
THE PIRATES

A Comic Opera Mad

Richard A. Epstein

“YOU CAN TRUST YOUR CAR to the man who wears the star” was Texaco’s slogan for many years. Now the question of trust has come back to haunt the giant oil company, to the tune of ten and a half billion dollars—the size of a judgment that, while not approaching the federal deficit, is nearly enough to wipe out Texaco’s net worth.

Even in an era jaded by sky-high legal judgments, Texaco’s ill-fated encounter with Pennzoil Corporation in a Texas courtroom has caught the fancy of the public at large and has raised the fears of the financial community. The day the judgment came out, Texaco’s stock lost more than \$714 million in value. All told, those shareholder losses have now exceeded \$2.8 billion since December 10, when Judge Solomon Casseb decided not to disturb the jury verdict of \$7.53 billion in actual damages and \$3 billion dollars in punitive damages. (Pennzoil’s stock, for its part, surged \$7.375 to \$57.25 per share on the day of the judgment, a gain to shareholders of \$300 million.)

The consequences continue to mount. Texaco’s lenders have become nervous, and the firm’s previously impregnable credit rating has

Richard A. Epstein is James Parker Hall Professor of Law at the University of Chicago. His book Takings: Private Property and the Power of Eminent Domain has just been published by the Harvard University Press.

been slashed for both long- and short-term borrowing. Suppliers, customers, and joint venturers are wondering whether Texaco will be forced into bankruptcy, and where its business dealings stand in the meantime. Texaco has obtained temporary relief from its Texas bond requirement in (of all places) the federal district court at White Plains, New York, on grounds that legal experts find mysterious. Secret and inconclusive settlement talks drag on, while public comments by the parties are alternatively cryptic, confusing, or corrosive. The size of the stakes and the uncertainty of the legal issues have left both sides with ample, indeed too much, room for maneuvering.

I

As is common knowledge by now, Pennzoil’s suit against Texaco arose out of the battle between the two firms over the takeover of the Getty Corporation. Getty Corporation had two dominant stockholders. The Sarah Getty Trust, controlled by Gordon P. Getty, its sole trustee, owned 40.2 percent of the total 79.1 million shares of Getty stock outstanding. The J. Paul Getty Museum controlled another 10.8 percent of the company. The remaining 49 percent was in widely separate hands, ostensibly represented by the Getty management.

OF PENNZOIL

Possible by a Grant from the Texaco Corporation

When it became clear that Gordon Getty and management did not see eye to eye on a wide variety of business issues, the stage was set for a possible takeover. Enter J. Hugh Liedtke, chief executive officer of Pennzoil. Liedtke saw in the demoralization at Getty Oil an opportunity for Pennzoil to become a major player in the oil industry by gaining control of Getty Oil's extensive reserves.

The two companies reached a deal, the gist of which was that Pennzoil and the Getty Trust were to establish a new corporate vehicle to purchase the Getty shares from the museum and the public at large for a price set at \$110 per share, plus \$5 in deferred compensation. Pennzoil would wind up with about a 43 percent stake, and the Trust with a 57 percent stake. In essence Pennzoil and the Getty Trust engineered a squeeze play meant to displace present management while providing a handsome profit for the museum and the public shareholders.

Champagne glasses tinkled in celebration, press releases were duly issued, and on January 4, 1984, the deal was reported in the newspapers. Much detailed drafting of complex corporate documents remained to be done. But that was never to come to pass. Within hours of the original announcement Texaco stepped in with an offer to purchase all shares of Getty at \$125 per share (later raised to \$128), for a total price

of just over \$10 billion. That offer was accepted with great alacrity by Gordon Getty and the museum on January 5, but only after Texaco agreed to indemnify the Getty interests for any liability they might have had to Pennzoil.

Five days later, on January 10, 1984, Pennzoil sued to block the merger in Delaware court. Its claim was that Texaco's actions had interfered with its own previous contract. The Delaware court refused to enjoin Texaco from the merger (which, as we shall see, should be a matter of great sorrow to Texaco). Pennzoil then shifted the battle to its home turf in Houston, Texas, by suing Texaco for the common law tort of inducement of breach of contract. The rest is history.

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At one level the ensuing Pennzoil/Texaco litigation seems like just another skirmish in the corporate takeover wars. But the playing field here is rather different. Most merger bat-

ties take place in the corporate law—the land of two-tier offers, leveraged buyouts, greenmail, and poison pills. But *Pennzoil v. Texaco* marks the revenge of the common law. Contracts and torts no longer form an inert backdrop to creative corporate maneuvers. With this case they move to center stage.

II

The core of the dispute is a body of nineteenth century law that passes under the technical name of intentional (or malicious) inducement of breach of contract. This branch of law envisions a game in which a minimum of three must play. As the law is generally formulated, a defendant will have engaged in wrongful conduct when the following conditions are met. First, there must be a contract between two other parties (as between Getty shareholders and Pennzoil). Second, there must be efforts by the defendant (Texaco) to induce one party under the contract (the Getty shareholders) to break the contract. Third, the inducer must have notice of the existence of the contract between the other two parties. Fourth, the jilted party must suffer damages that follow from the commission of the wrong.

The origins and the rationale of this tort are found in the seminal case of *Lumley v. Gye*, decided by the English courts in 1854. Benjamin Lumley was an opera impresario who held a long-term contract with Johanna Wagner, a singer of evident operatic skills, Frederick Gye, the operator of a rival establishment, prevailed on her to desert her original employment. The contract between Lumley and Wagner was unquestionably binding, and it contained an express provision whereby the diva agreed that she would not sing for another company. Wagner was successfully enjoined from singing for Gye, but she refused to return to her original employment with Lumley. Lumley then brought a second suit against Gye asking for damages because of the deliberate interference with his contract with Wagner.

Lumley's novel suit occasioned a good deal of difficulty in the English courts, for inducement of breach of contract differs in a number of ways from the ordinary torts to person or property. Most torts are actionable on principles either of ordinary negligence or of strict

liability—the latter of which means that the defendant can be liable whether or not he acted with negligence or with an intent to harm the plaintiff. The British court was evidently reluctant to say that any defendant can be held liable (even on a theory of negligence) for inducing the breach of a contract of which he had never heard. Yet ignorance of the harm caused is not normally a reason to withhold liability in a tort case. The defendant who chops down the plaintiff's trees, reasonably and honestly thinking them his own, normally must pay the owner for the loss. The majority of judges did not give a convincing theoretical explanation why this tort should be different from cutting trees. A powerful dissent by Judge Coleridge made just this point and argued that Lumley's sole remedy should be a damage action against Wagner.

Recently modern writers have echoed Coleridge's concern on economic grounds. The now fashionable theories of "efficient breach" say that inducing a breach of contract is a good thing, so long as it moves the labor or property of the contract breaker to a higher-valued use. The proper response, therefore, the argument continues, is for the breaker to pay "expectation damages," that is, damages that leave the party jilted in the same position that he would have been in if the contract had been fully performed. Those damages being paid, the contract breacher and the inducer can then split the efficiency gain between them. Any rule that allows the innocent party to block the second contract (as happened with Lumley's injunction against Wagner) is said to thwart the reallocation of resources to their best social use.

The case against the tort of inducement of breach of contract thus rests on two propositions: the want of parity to ordinary torts to property, and the theory of efficient breach. Yet neither point carries the day. As to the first, the law contains many areas where liability turns not on negligence or simple wrongful conduct, but on notice. Take the eternal legal triangle that arises when a faithless middleman who holds an innocent owner's property proceeds to sell it to a third party. One common way the law resolves this triangle is to protect the purchaser against suit by the original owner in cases where the purchaser had no notice that the middleman had misbehaved. If he purchased the goods in bad faith, however, then he

and the middleman jointly caused the plaintiff a loss, and a suit against either or both has been regarded as perfectly appropriate. Along with compensating the original owner for damages, such suits prevent bad-faith purchasers from enjoying ill-gotten gains, while additionally reducing the incentive of all parties to engage in illicit transactions.

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There is, in fact, no real reason to worry that the use of tort liability to enforce contracts will impede useful social exchanges. If someone wants "out" of a contract, he can negotiate his release. In fact, a framework for such negotiations can be made part of the original deal. Such contracts are not farfetched: it had been reported, for example, that Lou Holtz's coaching contract with the University of Minnesota allowed him to terminate without breach in the event of an offer from Notre Dame, which did come. In short, good contract drafting and sensible renegotiation form a far more "efficient" system than the deliberate breach of contract. No innocent party should be limited to an uncertain contract action solely against the original contracting party, who may be insolvent or beyond the jurisdiction of the court, when there is another party available that knowingly induced and profited from the breach.

III

This quick sketch of the law of inducement of breach of contract suggests that there is nothing in principle wrong with the basic legal theory on which Pennzoil relied. Nonetheless, there is many a slip between a sound legal theory and its proper application. The normal lay response to the \$10.5 billion verdict has been to call it "ridiculous" or "absurd." A *New York Times* editorial called the case a "sad farce." In both cases the size of the damage award attracted far more attention than the fact of lia-

bility itself. There is good sense in this popular perception.

To understand what is going on it is necessary to comment on four separate issues: first, was there a deliberate inducement of breach of contract? Second, what remedy is appropriate, damages or injunction? Third, if damages, how should they be calculated? Fourth, should punitive damages be awarded, and in what amount?

Liability. Pennzoil's case for liability rests on its ability to show that the Getty interests breached a valid contract with it. The critical question therefore becomes the traditional one of deciding whether the contract is valid. Normally this sort of decision is straightforward legal business. But the elusive line between preliminary negotiations and a completed and binding contract has generated extensive litigation. The problem has proved to be intractable enough in real estate transactions, for example, that there is widespread support for the requirement, everywhere embodied in the Statute of Frauds, that contracts for the sale of land or buildings (aside from short-term leases) are binding only if evidenced in writing and signed "by the party to be charged." In an area where deals often take surprising twists, where critical conditions can be added or subtracted from an agreement at a moment's notice, this requirement of written contracts provides a nice "bright line" test that obviates many (though by no means all) acrimonious disputes over contract formation that otherwise might arise.

Strange as it might seem, there is no parallel writing requirement for the sale of common stock. The enforcement of oral contracts is strictly necessary for the ordinary telephone brokerage business, but matters are quite different when the sale of corporate assets amounts to the sale of a billion-dollar business, many of whose assets are in real estate—as oil and gas assets are generally classified. The want of the legal writing requirement for merger cases gave rise to the murkiness of contract formation that led to Texaco's undoing.

Texaco argued that Pennzoil and the Getty interests showed no clear intention to create legal relations. It might be that the custom in the mergers and acquisition business is such that, as Yogi Berra says, "It ain't over 'till it's over"—in which case signing on the dotted line would be the only step that matters. But there

is always the lurking exception: Could that custom (if it is a custom) be displaced by a joint handshake, smile, and toast? Or are these lesser formalities only evidence of substantial progress on the long road to contractual union?

Texaco might have fared better if it had downplayed the question of intention and argued instead that even if the parties had a clear intention to create a legally enforceable agreement, they had in fact had not done so. Normally contracts are enforceable only when their terms are sufficiently definite. Here the basic transaction was a complex reverse triangular merger necessarily containing countless terms that were nowhere captured by a champagne toast or a handshake. If squads of lawyers still had hours of paperwork in front of them, many hidden issues were sure to surface. If some of these proved insurmountable, then the deal would be off, without either side's being in breach. There are many cases on the books where courts have been exceedingly strict—often too strict—in requiring that a contract be definite before declaring it valid. Texaco surely had a shot on these grounds—and on an issue that is normally decided by judge rather than jury. It is hard for an outsider to the case to be confident about either the question of intention or the question of definiteness. But it would surely not be remarkable for the jury to have erred on this point.

The harder question is whether there would still be a case against Texaco for inducement of breach if Pennzoil's preliminary agreement were unenforceable against the key Getty shareholders. Here the basic case law is divided, with some courts holding that the third party will not be liable unless a second party is too, and a majority holding the contrary. There is a good deal to be said for the position that the tort vanishes if the contract is not enforceable. If a buyer can walk away from an unwritten real estate sale because he entertains general prospects of a better deal, why worry if one such concrete prospect makes a flesh-and-blood appearance and induces him to back out? When agreements are fully binding and enforceable, it generally does not make a difference whether the inducer approaches the contracting party or the contracting party approaches the outsider. If Getty were free to walk, then Texaco should be free to induce Getty to walk with it without having to face any

legal sanctions. To take the other side is to assume that both parties have made implied interim promises not to deal with third parties while still negotiating with each other, a plausible but unlikely state of affairs.

Nonetheless, the dominant doctrine holds otherwise. The authoritative Restatement (Second) of Torts notes that

by reason of the statute of frauds, formal defects, lack of mutuality, infancy, unconscionable provisions, conditions precedent to the obligation or even uncertainty of particular terms the third person [here Getty] may be able to avoid liability for any breach. The defendant actor [here Texaco] is not, however, for that reason free to interfere with performance of the contract before it is avoided.

The Restatement does not, unfortunately, give any reasons for its broad conclusion. Instead it merely analogizes the situation to one in which there is a contract "at will," that is, one in which either party is entitled to terminate at any time for any reason. It notes that while the contracting party may terminate for no reason at all, a third party may not induce such a breach. If that is literally the law, then American business should tremble in its boots, for ordinary worker recruitment in which one firm seeks to lure away the at-will employees of a rival becomes presumptively illegal. Do executive headhunters engage in illegal behavior when they ply satisfied employees with tempting offers? It is imperative that the lines of liability be clear throughout this area, and the simplest and most logical rule is: if there was no contract enforceable between the original parties, then there should be no action for inducement of any asserted breach.

What the law should be, however, is perhaps less relevant than what the law is. Texaco is in deep trouble on liability if the unwise Restatement rule governs. On the other hand, it is far from out of the woods even if a binding contract is a prerequisite to breach.

Choice of Remedy. The issues become much less evenly balanced when we move to the remedial aspects of the case. Initially, the plaintiff in such a case is faced with the question of whether it wants to enjoin the breach (as did Lumley with Wagner) or to seek damages. In principle Pennzoil should have been granted a

preliminary order requiring Texaco to keep the Getty operations separate from its own until the suit was resolved. If Pennzoil won the underlying suit, it could have gotten its Getty

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shares back directly, along with additional monetary damages (perhaps in the millions) to "clean up" any residual losses. The great advantage of such injunctive relief is that it reduces the need to make accurate assessments of monetary losses later on. So long as Pennzoil can get the shares, it will necessarily ride up and down with the value of the oil in place, just as it would have done if Texaco had never intervened.

What Damages? Pennzoil received a stroke of good fortune when its original request for an injunction was denied, because it was then freed to claim damages. But how should they be calculated? Texaco was reticent about introducing evidence on this point, for fear that quibbles about damages would have been taken as tantamount to an admission of guilt. (In a sense it need not have worried, because the jury took the indemnity agreement between Texaco and the Getty interests as powerful evidence on that point.) So it staked its case on the question of liability where its position, though not without merit, was surely at its weakest.

Left a relatively clear field, Pennzoil grabbed for the brass ring and got it. It insisted that it had acquired its Getty interest largely for the sake of obtaining Getty's proven oil reserves. Now that Texaco's conduct had denied it those reserves, Pennzoil asked for actual damages equal to the cost of developing comparable reserves *by exploration*, less the cost of its Getty acquisition. The cost of such development was estimated at \$10 billion, while the purchase price of its Getty shares was \$2.5 billion, leaving a bottom line of \$7.5 billion.

Breathtaking, but wrong. Arguably, the right figure for damages is zero. One critical

fact is that the price of oil dropped after the original Pennzoil/Getty deal was struck. If the deal had gone through, therefore, Pennzoil would have come out of it a loser, for there would have been no way it could have unloaded the Getty reserves before the market broke. No one doubts that Pennzoil was no longer bound by the deal once Getty repudiated it. Why does Pennzoil need damages in addition to that welcome escape? It is therefore perfectly respectable to argue that Pennzoil should not receive any damages to augment its good fortune. If Pennzoil would have sustained a loss by acquiring the Getty shares, then why should it turn a profit when Texaco's wrong worked to its advantage?

The general rule of expectation damages is, however, more favorable to Pennzoil. On the critical question of timing, it measures the plaintiff's loss not by the subsequent movement in the marketplace, but solely by the anticipated profit on the day of the deal. Yet even on this conventional view the right question to ask is, how much more would Pennzoil have had to pay *to buy* comparable reserves from another oil company? To take an analogy, suppose company A refuses to make you a custom chair for \$100, as it had promised. If you can get company B to make that chair for \$125, then your damages are \$25, even if it would cost you (clumsy you) \$500 to make the chair yourself. Drilling for oil is the wrong measure because Pennzoil could have searched for oil reserves by searching for another seller.

Looked at the right way, then, the correct damages are a lot less than the \$7.5 billion claimed. If the oil reserves were worth as much to Pennzoil as it claimed, then why did the Getty interests give them away for a song? Look at some rough calculations. If Texaco paid \$10 billion for the entire business, then (assuming that all shares are worth the same regardless of who controls them) it would have paid about \$4.3 billion for Pennzoil's 43 percent interest. Pennzoil had bid about \$3.8 billion to acquire that same interest. The damages look to be at most on the order of \$500 million, so long as we ignore the subsequent decline in value of the Getty assets. It might be possible to eke out a slightly larger number, on the theory that Texaco got a bargain at the higher price it bid. If Texaco had overpaid, on the other hand, then a lower number would be in

order. All in all it is instructive, though not conclusive, that in an industry of informed and active bidders, Pennzoil did not raise its original offer, while no third party was prepared to intervene at a higher price.

To accept Pennzoil's story, therefore, is to assume that first it and then Texaco had ripped off the Getty interests by an enormous sum. It is, however, very odd to assume massive ignorance and incompetence on one side of a competitive bidding situation involving such sophisticated players. The stock markets did not discern any enormous increase in the value of Texaco's assets when the merger went through. Neither should we.

A half billion dollars is a big number, and one that admits a lot of refinement, up or down. But Texaco could survive such a judgment. As matters now stand the jury verdict does not just give Pennzoil the equivalent of the 43 percent stake in Getty it planned to buy; it gives it a 100 percent stake in Getty and most of

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Texaco to boot. Does anyone really think that Pennzoil would rather have its original deal than this damage award? With awards like these, all contracting parties should pray continuously for breach by their opposite numbers.

So what will happen to the damage award on appeal? At this writing it is anyone's guess. Since the wrong formula has been used to calculate the damages, appellate courts should be able to set the matter aright. But actual litigation is never as clear as legal theory. The moment that the trial judge loses control over the case, the odds shift in favor of the party with the verdict in hand. If the question of the measure of damages is (mistakenly) regarded as one of fact, then the presumption swings more strongly in favor of the jury once the case passes out of the hands of the trial judge to an appellate court. If the question is one of law, then on appeal it can be raised only if the point had first been argued at trial, which Texaco

might not have done. Again a lot turns on the state of the record, but in close cases much could turn on the attitude of judges, which on these procedural issues varies enormously. Some judges take a hard line, and will not be swayed by the magnitude of the judgments. Yet even if the damage question is decided on its merits, nothing says that Pennzoil's audacity will not win out on appeal as it did with Judge Casseb at trial.

Punitive Damages. Punitive damages amounted to \$3 billion. Why? Normally, punitive damages are awarded to punish and deter deliberate and outrageous forms of conduct. The exact formulation of the rule has been the subject of intense, if inconclusive, judicial debate. It is clear that simple negligence and even gross negligence is not enough to trigger such awards. Yet the consensus breaks down as to what kind of deliberate misconduct—that is, acts done with substantial knowledge of the consequences in question—is needed for punitive damages. Here the verbal niceties matter, because the issue of punitive damages is a natural in any action for inducement of breach of contract. Recall that sometimes the tort is called *maliciously* inducing a breach of contract. If the defendant has to act maliciously in order to commit the tort at all, it is tempting to conclude that punitive damages should be allowed routinely in these cases. Nonetheless, this case is a poor candidate for such an award.

First, malice in ordinary language connotes the ideas of personal spite and ill will. Here it connotes at most the knowledge of another contract, clearly a lesser wrong.

Second, the basic uneasiness on the issue of liability should count heavily against any award of punitive damages. If Texaco thought in good faith that it was acting within its rights—that there was no binding or no enforceable contract between Pennzoil and Getty—then wherein lies the terrible intent that would justify punitive damages?

Third, punitive damages seem here to be an unattractive way of reinforcing the underlying tort law. There is little chance that Texaco could escape detection, since its wrongful behavior consists of a public offer. Nor is there much reason to think that personal ill will and spite against Pennzoil motivated its takeover:

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The Pirates of Pennzoil

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on the contrary, it wanted the reserves to recoup from some serious drilling failures.

Finally, it seems odd to think that \$3 billion in damages is needed to compensate for corporate pain and suffering. There is no reason whatsoever to compound the error in the contract damages by an excessive award of punitive damages. If actual damages should have been around \$500 million, then the \$3 billion in punitive damages is off by a factor of fifteen or twenty or more, even on the dubious assumption that these damages should be allowed at all.

IV

With so many serious doubts attached to every aspect of the Pennzoil/Texaco litigation, how was it that Pennzoil was able to succeed before the jury? The secret of its success, I think, was that it imported to the world of corporate takeovers the trial techniques that have proved so successful in product liability litigation, where frail consumers are pitted against huge corporations. It is no accident that Pennzoil's chief counsel was Joseph Jamail, who has won many large product liability cases. His key appeal was made on moral grounds, where he presented the issue in stark terms of black and white. The central point pounded into the jury's head was that Texaco had acted not only improperly but immorally by placing greed and self-interest above the ordinary scruples of commercial dealing. Jamail's theme was captured in the single most expensive sentence in tort history: "Send corporate America a message." And since big damage awards are the only message that corporate America understands, why worry about precise financial calculations? The larger the number, the more unmistakable the message. The strategy worked.

In one sense, this case amounts to little more than a freak incident. One can guess that all future takeover and merger negotiations will be conducted under a clear legal understanding that no contract for acquisition is final until it is signed on the dotted line. The decision might be regarded as unimportant in another sense, too: the assets in question have not been extinguished, even if they have shifted from one

set of shareholders to another. Yet the short-term losses from dislocation are substantial, for acquisition by litigation does not have the same consequences as acquisition by purchase.

It is sobering that the increase in the value of Pennzoil stock in the month after the verdict came down was smaller than the decline in value of Texaco stock. As of early January, for example, the Texaco stock has lost well over \$2 billion in value, while the Pennzoil stock has gained only between \$800 and \$900 million in value. (Days later Pennzoil stock spiked by 19 points while Texaco remained unchanged, so there is a lot of movement in the market.) Many other factors may have worked to influence the market value of the two firms, but even after these are taken into account, the loss in the *combined* value of the two firms is one rough measure of the social losses that arise when a large corporation is forced to litigate for survival. The legal uncertainty works to depress the value of the Texaco stock below the most accurate estimate of the gain. Uncertainty therefore magnifies losses and reduces gains.

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The uncertainty will also affect the behavior of third parties. Texaco will lose business opportunities because others fear dealing with it, while Pennzoil will not gain comparable opportunities until the dust settles. If bankruptcy were costless and without harmful effects on the business opportunities of third parties, the social concern would be negligible. But as frictions dominate social life, the possible extinction of a major corporation, like the sinking of an ocean liner, can easily bring others down in its wake. What is disturbing here is that no one can point to any substantial social gains from this suit that might make the substantial losses worth bearing. We should all hope for a quick resolution—any resolution—that reduces the struggle to more manageable terms. A quick appellate decision that eliminates punitive damages, and reduces actual damages to around \$500 million, is not a bad place to start. ■