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Case Study: Texaco versus Pennzoil

In early 1984, Pennzoil and Getty Oil agreed to the terms of a merger. But before any formal documents could be signed, Texaco offered Getty Oil a substantially better price, and Gordon Getty, who controlled most of the Getty shares, reneged on the Pennzoil deal and sold to Texaco.

Naturally, Pennzoil felt as if it had been dealt with unfairly and immediately filed a lawsuit against Texaco alleging that Texaco had interfered illegally in the Pennzoil–Getty negotiations. Pennzoil won the case; in late 1985 it was awarded \$11.1 billion, the largest judgement ever in the U.S. An appeals court reduced the judgement by \$2 billion, but interest and penalties drove the total back up to \$10.3 billion.

James Kinnear, Texaco's CEO, had said that Texaco would file for bankruptcy if Pennzoil obtained court permission to secure the judgement by filing liens against Texaco's assets. Furthermore, Kinnear had promised to fight the case all the way to the Supreme Court if necessary, arguing in part that Pennzoil had not followed S.E.C. regulations in its negotiations with Getty.

In April 1987, just before Pennzoil began to file the liens, Texaco offered to pay Pennzoil \$2 billion to settle the entire case. Hugh Liedtke, chairman of Pennzoil, indicated that his advisors were telling him that a settlement between \$3 billion and \$5 billion would be fair.

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What should Liedtke do? Should he accept the offer of \$2 billion, or should he refuse and make a firm counteroffer? If he refuses the sure \$2 billion, then he faces a risky situation. Texaco might agree to pay \$5 billion, a reasonable amount, Liedtke thinks. If he counteroffered with \$5 billion as a settlement amount, perhaps Texaco would counter with \$3 billion or simply pursue further appeals.

Model this situation as Pennzoil's Liedtke sees it: a final judgement might range between nothing and the \$10.3 billion of now. Ignore Texaco's option of filing for bankruptcy.

Consider varying:

- Liedtke's initial counteroffer of \$5 billion
- Texaco's counteroffer of \$3 billion
- The possible final judgements of \$10.3 billion, \$5 billion, or nothing.

What are the chances of Texaco's possible reactions to the \$5-billion counter offer? and of the three possible judgements?

Assume an even chance (0.50) that Texaco refuses to negotiate further. Assume that a Texaco counteroffer of \$3 billion is about twice as likely as Texaco's accepting \$5 billion, which means probabilities of 0.33 and 0.17, respectively.

Assume a 20% chance of the entire \$10.3 billion being awarded to Pennzoil, and a 30% chance of nothing, leaving a 50% chance of \$5 billion.

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What happened?

Liedtke turned down Texaco's offer of \$2 billion, and within days — and only one day before Pennzoil began to file liens on Texaco's assets — Texaco filed for protection from creditors under Chapter 11 of the U.S. bankruptcy code, as it had promised to do. Later in 1987 Pennzoil submitted a financial reorganisation plan on Texaco's behalf, under which Pennzoil would have received approximately \$4.1 billion. Finally, just before Christmas, 1987, the two companies agreed on a \$3-billion settlement as part of Texaco's financial reorganisation.