several reasons. First, the danger of irrational decision-making is particularly high due to the vast amount of information, the significant uncertainties and the time pressure. Second, the clear and widely similar structure of transaction processes facilitates the development of common strategies to approach the problem. Third, M&A transactions typically have a considerable and immediate impact on the involved companies and are particularly difficult and costly to unwind in case of failure.

Part I of the article provides an overview of insights from behavioral economics relevant to M&A. Part II identifies potential dangers of irrational decision-making in the different phases of an ideal M&A transaction. Part III deals with the current legal framework sanctioning misjudgments—in particular the decision-makers' potential liability. Part IV develops strategies against irrational decision-making in M&A, which form the basis for their suggested regulatory implementation in Part V. This regulatory model draws on experiences with U.K. and German corporate governance law.

I. Insights from Behavioral Economics

Besides providing some background on fundamental psychological findings regarding the handling of information and human needs relevant

to decision-making processes, this section enumerates behavioral biases potentially influencing decision-making processes in M&A transactions and discusses the transferability of scientific findings on the specific situation of M&A with its highly sophisticated actors compared to the general public.

To begin with, empirical studies stipulate that people of average talent can only process seven pieces of information at a time—illustrating people's limited cognitive capabilities.[11] To nevertheless overcome complex moments of decision-making people—consciously or subconsciously—rely on heuristics, or rules of thumb, to simplify the circumstances taken into account.[12]

The need for avoiding cognitive dissonance, an aspect explored in-depth by psychology, also matters in this context.[13] People are discomforted by conflicting cognitions. Thus, they try to completely avoid them, amongst others by manipulation, or to eliminate them as fast as possible. These consequences are subject to the theory of cognitive dissonance.

The need for control is another fundamental need regulating human behavior. The theoretical conception presumes that every person wants to perceive himself as the initiator of changes in his environment to gain the feeling of competence and to preserve his self-esteem.[14] The satisfaction of the need for control does not depend on the objective facts but rather on the individual's subjective perception.[15]

Finally, psychology points to the fact that people in principal evaluate circumstances on decision-making processes relative to a point of reference.[16]

The following provides an overview on behavioral biases potentially

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[11] George A. Miller, *The Magical Number Seven, Plus or Minus Two: Some Limits on our Capacity for Processing Information*, 63 PSYCHOL. REV. 81 *passim* (1956).

[12] Gerd Gigerenzer & Wolfgang Gaissmaier, *Heuristic Decision Making*, 62 ANN. REV. PSYCHOL. 451, 454-455.

[13] LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE *passim* (1957).

[14] RICHARD DE CHARMS, PERSONAL CAUSATION – THE INTERNAL AFFECTIVE DETERMINANTS OF BEHAVIOR *passim* (1968); Robert W. White, *Motivation Reconsidered: The Concept of Competence*, 66 PSYCHOLOG. REV. 297 *passim* (1959).

[15] Lauren A. Leotti, Sheena S. Iyengar, Kevin N. Ochsner, *Born to Choose: The Origins and Value of the Need for Control*, 14(10) TRENDS COGN. SCI. 457, 457-58 (2010).

[16] This observation constitutes an integral part of the prospect theory developed by Daniel Kahneman and Amos Tversky. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision under Risk*, 47 ECONOMETRICA 263, 274 (1979); *see generally* Daniel Kahneman & Amos Tversky, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297 *passim* (1992).

influencing decision-making in M&A transactions. Phenomena relevant for irrational behavior regarding the perception of information are primarily confirmation bias,[17] availability bias,[18] focus on the present or myopia,[19] framing,[20] contrast effect,[21] herding,[22] and hindsight bias.[23] With regard to processing of information the following heuristics or biases

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[17] Bogan & Just, *supra* note 4, at 932; Jack W. Brehm, *Postdecision Changes in the Desirability of Alternatives*, 52 J. ABNORMAL & SOC. PSYCHOL. 384 *passim* (1956); David Hirshleifer, *Investor Psychology and Asset Pricing*, 56 J. FIN. 1533, 1550 (2001); Dan Lovallo et al., *Deals Without Delusions*, HARV. BUS. REV., Dec. 2007, at 92, 94; Mark Snyder & William B. Swann, Jr., *Hypothesis-Testing Processes in Social Interaction*, 36 J. PERSONALITY & SOC. PSYCHOL. 1202 *passim* (1978).

[18] Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 207 *passim* (1973); Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics an Biases – Biases in Judgments Reveal Some Heuristics of Thinking under Uncertainty*, 185 SCI. 1124, 1127-1128 (1974) [hereinafter Tversky & Kahnerman, *Judgment under Uncertainty*]; *see also* Kent Daniel, David Hirshleifer, Siew Hong Teoh, *Investor Psychology in Capital Markets: Evidence and Policy Implications*, 49 J. MONETARY ECON. 139, 169-170 (2002); Terrence Odean, *Volume, Volatility, Price, and Profit – When All Traders Are Above Average*, 53 J. FIN. 1887, 1889 (1998); Cass R. Sunstein, *What's Available? Social Influences and Behavioral Economics*, 97 NW. U.L. REV. 1295, 1301, 1305 (2003).

[19] See George Loewenstein & Drazen Prelec, *Anomalies in Intertemporal Choice: Evidence and an Interpretation*, 107 Q.J. ECON. 573 *passim* (1992); Samuel M. McClure et al., *Separate Neural Systems Value Immediate and Delayed Monetary Rewards*, 306 SCI. 503 *passim* (2004); Samuel M. McClure et al., *Time Discounting for Primary Rewards*, 27 J. NEUROSCI. 5796 *passim* (2007); Ted O'Donoghue & Matthew Rabin, *Doing It Now or Later*, 89 AM. ECON. REV. 103 *passim* (1999); *see also* George Ainslie, *Specious reward: A Behavioral Theory of Impulsiveness and Impulse Control*, 82 PSYCHOL BULL. 463, 464 et seqq. (1975); George A. Akerlof, *The Short-Run Demand for Money: A New Look at an Old Problem*, 72 AM. ECON. REV. 35 *passim* (1982); B. Douglas Bernheim & Antonio Rangel, *Addiction and Cue-Triggered Decision Processes*, 94 AM. ECON. REV. 1558 *passim* (2004).

[20] Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOL. 341, 343-44 (1984); Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCI. 453 *passim* (1981); Amos Tversky & Richard H. Thaler, *Anomalies – Preference Reversals*, 4 J. ECON. PERSP. 210 *passim* (1990).

[21] Peter H. Farquhar & Anthony R. Pratkanis, *Decision Structuring with Phantom Alternatives*, 39 MGMT. SCI. 1214 *passim* (1993).

[22] Sushil Bikchandani, Davird Hirshleifer & Ivo Welch, *Learning from the Behavior of Others: Conformity, Fads, and Informational Cascades*, 12 J. ECON. PERSP. 151, 152-153 (1998); Laurens Rook, *An Economic Psychological Approach to Herd Behavior*, 40 J. ECON. ISSUES 75 *passim* (2006); David S. Scharfstein & Jeremy C. Stein, *Herd Behavior and Investment*, 80 AM. ECON. REV. 469, 476 (1990); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 148 (2000).

[23] Baruch Fischhoff, *Hindsight ? Foresight: The Effect of Outcome Knowledge on Judgment under Uncertainty*, 104 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 288 *passim* (1975); Baruch Fischhoff, *An Early History of Hindsight Research*, 25 SOC. COGNITION 10 *passim* (2007); Baruch Fischhoff & Ruth Beyth, *"I Knew it Would Happen" – Remembered Probabilities of Once-Future Things*, 13 ORGAN. BEH. & HUM. PERFORMANCE 1 *passim* (1975).

should be considered: simplification,[24] mental accounting,[25] anchoring,[26] inside view,[27] and representativeness.[28] Decision-making itself is particularly vulnerable to the effects of overconfidence[29] and sunk cost.[30]

Apparently, the described insights from psychology and behavioral economics do not apply to everyone in every situation in a way that behavior could reliably be predicted. The occurrence of biases and heuristics as well as their extent and impact rather depend on the individual person and the specific situation. However, the vast amount of studies in that area at least proves an existing tendency that people are subconsciously influenced in their decision-making processes.

Due to the sophistication of the decision-makers in M&A transaction as well as the involvement of numerous specialized consultants, one can expect these actors to be less susceptible to the described psychological phenomena and therefore to act more cognitively adept and rational than

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[24] Kahneman & Tversky, *supra* note 16, at 271.

[25] Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. AND ORG. 39 *passim* (1980); Richard H. Thaler, *Mental accounting and consumer choice*, 4 MKTG. SCI. 199 *passim* (1985); Richard H. Thaler, *Mental Accounting Matters*, 12 J. BEHAV. DECISION MAKING 183 *passim* (1999).

[26] Tversky & Kahneman, *Judgment under Uncertainty*, *supra* note 18, at 1128; *see also* Nicholas Epley & Thomas Gilovich, *The Anchoring-and-Adjustment Heuristic: Why the Adjustments Are Insufficient*, 17 PSYCHOL. SCI. 311 *passim* (2006); Dan Lovallo & Daniel Kahneman, *Delusion of Success – How Optimism Undermines Executives' Decisions*, HARV. BUS. REV., July-Aug. 2003, at 56, 60.

[27] Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17, 24 (1993); Lisa M. Sedor, *An Explanation for Unintentional Optimism in Analysts' Earnings Forecasts*, 77 ACC. REV. 731, 739 (2002); *see also* Arnold C. Cooper, Carolyn Y. Woo & William C. Dunkelberg, *Entrepreneurs' Perceived Chances for Success*, 3 J. BUS. VENTURING 97 *passim* (1988); Kathryn Kadous, Susan D. Krische & Lisa M. Sedor, *Using Counter-Explanation to Limit Analysts' Forecast Optimism*, 81 ACCT REV. 377, 378 (2006).

[28] Daniel Kahneman & Amos Tversky, *Subjective Probability: A Judgment of Representativeness*, 3 COGNITIVE PSYCHOL. 430 *passim* (1972); Tversky & Kahneman, *supra* note 18, at 1124 *passim*.

[29] *See* Mark D. Alicke, *Global Self-Evaluation as Determined by the Desirability and Controllability of Trait Adjectives*, 49 J. PERSONALITY & SOC. PSYCHOL. 1621 *passim* (1985); Mark D. Alicke et al., *Personal Contact, Individuation, and the Better-than-Average Effect*, 68 J. PERSONALITY & SOC. PSYCHOL. 804 *passim* (1995); Colin F. Camerer & Dan Lovallo, *Overconfidence and Excess Entry: An Experimental Approach*, 89 AM. ECON. REV. 306 (1999); Kent Daniel & Sheridan Titman, *Market Efficiency in an Irrational World*, 55 FIN. ANALYSTS J. 28, 28-29 (1999); Odean, *supra* note 18 at 1892-93; Ola Svenson, *Are We All Less Risky and More Skillful than Our Fellow Drivers?*, 47 ACTA PSYCHOLOGICA 143 *passim* (1981); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806 *passim* (1980).

[30] Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Cost*, 35 ORGAN. BEHAV. & HUM. DECISION PROCESSES 124 *passim* (1985); George Loewenstein & Samuel Issacharoff, *Source Dependence in the Valuation of Objects*, 7 J. BEHAV. DECISION MAKING 157 *passim* (1994); Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 47 (1980); Barry M. Staw, *Knee-Deep in the Big Muddy: A Study of Escalating Commitment to a Chosen Course of Action*, 16 ORGAN. BEHAV. & HUM. DECISION PERFORMANCE 27 *passim* (1976).

the general population.[31] Nonetheless, it seems highly unlikely that they are immune to irrational decision-making. In particular with regard to overconfidence as well as some other phenomena, there even are strong indications for managers being affected in their decisions and decision-making processes.[32] In light of that, albeit hard scientific proof so far does not exist, the present state of knowledge constitutes "at least a prima facie case" that these findings provide potentially further references on how to improve decision-making processes in M&A transactions.[33] Hence, despite remaining doubts and a considerable amount of speculation, the occurrence of behavioral biases influencing the decision-making processes in M&A transactions is too conclusive and the potential gains given the importance of M&A transaction for the involved companies too significant to ignore the existing research.

II. Dangers of Irrational Decision-Making Processes in an Ideal M&A Transaction

This section illustrates how the insights of behavioral economics relate to M&A transactions by describing the structure of an ideal transaction in the form of an acquisition of a company or its shares and examining specific situations that pose the risk of irrational behavior.

In general, M&A transactions involve a multitude of typically highly complex decisions, which are made under great uncertainty and time pressure.[34] The complexity is above all caused by the amplitude of relevant information and the confusing amount of interconnected processes. In addition, there are interdisciplinary tasks and the natural divergence of interest among the involved actors. The significant uncertainty is based on the information asymmetry among the involved parties as well as the need of forecasting future developments. The time pressure results from the costs of the transaction process, potential competitors for the target company, the respective market situation, a fixed time frame or the need for secrecy. Given that complexity, uncertainty, and time pressure increase the probability of irrational behavior in decision-making processes,[35] particular attention is paid to these aspects.

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[31] *See* Donald C. Langevoort, *The Behavioral Economics of Mergers and Acquisitions*, 12 TENN. J. BUS. L. 65, 71 (2011).

[32] *See, e.g.*, Ulrike Malmedier & Geoffrey Tate, *Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction*, 89 J. FIN. ECON. 20 *passim* (2008).

[33] Langevoort, *supra* note 31, at 74.

[34] *See* ROSS ET AL., *supra* 2, at 796.

[35] *See, e.g.*, Tversky & Kahneman, *Judgment under Uncertainty*, *supra* note 18, at 1124.

With regard to M&A transactions in general, there is one structural problem worth mentioning in this context. Executive compensation and perquisites are typically more closely linked to a company's growth than to its efficiency, not least due to the focus on short term instead of long-term success.[36] Thus, managers are incentivized to favor acquisitions—independent of their value-adding potential—over efficiency and profitability, creating a considerable agency cost problem and amplifying the risk and frequency of irrational decision-making.[37]

An ideal M&A transaction can be subdivided into three phases, which do not run chronologically but rather integrative and iterative.[38] These are the planning, transaction, and integration phases. The following describes the different phases' elements and identifies at what point, respectively, the above-mentioned phenomena of behavioral economics are of particular importance due to the increased risk of irrational behavior in perceiving and processing information—as well as the decision-making process itself.

A. Planning Phase

The planning phase sets the groundwork for the future M&A transaction and is of crucial importance for its success. Decision-makers' misjudgments in this phase can often have a fatal impact on the transaction process as a whole and are difficult to adjust in later stages.

1. Main Elements of the Planning Phase

The planning phase initially contains an analysis of the individual company, in particular with regard to the company's objectives, internal potentials capable of being influenced, and the pursued strategy.[39] Relevant diagnostic instruments one can resort to are value chain analysis, strength and weaknesses analysis, factors for success analysis, diversification

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[36] Langevoort, *supra* note 31, at 70; Troy A. Paredes, *Too Much Pay, Too Much Deference: Behavioral Corporate Finance, CEOs, and Corporate Governance*, 32 FLA. ST. U. L. REV. 673, 684-686 (2005).

[37] Langevoort, *supra* note 31, at 70. With respect to overconfidence, see Paredes, *supra* note 36.

[38] JANSEN, *supra* note 2, at 249; Reinhard Meckl, *Organising and Leading M&A Projects*, 22 INT'L J. PROJECT MGMT. 455, 456-57 (2004). For further models see: DONALD DEPAMPHILIS, MERGERS, ACQUISITIONS, AND OTHER RESTRUCTURING ACTIVITIES: AN INTEGRATED APPROACH TO PROCESS, TOOLS, CASES, AND SOLUTIONS 135-232 (6th ed. 2012); FLORIAN FRENSCH, THE SOCIAL SIDE OF MERGERS AND ACQUISITIONS – COOPERATION RELATIONSHIPS AFTER MERGERS AND ACQUISITIONS 64-65 (2007); GALPIN & HERNDON, *supra* note 3, at 9-19.

[39] DEPAMPHILIS, *supra* note 38, at 139-40 (6th ed. 2012); JANSEN, *supra* note 2, at 250.

tests, portfolio tests, or core competence analysis.[40] In addition to this examination of internal aspects, an analysis of the business environment is required. For instance, one might distinguish between analysis and forecast in the areas of politics, society, economy, technology, industry analysis, and the company's position in the industry.[41]

Based on these findings one attempts to determine gaps between actual and potential performance that is deemed realistic, particularly with regard to the environment analysis (so called Gap Analysis).[42] Having detected gaps, one now has to consider various ways to close them. In case decision-makers identify an M&A transaction as the most promising measure, one should determine motive, objective, form and time frame of the intended transaction as well as criteria for a potential target company.[43] Finally, developing a detailed strategy for the transaction is necessary.[44]

2. *Dangers of Irrational Behavior in the Planning Phase*

During the planning phase of an M&A transaction the decision-makers are confronted with various situations in which there are risks that some of the above-mentioned behavioral biases[45] occur subconsciously and result in irrational behavior.

The initial self-analysis of a company is carried out on the basis of a vast amount of information that is virtually impossible to overlook. Despite the much more comprehensive—though still incomplete—availability of records compared to the information on a potential target company it is typically difficult to reach unambiguous results. In addition to the complexity of the diagnostic tools and the interrelation of various data, this can be explained with the dependence on external aspects that are difficult to precisely detect as well as numerous forecasts. Moreover, the significant costs of a thorough analysis lead to time pressure.

The inspection of the data from one's own company bears the risk of confirmation bias. It is hardly avoidable to approach the inspection without certain expectations. As a consequence, decision-makers could

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[40] David Hussey, *Company Analysis: Determining Strategic Capability*, 11 STRAT. CHANGE 43, 43, 50 (2002); JANSEN, *supra* note 2, at 250.

[41] DEPAMPHILIS, *supra* note 38, at 137-41; JANSEN, *supra* note 2, at 253-254.

[42] *See* JANSEN, *supra* note 2, at 253-54; JOHN E. TRIANTIS, CREATING SUCCESSFUL ACQUISITION AND JOINT VENTURE PROJECTS 95 (1999).

[43] DEPAMPHILIS, *supra* note 38, at 153-54; JANSEN, *supra* note 2, at 256.

[44] DEPAMPHILIS, *supra* note 38, at 158-60; JANSEN, *supra* note 2, at 264.

[45] *See supra* Part I.

disregard information not conforming to their expectations. For instance, they might miss data indicating a negative development of a currently successful branch. In addition, ambivalent information is often interpreted correspondingly to one's expectations. This problem is significantly likely to occur in cases where the decision-makers initiate the analysis with the aspiration of a transaction.

In order to process the vast amount of data, the involved individuals might also resort to simplification, specifically by suppressing information qualified as insignificant. Besides difficulties in determining which information is insignificant in the individual case, information, once excluded from further analysis, will probably not be returned to when it appears to be relevant later in the process. Rounding might also result in distortion, especially if it concerns multiple variables.

Forecasts regarding strategic objectives tend to be particularly vulnerable to irrational behavior. Overconfidence poses the greatest danger in this context. Given the tendency to overestimate the individual capabilities and the level of control, decision-makers might misjudge future developments, attach too much weight to their own interpretations and stipulate unrealistic goals (planning fallacy). Another bias that has to be considered is the inside view which could lead decision-makers to ignore statistical data and basic probabilities. Representativeness poses a similar risk.

With regard to in what way gaps identified in the Gap Analysis shall be approached, herding has to be taken into account. If there is a general trend among M&A transactions, such as toward acquisitions, in a respective industry or by competitors, decision-makers could be strongly influenced by this fact. Therefore, they might fail to seriously consider other alternatives or specifics of their own situation. Decisions could also be affected by confirmation bias, for instance if decision-makers themselves or their competitors recently had positive experience with an acquisition. In that case they might overestimate the probability of success.

B. Transaction Phase

The transaction phase describes the actual deal-making—starting with the first contact with the target until the formation of the purchase agreement.[46] While a company mainly focuses on itself in the planning

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[46] JANSEN, *supra* note 2, at 265; *see also* David R. Willensky, *Making it Happen: How to Execute an Acquisition*, 28 BUS. HORIZONS 38, 42-43 (1985).

phase, the transaction phase concentrates on one or more other companies.

1. Main Elements of the Transaction Phase

Pursuing the strategy developed in the planning phase, the transaction phase begins with contacting companies that match the respective criteria of a pre-selection prior to entering into negotiations.[47] Typically, the parties conclude a confidentiality agreement right at the beginning in order to protect sensitive data and to keep the transaction a secret.[48] In the course of the negotiations the target company provides potential buyers with some basic information on the company in a teaser or—if more detailed—an information memorandum.[49] Usually, potential buyers then render a term sheet or a more detailed letter of intent (LoI) setting out the results of the previous negotiations and indicating their willingness to come to an agreement on this basis.[50]

The LoI is followed by the due diligence, a thorough analysis and investigation of the target company that is meant to provide decision-makers with information and assess risk and opportunities on the economic and legal level in preparation for a M&A transaction.[51] The due diligence has various functions. Besides risk assessment and valuation, it typically prepares for the composition of the contractual representations and warranties.[52] Moreover, the due diligence serves the purpose of later evidence on the information asymmetry at the time of the formation of the contract as well as the decision-makers' exculpation.[53] One can distinguish between commercial, financial, tax, legal, human resources,

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[47] JANSEN, *supra* note 2, at 265; *see also* DEPAMPHILIS, *supra* note 38, at 174-75.

[48] DEPAMPHILIS, *supra* note 38, at 176; DONALD DEPAMPHILIS, MERGERS AND ACQUISITIONS BASICS: NEGOTIATION AND DEAL STRUCTURING 13-14 (2011) [hereinafter DEPAMPHILIS, NEGOTIATION AND DEAL STRUCTURING].

[49] *See* Jana P. Fidrmuc et al., *One Size Does Not Fit All: Selling Firms to Private Equity Versus*, 18 J. CORP. FIN. 828, 833 (2012).

[50] DEPAMPHILIS, *supra* note 38, at 173-75; DEPAMPHILIS, NEGOTIATION AND DEAL STRUCTURING *supra* note 48, at 14-15 (2011); JANSEN, *supra* note 2, at 273-274.

[51] DEPAMPHILIS, *supra* note 38, at 180-183.

[52] Heinrich Pack, *Due Diligence*, *in* Handbook of International Mergers and Acquisitions 153, 156 (Gerhard Picot ed., 2002); LINDA S. SPEDDING, DUE DILIGENCE HANDBOOK: CORPORATE GOVERNANCE, RISK MANAGEMENT AND BUSINESS PLANNING 11 (2009).

[53] BORIS BECKMANN, DUE DILIGENCE DURING COMPANY MERGERS & ACQUISITIONS 10 (2006); JANSEN, *supra* note 2, at 276.

and environmental due diligence.[54] For this often essential phase to overcome information asymmetries, the target company typically provides a data room with a selection of information about the company for a limited period of time.[55] Due to the pre-selection of the data and the tight schedule, the due diligence by no means leads to the decision-makers being exhaustively informed about the target.

Another component of the transaction phase is the valuation of the company, which has crucial impact on the determination of the purchase price.[56] There are various concepts to assess the value of a company.[57] However, the most common ones are discounted cash flow (DCF) or relative value models.[58] DCF models rely on estimating and discounting all future cash flows to determine the net present value.[59] The relative value models rest on the fair market value and rely on the assumption that a company value cannot be assessed by solely considering the company itself but requires the inclusion of external factors, relations and market data as well as a comparison to the other companies, such as known purchase prices.[60] The significance of the valuation concepts largely depends on quality and extent of the available data. Evidently, the greatest weakness of all described valuation models lies in the necessity of predictions of future developments.[61]

The final important aspects of the transaction phase are the actual negotiations as well as signing of the purchase agreement and the closing of the transaction. For the purposes of this article the negotiations are of particular interest. Especially in cases of more than one potential buyer or a tendering procedure, oftentimes a difficult to control dynamic develops due to the competitive situation and the time pressure.[62]

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[54] *See, e.g.*, GALPIN & HERNDON, *supra* note 3, at 14; GARY M. LAWRENCE, DUE DILIGENCE IN BUSINESS TRANSACTIONS §§ 3-4 to 3-14 (2004).

[55] DEPAMPHILIS, *supra* note 38, at 181-182 n.9.

[56] JANSEN, *supra* note 2, at 278.

[57] *See generally* DEPAMPHILIS, *supra* note 38, at 235-405; JOHN B. VINTURELLA & SUZANNE M. ERICKSON, RAISING ENTREPRENEURIAL CAPITAL 153-188 (2004).

[58] SCHWEIGER, *supra* note 4, at 20.

[59] GAUGHAN, *supra* note 2, at 542-543.

[60] HANDBOOK OF MARKETING AND FINANCE 68-70 (Shankar Ganesan ed., 2012).

[61] *Id.* at 68-69; IAN RATNER ET AL., BUSINESS VALUATION AND BANKRUPTCY 41 (2009).

[62] Deepak Malhotra et al., *When Winning is Everything*, HARV. BUS. REV., May 2008, at 78 *passim*; *see generally* Paul R. Milgrom & Robert J. Weber, *A Theory of Auctions and Competitive Bidding*, 50 ECONOMETRICA 1089 *passim* (1982) (describing a new model of competitive bidding with greater risk aversion and more complete information).

2. Dangers of Irrational Behavior in the Transaction Phase

Similar to the planning phase there are manifold situations posing risks of irrational behavior in the transaction phase. Compared to the planning phase, the decision-makers uncertainty is even intensified, as less data are available for the target company. Simultaneously, complexity and time pressure increase. Potential competitors, the negotiation situation, or the public learning about the transaction may lead to further difficulties.

In general, one has to consider that decision-makers, particularly in the case of acquisitions, tend to be too positive in their outlooks, which can influence future decision-making processes. Besides the publicly available information especially the teaser or the information memorandum provide the agents of the target company with an opportunity to influence the potential buyers. In particular, framing and contrast effect should be considered.

For clarity reasons the following is limited to identifying the risks of behavioral biases in the core elements of the transaction phase: due diligence, business valuation and purchase price determination, as well as negotiations.

a) Due Diligence

In the course of the due diligence, the involved actors usually grasp as much new information as possible, which will most likely influence the rational perception of information. Due to prior information and respective instructions, the actors will have a rough image of the target company. In consequence they might tend towards confirmation bias[63] and disregard data that does not confirm the expectations—or even refrain from searching for such data.[64] For instance, with regard to confusing information or information difficult to understand availability bias could occur subconsciously. Selection and presentation of the available data—for example, either by framing or contrast effect—might also contribute to irrational behavior. Contrast effect could also have an effect on the evaluation of recent deviations from long-term continuous developments.

b) Business Valuation and Purchase Price Determination

With regard to the business valuation of the target and, closely related,

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[63] Lovallo et al., *supra* note 17, at 94-95.

[64] *See also* Bogan & Just, *supra* note 4, at 932-934 (focusing on the costs of confirmation bias on merger integration).

the purchase price determination, overconfidence poses the central problem. Predicting the target's future profits or efficiency and cost gains due to intended synergies might well be too positively forecasted.[65] Frequently, decision-makers overestimate their influence on increasing the target's profitability and their capabilities compared to the present management. This might result in overrating the target's value and determining too high of a price. Inside view could contribute to this effect, for instance, by disregarding statistical data of comparable transactions and therefore overestimating probabilities. The same applies for representativeness.

Besides overly optimistic forecasts—as in the analysis of one's own company[66]—simplification might lead to distortions in processing information. Mental accounting could result in decision-makers failing to incorporate into their evaluation relationships among different product divisions. The valuation concepts are not able to display this aspect.

In the context of the purchase price determination anchoring and sunk-cost should be paid attention to. The purchase price preliminary stipulated in the Letter of Intent or the Memorandum of Understanding on the basis of the teaser and the publicly available information might function as the "anchor." Being drawn to this anchor could lead decision-makers to inadequately adjust the price with regard to new information discovered in the due diligence process.[67] The sunk cost effect, in the form of considering the already made investments, is likely to occur because of the significant efforts and resources attributed to planning a transaction and conducting the due diligence.

c) Negotiations

Irrational behaviors that have already occurred in the transaction continue to affect the process during the negotiations. In addition, further biases are likely to specifically influence behavior in this phase.

In particular, mental accounting might lead decision-makers to overlook connections between the amount of the purchase price and possible provisions on representations and warranties, arrangements with important employees and suppliers, the transfer of loss-making branches, or pricing in risks that contribute to a debit of the "money account." In

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[65] *See also* Lovallo et al., *supra* note 17, at 95-96; *see generally* Roberto A. Weber & Colin F. Camerer, *Cultural Conflict and Merger Failure: An Experimental Approach*, 49 MGMT. SCI. 400 (2003).

[66] *See supra* Part II.A.2.

[67] Lovallo et al., *supra* note 17, at 99.

case several accounts are kept relative to a point of reference, the decreasing sensitivity for values may result in overpayments. For instance an additional sum of $5 million seems to hardly matter in an overall purchase price of $300 million.

Furthermore, the sunk cost effect is of particular relevance. At a certain point decision-makers tend to close a deal at all costs given the significant investments already made for the transaction.[68] This problem is even more aggravated in case the public knows about the efforts to acquire the target company as—at least allegedly—the participants' reputation is at stake. If the transaction is structured as a tendering procedure this might lead to proper bidding wars raising the purchase price far beyond the initial valuation.[69] Tendering procedures are likely to maximize revenues also due to this aspect.[70] In this context one might allude to the winner's curse, describing the fact that the successful actor in a negotiation with an asymmetric allocation of information and uncertainty about the actual value of the object of purchase oftentimes overpays.[71] The seller typically possesses the most meaningful information and therefore is in the best position to assess the real value. Hence, he will rarely sell under value, unless he is forced to sell for some reason.

C. Integration Phase

The integration phase describes the planning and implementation of the actual merging of the target company with the acquiring company.[72] A successful integration is of crucial importance for the overall success of an M&A transaction.[73] In light of this, it is astonishing that comparably little attention is attached to this aspect.

1. Main Elements of the Integration Phase

The integration phase begins in an early stage of the transaction process as it requires intense planning that has to be incorporated in the

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[68] *Id.*

[69] Malhotra et al., *supra* note 62; Patrick J. Meister & Kyle J. Anderson, *Lessons from a Failed Airline Auction*, 44 ECON. INQUIRY 311 *passim* (2006).

[70] Milgrom & Weber, *supra* note 62 *passim*.

[71] Audra L. Boone & Harold J. Mulherin, *Do Auctions Induce a Winner's Curse? New Evidence from Corporate Takeover Market*, 89 J. FIN. ECON. 1 *passim* (2008); Barry Lind & Charles R. Plott, *The Winner's Curse: Experiments with Buyers and with Sellers*, 81 AM. ECON. REV. 335 *passim* (1991).

[72] *See, e.g.*, Meckl, *supra* note 38.

[73] Epstein, *supra* note 8; GALPIN & HERNDON, *supra* note 3, at 3-4; Lovallo et al., *supra* note 17, at 96; Weber & Camerer, *supra* note 65 *passim*.

considerations regarding the business strategy.[74] Moreover, there are strong tendencies towards a cultural due diligence to better organize the integration process and predict potential risks.[75] Predominantly, in corporate acquisitions, integration measures are commonly distinguished between organizational, strategic, administrative, operative, cultural, and external levels.[76] Finally, instruments to measure the success of an M&A transaction are attributed to the integration phase.[77]

2. *Dangers of Irrational Behavior in the Integration Phase*

The danger of irrational behavior already exists within the scope of the integration planning. Due to overconfidence decision-makers often underestimate the potential for conflict among the different corporate cultures and the loss of efficiency caused by the integration of the targets' employees.[78] In consequence, decision-makers develop unrealistic objectives (planning fallacy).[79] Inside view might also contribute to this problem, such as if experience and statistical data of similar procedures are not attached with the necessary weight.

Moreover, irrational behavior might occur in the context of necessary adjustments to the original planning after the execution of the transaction. In case the integration does not work as expected, prompt measures are required to countervail these undesirable developments. Following the need for avoiding cognitive dissonance, decision-makers could tend to conformation bias, such as disregarding early indicators of undesirable developments and instead focusing on information affirming prior decisions or interpret ambiguous facts respectively. The need for action will then be discovered too late and this might then lead to a momentous delay. This effect is amplified by self-attribution bias as adjusting the original integration planning which constitutes the uncomfortable admission of a previous misjudgment, which can hardly be reconciled with a self-conception characterized by overconfidence.

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[74] Epstein, *supra* note 8, at 175-176; JANSEN, *supra* note 2, at 318-20; JENS KIRCHNER, PASCAL R. KREMP, MICHAEL MAGOTSCH, KEY ASPECTS OF GERMAN EMPLOYMENT AND LABOUR LAW 251-252 (2010).

[75] *See, e.g.*, Spedding, *supra* note 52, at 286-288. *But see* JANSEN, *supra* note 2, at 323-24.

[76] JANSEN, *supra* note 2, at 318.

[77] Epstein, *supra* at 8, at 178-179; JANSEN, *supra* note 2, at 330.

[78] Lovallo et al., *supra* note 17, at 95.

[79] *Id.* at 96.

III. LIABILITY FOR FAILED M&A TRANSACTIONS

The legal framework basically fails to address the described dangers of irrational[80] decision-making. Courts usually assume that directors and officers of a company act rationally.[81] Executives and board members can rarely be held liable for their misjudgments irrespective of how severe the consequences of a failed M&A deal are for the company. According to section 4.01 of the ALI's Principles of Corporate Governance, the relevant fiduciary duty of care requires directors and officers to perform their functions in good faith, in a manner they reasonably believe to be in the best interest of the corporation, and with the care "that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances."[82] More specifically, the duty of care obliges directors and officers, amongst others, to "inform themselves, prior to making a business decision, of all material information reasonably available to them."[83] Despite this demanding standard of conduct,[84] directors and officers in practice are only held liable for gross negligence due to the not very stringent standard of review applied by the courts under the business judgment rule in contrast to the strict duty of loyalty.[85]

The doctrinal classification of the business judgment rule is still

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[80] *Irrational* decision-making by some authors is understood as indication for liability with regard to the business judgment rule in contrast to mere *unreasonable* decisions. *See, e.g.*, William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporate Law*, 56 BUS. LAW. 1287, 1296 (2001); Melvin Aron Eisenberg, *The Divergence of Standards of Conduct and Standards of Review in Corporate Law*, 62 FORDHAM L. REV. 437, 443 (1993). However, the term irrational decisions caused by the described biases in the context of this article does not follow this understanding, particularly given that most biases subconsciously influence decision-making. Rather, it is even questionable whether irrational decisions of this type will be classified as unreasonable under the present definition of the fiduciary duty of care.

[81] James A. Fanto, *Quasi-Rationality in Action: A Study of Psychological Factors in Merger Decision-Making*, 62 OHIO ST. L. J. 1333, 1381-86 (2001).

[82] AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS 138-39 (1994); *see also* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

[83] *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson, 473 A.2d at 812).

[84] Distinguishing between a standard of conduct and a standard of review assumes that the business judgment rule constitutes a standard of liability.

[85] Allen et al., *supra* note 80; Eisenberg, *supra* note 80, at 440-41; Paredes, *supra* note 36, at 747.

disputed.[86] While some perceive it as a standard of liability,[87] shielding directors from liability as long as they act in good faith,[88] others view it as raising the liability bar from negligence to gross negligence.[89] Again others suggest qualifying the rule as an abstention doctrine that establishes a presumption against judicial review of duty of care claims unless the plaintiff can challenge that the defendant acted in good faith.[90] For the purposes of this article, however, there is no need to determine which classification is favorable given the general consensus regarding the required elements of the business judgment rule.

The business judgment rule stipulates four requirements. A business judgment in good faith, first, has to be made by a director or officer who is, second, not interested in the subject of the decision, third, "informed with respect to the subject of the business judgment to the extent" he "reasonably believes to be appropriate under the circumstances," and, fourth, "rationally believes that the business judgment is in the best interest of the corporation."[91] In case these conditions are fulfilled, the business judgment rule shields directors and officers from personal liability for negligent conduct that would otherwise have constituted a violation of the fiduciary duty of care.[92] Thereby, judicial review is focused on the procedural aspects of corporate decision-making rather than its substance.[93]

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[86] *See* Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 89 (2004); *see also* R. Franklin Balotti & James J. Hanks, Jr., *Rejudging the Business Judgment Rule*, 48 BUS. LAW. 1337, 1342 (1993); Franklin A. Gevurtz, *The Business Judgment Rule: Meaningless Verbiage or Misguided Notion?*, 67 S. CAL. L. REV. 287, 287-88 (1994); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 270-71 (1967).

[87] Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 927 (Del. 2003); *see also* Wayne O. Hanewicz, *When Silence Is Golden: Why the Business Judgment Rule Should Apply to No-Shops in Stock-for-Stock Merger Agreements*, 28 J. CORP. L. 205, 217 (2003).

[88] William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of* Van Gorkom *and its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449 *passim* (2002); Eisenberg, *supra* note 80, at 444-45.

[89] FRANKLIN A. GEVURTZ, CORPORATION LAW 284-86 (2000).

[90] *See* Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989); Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968); Bainbridge, *supra* note 86 *passim*; Lyman Johnson, *The Modest Business Judgment Rule*, 55 BUS. LAW. 625, 632 (2000).

[91] AMERICAN LAW INSTITUTE, *supra* note 82, at 139; *see also* Rosenfield v. Metals Selling Corp., 643 A.2d 1253, 1262 (Conn. 1994); Omnibank of Mantee v. United S. Bank, 607 So. 2d 76, 85 (Miss. 1992); Cuker v. Mikalauskas, 692 A.2d 1042, 1045-46 (Pa. 1997).

[92] *See, e.g.*, Joy v. North, 692 F.2d 880, 885 (2d Cir. 1982); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 811 (Sup. Ct. 1976); Bayer v. Beran, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944); Bainbridge, *supra* note 86, at 88.

[93] A classic example for the procedural focus can be seen in the *Van Gorkom* case. *See* Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); *see also* Christopher M. Bruner, *Good Faith, State of Mind, and the Outer*

The underlying considerations behind the business judgment rule are, amongst others, that judges tend to be rather ill-equipped for reliably second-guessing the quality of business decisions—not least due to the fact that judges are typically quite risk-averse—and, moreover, their decisions will likely be influenced by hindsight bias knowing the negative outcome of the challenged corporate behavior.[94] In addition, a substantive judicial review of business decisions would require significant resources, which the courts are not willing to provide.[95] The business judgment rule basically tries to strike the balance between the competing values of authority—including the incentives for assuming that role—and accountability.[96] It expresses an economic policy embracing economic freedom and encouraging informed risk-taking and apparently presumes that the benefits from entrepreneurial risk-taking exceed the costs resulting from wrong business decisions.[97]

The third element, the requirement to be reasonably informed, is of particular interest with regard to good faith misjudgments in M&A transactions based on the described dangers of irrational decision-making. Focusing on information that humans subconsciously tend to disregard could probably prevent most of the mentioned biases' influence on decision-making.[98] Hence, given that the existence of these biases is widely accepted and, because of the emerging field of behavioral economics, commonly known to business practitioners, one might argue that failing to gather and consider the relevant information to actively counteract the biases does not suffice as informing oneself "reasonably." While the courts might very well redefine what constitutes being "reasonably informed"[99]—and have even recognized the relevance of

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Boundaries of Director Liability in Corporate Law, 41 WAKE FOREST L. REV. 1131, 1133-1134 (2006); Lynn A. Stout, *In Praise of Procedure: An Economic and Behavioral Defense of* Smith v. Van Gorkom *and the Business Judgment Rule*, 96 NW. U.L. REV. 675 *passim* (2002).

[94] Allen et al., *supra* note 80; Langevoort, *supra* note 31, at 76; Paredes, *supra* note 36, at 735; Stout, *supra* note 93, at 676; *see also* Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997).

[95] WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 248 (2003); STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 208 (2002); Bruner, *supra* note 93, at 1134; Langevoort, *supra* note 31, at 76.

[96] Bainbridge, *supra* note 86, at 84.

[97] *See* Allen et al., *supra* note 88, at 451; Douglas M. Branson, *The Rule that Isn't a Rule – The Business Judgment Rule*, 36 VAL. U.L. REV. 631, 632 (2002); Bruner, *supra* note 93, at 1134.

[98] *See supra* Part IV.

[99] For example, the former Chief Justice of the Delaware Supreme Court, E. Norman Veasey, suggested that directors should be expected to "completely understand . . . every aspect of a company's business and legal issues." *See* Paredes, *supra* note 36, at 751 (citing Alison Carpenter, *Records Inspections: Delaware's Veasey Highlights Merits of Books and Records Inspections,* 2 Corp. Accountability Rep. (BNA), May 21, 2004, at 535).

psychological factors in individual cases[100]—the prevailing legal norms clearly apply a less restrictive understanding.[101] The described situation would only fail to satisfy the business judgment rule if actual indications of managerial misconduct had been ignored.[102]

There is an important and potentially outcome-determinative difference worth mentioning between the business judgment rule in its version in section 4.01(c) of the ALI's Principles of Corporate Governance, which has been adopted by the highest courts of several states, and the way it is applied in Delaware and other jurisdictions following Delaware law: while the former lays the burden of establishing the rule's elements on the challenged directors, the latter, by presuming the rule's fulfillment, requires the opposite.[103] Plaintiffs have to demonstrate that it has not been satisfied.[104]

Concluding, despite the significant and potentially preventable risks of irrational decision-making that lead to misjudgments and bad business decisions contributing to the failure of M&A transactions, directors and officers practically cannot be held liable under the current law. In combination with rewarding executives for non-value-enhancing growth,[105] this setting provides little incentive to develop strategies challenging the described dangers.

IV. Strategies Against Irrational Decision-Making Processes

Having identified the dangers of irrational behavior in perceiving and processing information as well as in decision-making and having dealt with the lack of potential liability for such behavior, this section will develop strategies against such irrational decision-making processes. General considerations on how the described behavioral anomalies should be counteracted are followed by suggestions of mechanisms against specific phenomena.

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[100] *In re* Oracle Corp. Derivative Litig., 824 A.2d 917, 938-39 (Del. Ch. 2003).

[101] *See* Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000).

[102] *See, e.g.*, Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125 (Del. 1963); *In re* Caremark Int'l, 698 A.2d 959 (Del. Ch. 1996).

[103] *See, e.g.*, Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); Cede & Co. v. Technicolor, 634 A.2d. 345, 361; Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995); *In re* Walt Disney Co. Derivative Litigation, 906 A.2d 27 (Del. 2006); Orman v. Cullman, 794 A.2d 5, 19-20 (Del. Ch. 2002).

[104] Branson, *supra* note 97, at 635-36, 645-647.

[105] *See supra* Part II.

A. General Considerations

When thinking of strategies against irrational decision-making processes, it is crucial to bear in mind that the described phenomena by no means shall be demonized per se given humans' cognitive limitations and natural psychological needs. Most phenomena are rather essential for an efficient decision-making process.[106] Biases concerning the perception of information, for instance, enable people to actually grasp complex circumstances in a reasonable time frame. Studies have shown that in individual cases limited information can lead to equal or even better decisions compared to including extensive data.[107] With regard to processing information, simplification and anchoring are suitable mechanisms for speedy decision-making. Finally, the tendency to overconfidence also entails positive aspects. Overconfidence contributes to motivation, persistence, and readiness to assume risk.[108] Particularly for CEOs, overconfidence—of course within certain boundaries—seems not only desirable but also a defining feature of a successful performance in this position.[109] Overconfidence specifically boosts self-esteem as well as the overall psychological well-being and has ego-protecting and anxiety-easing implications.[110] This presumably prevents CEOs from being too tentative and deliberate and at the same time enhances visionary, clear-cut and risk-seeking decision-making.[111] Projecting confidence also tends to be beneficial for the external appearance, such as towards competitors or

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[106] *See generally* Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797 (2001); Jeffrey J. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 CORNELL L. REV. 739, 753 (2000).

[107] GERD GIGERENZER, PETER M. TODD, ABC RESEARCH GROUP, SIMPLE HEURISTICS THAT MAKE US SMART *passim* (1999); Gerd Gigerenzer & Daniel Goldstein, *Reasoning for the Fast and Frugal Way: Models of Bounded Rationality*, 103 PSYCHOL. REV. 650 *passim* (1996).

[108] Lovallo & Kahneman, *supra* note 26, at 63; Malmendier & Tate, *supra* note 32, at 21; Eric van den Stehen, *Organizational Beliefs and Managerial Vision*, 21 J.L. ECON. ORG. 256 *passim* (2005).

[109] *See* David Hirshleifer et al., *Are Overconfident CEOs Better Innovators?*, J. FIN. (forthcoming 2012); *see also* David A. Hofman, *Self-Handicapping and Managers' Duty of Care*, 42 WAKE FOREST L. REV. 803, 810 (2007); Anand M. Goel & Anjan V. Thakor, *Overconfidence, CEO Selection, and Corporate Governance*, 63 J. FIN. 2737 *passim* (2008); *see also* Donald C. Langevoort, *The Organizational Psychology of Hyper-Competition: Corporate Irresponsibility and the Lessons of Enron*, 70 GEO. WASH. L. REV. 968, 969-71 (2002); Paredes, *supra* note 36, at 684-685, 719-720.

[110] *See generally* Andrew D. Brown, *Narcissism, Identity, and Legitimacy*, 22 ACAD. MGMT. REV. 643 (1997); Lisa Farwell & Ruth Wohlwend-Lloyd, *Narcissistic Processes: Optimistic Expectations, Favorable Self-Evaluations, and Self-Enhancing Attributions*, 66 J. PERSONALITY 65 *passim* (1998).

[111] Paredes, *supra* note 36, at 699-700.

investors.[112] Therefore, in developing strategies against the described behavioral biases it is important to find a balance that implements boundaries to prevent potentially harmful excesses in irrational decision-making but at the same time—at least with regard to most phenomena—does not result in a complete *de*biasing or, even worse, a *re*biasing.

Misjudgments and bad business decisions are considerably more likely if the identified psychological phenomena occur subconsciously. An essential step towards avoiding disadvantageous consequences from irrational behavior therefore means to alert directors and officers at what point in decision-making processes they are vulnerable to these phenomena.[113] For instance, when there is a specific danger of disregarding potentially important information, attaching too much value to certain circumstances, wrongly interpreting ambiguous data, failing to diligently analyze individual characteristics in contrast to other market participants, or vastly overestimating potential synergies. However, insights from empirical studies indicate that recognizing behavioral anomalies does not automatically lead to their avoidance.[114] Humans appear to be considerably resistant against behavior changes in this respect.

The obvious way to make someone aware of the dangers associated with the irrational handling of information is to specifically deal in detail with the above mentioned phenomena[115] and their occurrence in the M&A transaction process. Potential measures could be creating handouts and brochures or providing workshops held, for instance, by psychologists, in which decision-makers are introduced to the subject matter. Due to the different roles of the various decision-makers in M&A transactions, especially with regard to directors and executives, it seems desirable to address them according to their specific function. For instance, directors should specifically learn about which biases potentially influence managers' decisions in what way as well as their own biases.[116] In

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[112] Brown, *supra* note 110, at 643; Farwell & Wohlwend-Lloyd, *supra* note 110; Paredes, *supra* note 36, at 701.

[113] *See* Joan MacLeod Heminway, *A More Critical Use of Fairness Opinions as a Practical Approach to the Behavioral Economics of Mergers and Acquisitions*, 12 TENN. J. BUS. L. 81, 81-82 (2011); Langevoort, *supra* note 31, at 78-79; Paredes, *supra* note 36, at 739-740; *see also* further Lovallo & Kahneman, *supra* note 26, at 61; J. Edward Russo & Paul J.H. Schoemaker, *Managing Overconfidence*, 33 SLOAN MGMT. REV. 7, 8-11, 13-15 (1992); Barry M. Staw & Jerry Ross, *Knowing When to Pull the Plug*, 65 HARV. BUS. REV., Mar.-Apr. 1987, at 68, 71.

[114] *See* HERSH SHEFRIN, BEHAVIORAL CORPORATE FINANCE 15-16 (2007); *see also* Edward Teach, *Watch How You Think – Insights from Behavioral Finance Could Change the Way Companies Approach Mergers and Acquisitions*, 20 CFO MAG. 55, 57 (2004).

[115] *See supra* Part II.

[116] With regard to this differentiation, see Paredes, *supra* note 36, at 740.

particular, this should suffice to contain the implications of framing, the contrast effect, or the decreasing sensitivity for values due to the increasing amount in question that comes from mental accounting.

A considerable number of decision-makers will likely deem that they are not affected by behavioral biases given their level of sophistication. To countervail this possible reaction, it should be emphasized that the findings of cognitive psychology in principle apply to all humans, albeit more or less distinctive, and that biases have been proven to specifically occur among managers.[117] One might also conduct small experiments with the workshop participants to illustrate individual irrational behavior.[118]

Another measure could be developing and introducing standardized checklists for specific situations, which would allow a review of one's own behavior with regard to possible influences of subconscious factors. Standardized checklists have been proven beneficial to more efficiently organizing the due diligence and thus are familiar as a supporting tool in the M&A context. A checklist for investment decisions in capital markets developed by Fromlet[119] could function as a reference point. Relying on insights from behavioral finance, Fromlet, amongst others, recommends questioning new information with regard to whether they are reported in a positive, neutral, or negative way and how they align with one's own position.[120] In addition, he suggests to specifically consider arguments from the opposing side.[121] Moreover, one should put the information in a broader context[122] and take into account the quality of the information source. When using checklists it is crucial to ensure that they do not constitute a mere formality or "check-the box" approach[123] but actually contribute to a more transparent, manifold, and informed decision-making process.

Furthermore, one should consider introducing a person responsible for raising awareness of the dangers stemming from behavioral biases. A proposal of Troy Paredes points in that direction: To challenge specifically CEO's overconfidence in M&A transactions, he has suggested appointing

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117 *See supra* Part I.

118 *See* Teach, *supra* note 114.

119 Hubert Fromlet, *Behavioral Finance – Theory and Practical Application*, 38 BUS. ECON. 63, 68 (2001).

120 *Id.*

121 *Id.*

122 *See* ANDREAS LASCHKE & MARTIN WEBER, DER ÖVERCONFIDENCE BIAS ÜND SEINE KONSEQUENZEN IN FINANZMAERKTEN 9 (1999).

123 With regard to the "naysayer," see Paredes, *supra* note 36, at 745.

a devil's advocate or "chief naysayer" to institutionalize dissent within the company aiming for a more deliberative process of corporate decision-making.[124] That person's task would basically be to ensure that the opposite to the intended strategy is contemplated, e.g. by asking probing questions, challenging key assumptions, focusing on counterfactuals or presenting other opinions.[125] According to Paredes, respected, term-limited, independent directors or shareholder nominees could fill out that role, and if needed, be supported by an independent staff of professional advisors.[126] The proposal relies on practical experience with the devil's advocate function in other settings[127] as well as studies that have proven negative feedback,[128] and considering counterarguments[129] as effective debiasing techniques, particularly with regard to overconfidence. To account for the naysayer's own vulnerability to biases as well as to prevent a "check-the-box" approach, e.g. asking only standard questions, Paredes recommends adopting procedures for monitoring and evaluating his performance.[130]

While this approach can surely contribute to a more balanced and deliberative decision-making process, in my opinion there remain shortcomings particularly with regard to specifically addressing the dangers of behavioral biases. Hence, I suggest to implement an external expert specialized in the effects of behavioral biases' and to make him part of the M&A team. Psychologists with the necessary economic knowledge

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[124] Paredes, *supra* note 36, at 740-747.

[125] *Id.* at 740-41.

[126] *Id.* at 745-46.

[127] For how it works in the European Commission with regard to antitrust decisions, or in the Pentagon, see Paredes, *supra* note 36, at 744.

[128] *See, e.g.*, Ward Edwards & Detlof von Winterfeldt, *Cognitive illusions and Their Implications for the Law*, 59 S. CAL. L. REV. 225, 239-242; Howard Garland et al., *De-Escalation of Commitment in Oil Exploration: When Sunk Costs and Negative Feedback Coincide*, 75 J. APPLIED PSYCHOL. 721 *passim* (1990); Jeffrey Rachlinski, *The Uncertain Case for Paternalism*, 97 NW. U.L. REV. 1165, 1212 (2003); Russo & Schoemaker, supra note 113, at 10-12; *see also* William K. Balzer et al., *Effects of Cognitive Feedback on Performance*, 106 PSYCHOL. BULL. 410 *passim* (1989); William Remus et al., *Does Feedback Improve the Accuracy of Recurrent Judgmental Forecasts?*, 66 ORG. BEHAV. & HUM. DECISION PROCESSES 22 *passim* (1996).

[129] *See, e.g.*, Hal R. Arkes, *Costs and Benefits of Judgment Errors: Implications for Debiasi*ng, 110 PSYCHOL. BULL. 486, 494 (1991); Stephen J. Hoch, *Counterfactual Reasoning and Accuracy in Predicting Personal Events*, 11 J. EXPERIMENTAL PSYCHOL.: LEARNING MEMORY & COGNITION 719 *passim* (1985); Charles G. Lord et al., *Considering the Opposite: A Corrective Strategy for Social Judgment*, 47 J. PERSONALITY & SOC. PSYCHOL. 1231 *passim* (1984); Russo & Schoemaker, *supra* note 113, at 12-13; Charles R. Schwenk & Richard A. Cosier, *Effects of the Expert, Devil's Advocate, and Dialectical Inquiry Methods on Prediction Performance*, 26 ORGAN. BEHAV. & HUM. PERFORMANCE 409 *passim* (1980).

[130] Paredes, *supra* note 36, at 746.

or economists trained about the psychological effects would be possible options. In contrast to an internal solution, this approach could particularly prevent personal ties or the aspiration for higher positions within the company influence how the expert exercises his role. Such an expert could particularly be consulted for fundamental decisions within the transaction process, for instance configuring the transaction strategy, selecting the target, developing the integration plan, determining the purchase price, or preparing the due diligence and contract negotiations. Simply initiating decision-makers to reconsider their handling of information in specific situations with questions and comments might suffice as a guard against irrational behavior. Detailed knowledge of all circumstances concerning a specific decision would not be necessary for this purpose. The expert does, however, have to be granted access to the respective information and responsible people to more accurately exercise his function. In order to ensure that the expert efficiently fulfills his role, a control and review mechanism with regard to his performance shall be installed. In addition, he should be incentivized to aim for the company's long-term success.[131] As a side note, the expert might not only be valuable to shield from irrational decision-making processes but could also advise the management on how to exploit the opponent's vulnerability to behavioral biases.

Despite all the described approaches making directors and officers aware of the negative effects of subconscious behavioral biases, it is important to be attentive that the introduction of these measures does not lead to the misperception that simply knowing about the dangers will shield someone from irrational decision-making.[132] It rather requires a thorough, continuous exploration of this topic and a serious application of the insights with regard to one's individual decision-making processes to achieve what Timur Kuran and Cass Sunstein would call "comprehensive rationality."[133]

B. *Strategies Against Specific Phenomena*

In addition to the described general strategies against irrational decision-making, the following will develop further measures to avoid

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[131] For instance, using the long-term success as the basis for a considerable bonus, instead of pleasing his client by e.g. encouraging the execution of the M&A deal independent of its potential value for the company.

[132] With regard to the naysayer and CEO overconfidence compare Paredes, *supra* note 36, at 745-746.

[133] *See* Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation*, 51 STAN. L. REV. 683, 746 (1999).

specific phenomena of behavioral economics from detrimentally affecting decision-making processes.

1. Strategy Against Confirmation Bias

Beyond merely envisioning the danger of conformation bias, this phenomenon should be countervailed by actively searching for information not conforming with or even contradicting personal expectations. [134] Thereby, decision-makers can learn about information that deviates from original expectations in time and consider them accordingly in the course of the transaction. This approach is also favorable as a retrospective method to identify and respond to undesirable developments as soon as possible.

2. Strategy Against Herding

To avoid that the phenomenon of herding potentially affects a decision in favor of an M&A transaction, decision-makers in the planning phase should specifically take into account whether increasing numbers of acquisitions of their competitors influence their own considerations and intentions in that regard, especially in case of a market trend towards acquisitions as a strategy for growth. They should thoroughly assess whether an acquisition is in fact the most promising strategy for their company. The same applies for a situation in which a potential target is deemed particularly interesting by several competitors at the same time. In such a case the positive evaluation could also in part rest upon unconsciously wanting to benefit from the others' search efforts.

3. Strategy Against Anchoring

The occurrence of anchoring can hardly be avoided for those involved in the determination of an original value. To prevent an inadequate adjustment of the original value after learning of new information, one should consult external experts that have not been participating in the previous process.[135] Their function is to undertake an evaluation on the basis of the available data by pricing in newly discovered risks—such as those found in the due diligence—without knowing about the "anchor."

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[134] Lovallo et al., *supra* note 17, at 94-95. *See also* SHEFRIN, *supra* note 114, at 54.

[135] Lovallo et al., *supra* note 17, at 99.

4. *Strategy Against Inside View and Overconfidence*

The danger of misjudgments due to inside view and—closely connected—the tendency towards overconfidence shall be countervailed by consulting statistical data of a reference class, hence by taking an outside view.[136] For this purpose, one first needs to determine a reference class with similar transaction projects. A second step requires one to closely examine these projects with regard to success, outcome, process, characteristics, etc. Based on this understanding, an intuitive prediction shall be made in a third step to where the intended project at hand would fall among the reference class transactions. To adjust a potentially too optimistic prediction its reliability shall be assessed in a fourth step to arrive at a more accurate forecast. Dan Lovallo and Daniel Kahneman suggest expressing the correlation between forecast and actual outcome with a coefficient between 0 and 1, 0 indicating no and 1 indicating complete correlation. [137] Complex calculations might require an expert statistician. In a fifth step, the prediction made in step three shall be adjusted by using the coefficients developed in step four. For instance, in case the expected synergy gains have been specifically quantified, the adjustment is undertaken by adding to this amount (SG)[138] the difference[139] of the average synergy gains of the reference transactions (GR)[140] and the individual estimate (IE)[141] multiplied by the developed coefficient (C). Hence, such determination of an adjusted probability of success (PS)[142] relies on the following formula: PS = SG + [C * (IE-GR)]. [143]

This process could be facilitated by consulting an expert who introduces the method, monitors the process and supervises the individual steps. In doing so he should also question the prediction of probabilities in

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[136] Bent Flyvbjerg et al., *Delusion and Deception in Large Infrastructure Projects: Two Models for Explaining and Preventing Executive Disaster*, 51 CAL. MGMT. REV. 170, 186 (2009); Kahneman & Lovallo, *supra* note 27, at 25-26; Lovallo & Kahneman, *supra* note 26, at 61; SHEFRIN, *supra* note 114, at 47; *see also* Fanto, *supra* note 81, at 1389-1401.

[137] Lovallo & Kahneman, *supra* note 26, at 61 *passim*.

[138] Acronym derived from (S)ynergy (G)ains

[139] Assuming that due to over-optimism the individual estimate is higher than the average of the reference transactions.

[140] Acronym derived from Average Synergy (G)ains (R)eference Transaction. .

[141] Acronym derived from (I)ndividual (E)stimate.

[142] Acronym derived from Adjusted (P)robability of (S)uccess.

[143] *See generally* Flyvbjerg et al., *supra* note 136; Lovallo & Kahneman, *supra* note 26, at 62; *see also* Daniel Kahneman & Amos Tversky, *Intuitive Predictions: Biases and Corrective Procedures*, *in* TIME'S STUDIES IN THE MANAGEMENT SCIENCES VOL. 12 313 *passim* (Spyros G. Makridakis & Steven C. Wheelwright eds. 1979).

the fourth step to countervail potential tendencies towards overconfidence.[144] Thereby the expert could contribute to adjust overly positive forecasts due to control illusion by pointing at the non-existence of possibilities to influence outcomes or at dependencies on external circumstances. Moreover, by requesting a plausible rationale for the assumption that specific tasks will probably take considerably less time than in a reference transaction, he might countervail the planning fallacy.

5. Strategy Against Sunk Cost

Similar to dangers due to anchoring,[145] the risk of decisions being affected by the sunk cost effect can be countervailed by consulting an external expert to evaluate the available data.[146] In addition, if feasible, decision-makers should not focus on one acquisition object only but keep other options open as long as possible and reasonably affordable.[147] Such a back-up plan facilitates ending negotiations, which do not any longer live up to the original expectations. Decision-makers should determine an absolute price limit[148] in any case to mark the moment when negotiations should be terminated beforehand. That way they diminish the risk of participating in so-called bidding wars, which often, especially in auctions, drive up the price to inadequate amounts.[149] Moreover, this constitutes an effective measure to avoid the winner's curse.[150]

V. Regulatory Implementation of Developed Strategies

Having described potential strategies against irrational decision-making processes in M&A transactions, this section will discuss possible forms of implementation as well as potential risks and, on this basis, suggest a specific regulatory approach relying on a "comply or explain" model. Given that insights from behavioral economics, despite their publicity, have still not been truly incorporated into decision-making processes in M&A transactions, the following considerations presume that a legislative intervention instead of a mere informative approach is needed to change this situation. Ultimately, I deem the deterrent of liability the

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144 *See also* Shefrin, *supra* note 114, at 47.

145 *See supra* Part IV.A.3.

146 Lovallo et al., *supra* note 17, at 99.

147 *Id.*

148 Compare, with regard to determining the price limit, Eccles et al., *supra* note 6, at 139.

149 Lovallo et al., *supra* note 17, at 99.

150 *Id.*

most efficient mechanism to implement the strategies developed above—of course, carefully balanced with embracing economic freedom in making business decisions.

A. *Intensity of Interference*

When considering possible forms of implementing the strategies against irrational decision-making, one first has to determine to what extent and level of detail directors and officers shall be obliged to apply the suggested mechanisms. The more paternalistic approach would specify in detail—and impose liability in case of violations—which measure has to be taken at what phase of a transaction up to the point to dictate, for instance, what type of questions a consulted external expert[151] would have to ask and what issues he would have to raise. Instead of such an intervention that would considerably restrict the economic freedom with regard to internal decision-making processes, one might also think of a mere procedural implementation stipulating, for instance, that there have to be institutionalized meetings scheduled at specific moments during a transaction where the board and managers are supposed to discuss new information and their implications for the transactions. The decision of whether to follow a rather substantive or more procedural approach largely depends on how one wants to strike a balance between the decision-makers' interest in economic freedom on the one hand and the shareholders'—as well as in part the public—interest in preventing potentially disadvantageous irrational decision-making processes in M&A transactions on the other.

As mentioned above,[152] the overall objective of the suggested strategies is to shield decision-makers from vulnerability to behavioral biases in cases where these biases lead to harmful decisions. Managers and directors, however, shall not be deterred from innovative but risky endeavors. Although the developed mechanisms do not directly affect the capacity to come to a specific business decision, by introducing new aspects into the decision-making process they are likely to result in further deliberations and reflections influencing decisions. Hence, it is a fine line between raising enough awareness to prevent harmful decisions caused by behavioral biases and spreading doubts in decision-makers slowing down or even precluding courageous, promising undertakings.

It seems hardly possible to define, on a general level, which intensity

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[151] *See supra* Part IV.A.

[152] *See supra* Part IV.A.

of consultation on the biases' effects is needed to provide every individual decision-maker with the necessary awareness. It rather depends heavily on the characteristics of the specific person as well as the concrete circumstances in question. Therefore, stipulating detailed provisions on when, to what extent, and how the danger of irrational decision-making shall be addressed lacks the necessary flexibility and might do more harm than good. For instance, adding an external expert on behavioral biases to the team[153] might serve the intended purpose well in one context but lead to a desirable project's failure in others. In addition, given the remaining need for further research with regard to the behavioral biases, such a legislative intervention would be particularly difficult to justify. Accounting for the specific characteristics of each individual case, the suggested implementation shall take place on a rather abstract level by requiring procedural safeguards complemented by suggestions to introduce certain information and evaluations into the decision-making process. This approach in the end relies on the presumption that awareness of the dangers of behavioral biases will lead to a more rational and conscious handling of the potential risks resulting in better decision-making. Decision-makers' economic freedom would be widely ensured and the level of questioning the decision-makers conduct would largely remain within the individual company's—more precisely the shareholders'—power, providing a reasonable degree of protection.

B. Possible Forms of Implementation

The legal implementation of such a mechanism could be designed in several different ways. One possibility would be to redefine the elements of the fiduciary duty of care or the business judgment rule respectively for instance with regard to the premise requiring directors and officers to "inform themselves, prior to making a business decision, of all material information reasonably available to them" or being reasonably informed according to the business judgment rule.[154] An adjustment might oblige decision-makers to gather and consider the relevant information to actively countervail the above-described biases and establish statutory requirements in this regard. The duty of care would impose personal liability in case of a violation. While this approach would clearly determine directors and officers to carefully address the dangers of irrational decision-making, possible side effects might be less desirable. In

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[153] *See supra* Part IV.A.

[154] *See generally* Paredes, *supra* note 36, at 747-757.

order to avoid liability, those responsible could tend to exaggerate protective measures by including too much information and too many eventualities into the decision-making process. This might foster risk-aversion to a level not favorable to the company's advancement[155] and in addition could result in an inefficient expansion of the internal information and reporting system or other internal control mechanisms. It also seems difficult to define a generalized set of rules substantiating the duty of care requirements that fits all different types of companies and their business models. For instance, the organization of a decision-making process will look entirely different in a small company focusing on high-risk investments compared to a large company looking to buy a reasonable supplement for their product range. This aspect is likely to lead to uncertainty among the relevant parties, which would probably further enhance the disadvantageous cautionary measures.

One might also indirectly initiate decision-makers to counteract the dangers resulting from behavioral biases by enhancing shareholder control over M&A transactions, such as allowing shareholders to specifically vote on acquisitions.[156] However, while this is likely to result in a more controversial questioning of the intended transaction's prospects, this alone is not sufficiently focused on the specific problem of behavioral biases' role in M&A transactions to structurally change the current approach. In addition, shareholder involvement poses risks to the confidentiality of important information with regard to the transaction, such as strategy, target valuation, etc. It further leads to greater uncertainty in the transaction process and in general causes significant costs.[157] Shareholders might also lack the necessary sophistication to meaningfully contribute to a more effective M&A process[158] and will themselves be subject to certain biases.

Another potential form of implementation has been suggested by James Fanto: To enhance the decision-making process in M&A transactions with regard to behavioral biases, he proposes to introduce a disclosure obligation, in particular illustrating the board's assignment of numerical weight and order of importance to each of the enumerated reasons in favor and against the transaction.[159] Evidently, this disclosure obligation would presuppose the creation of such a document requiring

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155 *See supra* Part IV.A.

156 *See* Langevoort, *supra* note 31, at 75; Paredes, *supra* note 36, at 757-761.

157 *See* Langevoort, *supra* note 31, at 75.

158 *See id.* at 75-76.

159 Fanto, *supra* note 81, at 1396-97.

the board to conduct a thorough and deliberate examination of the acquisition's prospects. While the disclosure obligation conveys a more rational and especially more transparent decision-making process, its introduction only addresses specific aspects of the suggested strategies.

Furthermore, accompanying measures would be necessary. First, enabling shareholders to meaningfully make use of the disclosed information would require revealing considerably more information than the mere weighting of arguments. Rather, details of the transaction, the underlying strategy and the target would be needed. Evidently, this would constitute considerable risks to the confidentiality of the information made available. Second, to increase the suggestion's impact on the decision-making process, the shareholders should be allowed to vote on the acquisition after an obligatory debate on the transaction in light of the disclosed document. The approach also raises practical concerns given that it is difficult to assess whether the disclosed considerations are complete. Finally, by involving the shareholders at a point where at least the due diligence supposedly took place, significant costs could already have been generated.

As a final approach, introduced in a comparable discussion by James Fanto[160] and further specified by Joan Heminway[161], one could require the issuance of a so-called fairness opinion. Fairness opinions are common instruments in M&A transactions, prepared by external financial advisers, usually investment bankers, to evaluate whether a specific transaction can be considered fair from a financial point of view.[162] The purpose is to establish an impartial review of decision-makers potential deviations from acting in the company's interest. However, fairness opinions are often formulated in rather vague terms, possibly to prevent liability by overemphasizing one factor and disregarding another.[163] In order to make use of fairness opinions as a response against the behavioral biases, Fanto and—in greater detail—Heminway suggest several modifications. First, fairness opinions could be extended so that the authors have to consider potential negative consequences and costs resulting from the transaction and have to address the deal's rationality.[164] Besides these content-based

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160 *Id.* at 1397-98.

161 Heminway, *supra* note 113, at 88-97.

162 *See, e.g.*, Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557 *passim* (2006); Heminway, *supra* note 113, at 83-85; Michael B. Rizik, Jr. & Matthew M. Wirgau, *Fairness Opinions: No Longer a Laughing Matter*, 25 T.M. COOLEY L. REV. 233 *passim* (2008).

163 Fanto, *supra* note 81, at 1397-98.

164 Fanto, *supra* note 81, at 1398; Heminway, *supra* note 113, at 88-89.

changes, Heminway proposes increasing the authors' accountability to shareholders and committing them to processes rather than outcomes to foster their independence from the company's directors and officers.[165] As a third step, the way fairness opinions are used and assessed by the boards shall be modified, specifically by requiring the board members to pose a series of questions with regard to the fairness opinions in order to raise awareness to potential flaws in the decision-making process.[166] These questions deal with the qualification of the authors of the fairness opinions, the reliability of the underlying data, the basis for assumptions, the treatment of inconsistent facts and the consideration of alternatives.[167] This approach would most likely contribute to a more deliberate and rational decision-making process and it addresses a number of the above-described behavioral biases. It would require considerably greater resources, however, to provide clearer and more detailed opinions as well as additionally consider and quantify negative scenarios, not to ask whether investment banks are at all qualified particularly for the latter issue. Significantly more information would be needed and would have to be made available to the external authors. In addition, the fairness opinions are drafted at a comparably late point of the M&A transaction so that disadvantageous consequences might already have occurred. Moreover, fairness opinions modified accordingly fail to specifically address behavioral biases and rather indirectly raise awareness of their consequences but not for the origin. Finally, standardized fairness opinions might lack the necessary degree of individualization to investigate the specifications of the individual transaction, at least without significantly greater efforts of the authoring investment banks.

C. "Comply or Explain"

Given that all potential forms of implementation described so far displayed weaknesses, the following will introduce a new and additional approach that I opine to provide a more balanced and effective solution. At the core of the proposal lies the development of a best practice guide—introduced by the SEC—containing specific suggestions on what strategies could constitute a best practice regarding decision-making processes depending on the individual case. Instead of obliging companies

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165 *See* Heminway, *supra* note 113, at 89-93.

166 *See id.* at 93-97.

167 Heminway, *supra* note 113, at 94-97 (citing Robert M. Lloyd, *Proving Lost Profits After Daubert: Five Questions Every Court Should Ask Before Admitting Expert Testimony,* 41 U. RICH. L. REV. 379, 380 (2007)).

to implement some or all of these suggestions, the proposal relies on a "comply or explain" mechanism, requiring decision-makers to provide their shareholders and, with regard to certain non-confidential aspects, the public, with specific reasons on all those best practice measures that have not been implemented in the M&A transaction at hand. This shall apply to every M&A transaction that is of relevant size, determined either by the estimated purchase price exceeding a certain percentage of the company's overall turnovers or a specific amount. Thereby, every transaction of considerable importance should be captured while also considering the individual relevance for the respective company.

"Comply or explain" is a regulatory approach first introduced in the field of corporate governance in the United Kingdom in the 1992 Cadbury Report.[168] Based upon the recommendations of the Cadbury Report, the U.K. Corporate Governance Code[169] contains principles and provisions on what is deemed to be a minimum standard of good governance specifically with regard to the separation of CEO and Chairman, the composition of boards, and board review.[170] Instead of providing a binding set of rules, companies may comply with the provisions in the Corporate Governance Code but they are not obligated to do so. In case of non-compliance, however, a company is required to provide an annual public explanation as to why it decided differently. The code only applies to companies listed on the stock exchange but is envisioned to also encourage private companies to comply. The "comply or explain" approach is meant to let the shareholders and the market decide what is seen as the most important aspects of good governance.[171] Due to its flexibility it is also understood to be superior to any of the common "one size fits all" mechanisms. Other European countries as well as Australia and Canada have followed this approach.[172] In particular, Germany added a considerable new aspect. The German Corporate Governance Codex distinguishes between recommendations and

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168 Sridhar Arcot, Valentina Bruno & Anoine Faure-Grimaud, *Corporate Governance in the UK: Is the Comply or Explain Approach Working?*, 30 INT'L REV. L. ECON. 193, 194 (2010); James E. Cicon, Stephen P. Ferris & Armin J. Kammel, *European Corporate Governance: A Thematic Analysis of National Codes of Governance*, 18 EUR. FIN. MGMT. 620, 623 (2010); Iain MacNeil & Xiao Li, *"Comply or Explain": Market Discipline and Non-Compliance With the Combined Code*, 14 CORP. GOVERNANCE: AN INT'L REV. 486, 486 (2006); Paul Sanderson et al., *Flexible or Not? The Comply-or-Explain Principle in UK and German Corporate Governance* 4-5 (Ctr. for Bus. Res., Univ. of Cambridge, Working Paper No. 407, 2010), *available at* www.cbr.cam.ac.uk/pdf/wp407.pdf.

169 UK CORPORATE GOVERNANCE CODE, FINANCIAL REPORTING COUNCIL (2010).

170 *Id.*

171 Arcot et al., *supra* note 168, at 194-195, 198, 200-01.

172 Cicon et al., *supra* note 168, at 623; MacNeil & Li, *supra* note 168, at 486.

suggestions.[173] Only the former require an explanation for non-compliance. The latter merely serve to illustrate what is seen as best practice. The "comply or explain" concept is widely seen as a success.[174]

The underlying rationale of the "comply or explain" mechanism in the context at hand would be that the shareholders themselves and the market shall decide which safeguards against the dangers of behavioral biases are desirable and should be implemented. Shareholders could simply demand the respective procedures or initiate changes to the articles of the company; the market could favor those companies with a certain standard of safeguards in place. This would allow the implementation of strategies specifically tailored to the individual company and even the individual transaction, offering maximal flexibility. Moreover, even if decision-makers are not determined to implement any of the suggested strategies, the mere existence of the obligation to explain ensures that the described strategies are at least considered, which alone would raise the level of awareness towards the dangers of irrational decision-making. This mechanism would also come at relatively low cost, as the mere explanation requires a limited and presumably reasonable amount of time and effort.

Personal liability of the directors and officers could basically only occur if the obligation to explain is violated or if the specific strategies are disregarded although they were previously incorporated in the articles of the company or otherwise stipulated as a binding standard. In the long run it might also be possible that a wide implementation of the suggested strategies changes the general corporate governance culture leading to a market standard for decision-making processes that would redefine what constitutes being "reasonably informed." However, liability could only be imposed on directors and officers if clear procedural obligations are disregarded. This would provide certainty and in particular prevent an expansion of the internal information processing systems to an inefficient and disadvantageous level due to the fear of personal liability. With regard to requests for specific strategies by shareholders as well as market developments, it would be entirely in the hands of the decision-makers

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[173] *See, e.g.*, Rules 3.10, 4.2.4, 5.1.2, 5.3.4, 5.3.5 DEUTSCHER CORPORATE GOVERNANCE KODEX (2010); *see also* Christian Andres & Erik Theissen, *Setting a Fox to Keep the Geese – Does the Comply-or-Explain Principle Work?*, 14 J. CORP. FIN., 289, 289-290 (2008).

[174] Gerhard Cromme, *Corporate Governance in Germany and the German Corporate Governance Code*, 13 CORP. GOVERNANCE 362, 364-365 (2005); HENRIK-MICHAEL RINGLEB, THOMAS KREMER, MARCUS LUTTER ET AL., KOMMENTAR ZUM DEUTSCHEN CORPORATE GOVERNANCE KODEX 1638-45 (4th ed. 2010); Sanderson et al., *supra* note 168, at 11. *But see* Arcot et al., *supra* note 168, at 196-201 (pointing at the importance of the quality of explanations in case of non-compliance); MacNeil & Li, *supra* note 168, at 493-494 (same).

whether to be exposed to liability by approving an implementation or not, of course accepting the risk of not being reelected in the latter case.

The content and structure of the best practice guide should be developed after consultation with all parties typically involved in M&A transactions as well as academics to create a catalogue of feasible, reasonably detailed strategies that will hopefully be widely accepted. The catalogue might include most of the above-suggested measures, especially the consultation of external experts. It appears desirable to distinguish—similar to the German Corporate Governance Codex—between recommendations and suggestions. Thereby, one could ensure that all sensible strategies are included in the catalogue to best countervail irrational decision-making while focusing the legally obligatory part on the most important strategies to guarantee a more efficient application. Moreover, the best practice guide should in particular include an explanatory section in the beginning describing the specific biases and their risks but also their significant positive effects.[175] Explanations on why certain strategies were not implemented could be manifold. One might think of substantive objections but also just a lack of resources or time pressure. However, it is important that the explanations provide meaningful content relating to the specific case at hand instead of general abstract excuses. The quality standard will mainly depend on what shareholders and the market demand.

Concluding, this approach provides a flexible, cautious mechanism with little external interference that embraces the decision-makers' economic freedom but still ensures that the awareness of behavioral biases is raised and specific strategies to counteract these dangers are available. It bears another important advantage worth mentioning, namely that changing and improving the decision-making processes would entirely come from within the company.

CONCLUSION

The article has outlined a new regulatory model to improve decision-making processes in M&A transactions by challenging the potential risks of subconscious behavioral biases influencing decision-makers. Presuming that decision-makers, despite their high level of sophistication, are nonetheless susceptible to behavioral biases, in particular given the complexity, the uncertainty, and the time pressure characteristic of M&A transactions, the article recommends the introduction of a best practice

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[175] *See supra* Part IV.A.

guide developed by an expert panel containing feasible strategies—several of which have been described above—to countervail irrational behavior. The suggested enforcement by a "comply or explain" mechanism ensures maximum flexibility and interferes as little as possible with the business judgment itself. Ensuring that the way and the extent of implementation of the respective strategies comes from within each individual company shall prevent the imposition of an excessive and inhibiting liability risk on decision-makers as well as a complete debiasing—or even rebiasing. In light of the significant number of failed—especially large scale—M&A transactions and their potentially devastating impacts as well as the strong indications from behavioral economics, it appears to be about time that the legislator intervenes by providing an innovative regulatory framework.