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I. INTRODUCTION

The name of the game in corporate America today is leverage. Whether through leveraged buyouts[1] or leveraged recapitalizations,[2] many of the United States' largest corporations are rapidly trading equity capital for debt.[3] This trend began only a few years ago when a

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1. "Leveraged buyout" (LBO) denominates a variety of corporate acquisition transactions in which the purchase of the target company is financed through a large increase in debt, whicb sometimes raises the debt-to-equity ratio by several hundred percent to as high as ten to one or more. In a "management buyout" (MBO), a species of the LBO, a small group of investors, including members of the target corporation's existing management, purchase the publicly held shares of the corporation, often through a tender offer, which allows the company to cease public reporting under Securities and Exchange Commission (SEC) requirements. The debt incurred in the purchase is retired with the sale of assets, the cash flow from earnings of the now private company, or both. *See infra* text accompanying notes 37-49.

2. A leveraged recapitalization also involves a substitution of debt for equity in the corporation's capital structure, often with a large, one-time cash payout to shareholders. Leveraged recapitalizations may be undertaken in response to hostile overtures from a third party or as a prophylactic defense. *See* Cowan, *The New Way to Halt Raiders*, N.Y. Times, May 29, 1987, at D1, col. 3. In either case, the goal is to increase "shareholder value" through tbe cash payout and a restructuring of assets and the corporate financial structure, while simultaneously discouraging hostile bidders who no longer can borrow against the target's heavily leveraged assets. The restructuring portion of the transaction will usually include divestiture of assets or entire lines of husiness. *See* Gogel, *Corporate Restructuring*, MGMT. REV., July 1987, at 28, 30. The difference between an LBO and a leveraged recapitalization is that in the latter the target's existing shareholders continue in their ownership capacity through the issuance of new "stub" shares that represent a roughly proportionate ownership interest in the newly capitalized company. Tbe stock market generally has looked favorably upon such leveraged recapitalizations. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 325 (1986); Smith, *Leveraged Recapitalization Plans*, BUYOUTS & ACQUISITIONS, July-Aug. 1987, at 13, 16. Professor Oliver Williamson explains the price increase by noting that debt financing is an efficient method of reducing the agency costs of some firms, specifically those firms that have a high ratio of redeployable to nonredeployable physical assets. *See* Williamson, Mergers, Acquisitions, and Leveraged Buyouts: An Efficiency Assessment, Discussion Paper No. 28, Law and Economics Program, Harvard Law School (Apr. 1987); *see also* Grossman & Hart, *Corporate Financial Structure and Managerial Incentives*, in THE ECONOMICS OF INFORMATION AND UNCERTAINTY (J. McCall ed. 1982) (indicating that debt more effectively bonds managers' incentives to shareholders' interests).

3. Pozdena, *Takeovers and Junk Bonds*, BUYOUTS & ACQUISITIONS, July-Aug. 1987, at 49; *see also* Labich, *Is Business Taking on Too Much Debt?*, FORTUNE, July 22, 1985, at 82.

The increased use of leverage is, in part, attributable to a changing risk/reward profile for several classes of investors. Banks, insurance companies, pension funds, and other institutional investors have increased their willingness to take positions in more highly leveraged firms because deregulation has permitted new forms of investment and low demand by traditional borrowers has increased the search for bigh-yield lending opportunities. The markets for corporate debt have also seen a dramatic increase in efficiency with much greater liquidity for and more accurate pricing of low quality, high-yield corporate bonds. *See* Gogel, *supra* note 2, at 31. Noninvestment grade, high-yield bonds now account for as much as 20% of all bonds outstanding, as compared with less than 10% a decade ago. Selby, *Learning to Like Leverage*, INST. INVESTOR, Dec. 1986, at 118, 119. Increased leverage is also a function of the equity repurchase programs undertaken by several major corporations. As common stock is repurchased and removed from the balance sheet, the leverage of the company increases just as surely as with the issuance of new debt. *Id.* at 125 (reporting that corporate acquisitions and equity repurchase programs have retired $220 billion in equity capital of American corporations in the last four years).

small group of financial entrepreneurs, which included Carl Icahn,[4] T. Boone Pickens,[5] Asher Edelman,[6] Irwin Jacobs,[7] and Ronald Perelman,[8] found that they could finance large stock purchases of major corporations through the use of high-yield ("junk") bonds[9] leading to either an acquisition of the target or its forced restructuring. The general goal of these financiers was to force a reconciliation between what they perceived as low stock prices and corporate assets of far greater potential value.[10] Their efforts have been tremendously profitable.

The corporate targets of these hostile share acquisitions, however, did not sit idly by and wait to have their shares gobbled up. The defenses they erected are now famous because of their frequent use and colorful names: the "Pac-Man" defense, the "scorched earth" defense, "shark repellents" and "poison pills."[11] While these defenses proved to

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4. *See, e.g.*, Leinster, *Carl Icahn's Calculated Bets*, FORTUNE, Mar. 18, 1985, at 142; Scherer, *Just Who is Carl Icahn and What Does He Want?*, U.S. NEWS & WORLD REP., Apr. 8, 1985, at 52; Carley, *USX Might Face TWA-Style Shake-Up Under Icahn*, Wall St. J., Oct. 10, 1986, at 6, col. 1.

5. *See, e.g.*, *High Times for T. Boone Pickens*, TIME, Mar. 4, 1985, at 52; Potts, *Raider vs. Corporate Executive*, Wash. Post, Sept. 17, 1987, at E1, col. 3.

6. *See, e.g.*, *Williams & Cohen, Newest Kid on the Takeover Block*, BARRON'S, Mar. 11, 1985, at 8, col. 1; *Offer is Begun for Burlington Industries*, Wall St. J., May 6, 1987, at 3, col. 4.

7. *See, e.g.*, *Irwin Jacobs Is Getting Ready to Pounce Again*, BUS. WK., June 4, 1986, at 36; Ross, *Irwin Jacobs Lands a Big One—Finally*, FORTUNE, July 8, 1985, at 130.

8. *See, e.g.*, *Big Investors on Wall Street*, FORTUNE, Oct. 26, 1987, at 8; *How the 12 Top Raiders Rate*, FORTUNE, Sept. 28, 1987, at 44; *Possible Revlon Buyout May Be Sign of a Bigger Perelman Move in Works*, Wall St. J., Mar. 9, 1987, at 16, col. 1.

9. These bonds are simply debt securities rated below investment grade by the major rating services, Standard & Poor's and Moody's. *See* Pozdena, *supra* note 3.

10. In several recent contests for corporate control, financial analysts' estimates of the "break-up value" of the target corporation have greatly exceeded the target's stock price prior to the bid. For an extreme example of this, see *Putting a Value on CBS Assets*, N.Y. Times, Apr. 22, 1985, at D6, col. 3 (noting that in Ted Turner's bid for control of CBS the market estimated tbe break-up value of CBS at two to three times its stock price); *see also Minstar's Jacobs to Sell AMF Businesses; Most of Corporate Staff Has Been Fired*, Wall St. J., Aug. 30, 1985, at 5, col. 2. For an explanation of how these differences between asset values and stock prices might arise, see Coffee, *Shareholders Versus Managers: The Strain in The Corporate Web*, 85 MICH. L. REV. 1, 31-35 (1986) (arguing that risk-averse managers who hold strong preferences for earnings retention and growth have caused many corporations to expand beyond their optimal size); *see also infra* note 49; *cf. The Restructuring Wave: A New Fact of Life*, BUYOUTS & ACQUISITIONS, July-Aug. 1987, at 23, *reprinted from* MGMT. PRAC. Q., Winter-Spring 1987.

11. The body of literature arguing the pros and cons of these and various other takeover defenses is enormous. *See, e.g.*, Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377 (1986); Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RESEARCH J. 341; Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Matheson & Norberg, *Hostile Share Acquisitions and Corporate Governance: A Framework for Evaluating Antitakeover Activities*, 47 U. PITT. L. REV. 407 (1986); Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117 (1986) [hereinafter *Oesterle I*]; Oesterle, *Target*

be an initial deterrent to hostile acquisitions, more creative financing techniques and other offensive weapons have rendered these defenses something of a Maginot Line.[12] Target managements, searching for a way to protect their shareholders, their jobs, or both, increasingly have taken the approach of fighting fire with fire—that is, using leverage and redeployment of assets in an attempt to create for themselves the same profits sought by the hostile bidder.

The present-day management buyout developed primarily as a defensive response to the attacks of the financial entrepreneurs and other acquisition hungry companies. Top executives who became the equity holders in the private companies that followed buyouts generally have found this new defense as enormously profitable as the comparable offensive purchases of the financiers who initiated the first round of leveraged stock acquisitions.[13] Likewise, the leveraged recapitalization can be viewed largely as management's attempt to effect the same reconciliation of values between stock prices and corporate assets by which a hostile bidder seeks to profit,[14] while keeping the company independent with ownership continuing in the hands of the public shareholders. Here too, however, management will often grab a slice of the equity pie as an "incentive booster" in the course of revamping the corporation's capital structure. It appears that like buyouts, top executives find the leveraged recapitalization quite profitable.[15]

Many buyouts have been so successful that rather than being seen primarily as a defensive response to a hostile tender offer,[16] management or specialty firms such as Kohlberg, Kravis, Roberts & Co.[17] and

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Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis, 71 CORNELL L. REV. 53 (1985) [hereinafter *Oesterle II*].

12. For examples of recent failed takeover defenses, see, e.g., Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Amalgamated Sugar Co. v. NL Indus., Inc., 644 F. Supp. 1229 (S.D.N.Y. 1986); Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985); Asarco, Inc. v. M.R.H. Holmes A Court, 611 F. Supp. 468 (D.N.J. 1985); Crown Zellerbach Corp. v. Goldsmith, 609 F. Supp. 187 (S.D.N.Y. 1985); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); *see also Life Becomes Easier For Corporate Raiders*, Wall St. J., Aug. 22, 1986, at 6, col. 1. *But see* GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016 (S.D.N.Y. 1985); Unocal Corp. v. Mesa Petroleum, Co., 493 A.2d 946 (Del. 1985).

13. *See infra* notes 26-29 and accompanying text.

14. *See* Cowan, *supra* note 2, at D4; Smith, *supra* note 2, at 14.

15. *See* Cowan, *supra* note 2, at D4.

16. Although a third-party offer may not exist at the time a buyout is initiated, all such transactions are carried out with very careful consideration of the firm's status as a potential target in the market for corporate control.

17. *See Leveraged Buy-Outs Are Facing Downturn After Crash*, Wall St. J., Nov. 6, 1987, at 6, col. 1 (reporting that Kohlberg, Kravis, Roberts had raised a $5 billion fund for use in financing leveraged buyouts); *King of the Buyouts, Kohlberg Kravis Helps Alter Corporate U.S.*, Wall St. J., Apr. 11, 1986, at 1, col. 6; *Kohlberg Kravis to Get $45 Million Fee If Its Purchase of Beatrice Is Completed*, Wall St. J., Mar. 19, 1986, at 4, col. 1 [hereinafter *Kohlberg Kravis Fee*]; *Kohlberg*

Forstmann Little & Co.[18] will initiate a buyout to capitalize on their belief that the target firm's stock price does not reflect its intrinsic value. Management thus approaches such an opportunity from nearly the same perspective as an outside bidder.

Equally important as management's role in the leveraging of the modern corporation is the role of the investment banks. Management buyouts, particularly in response to a hostile bid, are a bonanza for investment banking firms. Managers entangled in tender offers turn to investment advisors for price evaluations and assistance in securing financing, issuing new securities, structuring bids, and mounting defenses.[19] The investment bankers play an important role when they give honest advice based on their special financial expertise. Too often, however, it appears that managers are not buying the services of open-minded experts, but rather are buying made-to-order recommendations, usually in the form of written "fairness opinions" that support managers' pre-established positions.[20] This practice is harmless when managers are intent on acting consistently with their shareholders' best interests.[21] But when managers' interests and shareholders' interests diverge, as they often do in the case of tender offers, this mercenary cooperation between investment advisors and managers may produce

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Kravis Bids $4.91 Billion, Or $45 a Share, for Beatrice Cos., Wall St. J., Oct. 17, 1985, at 3, col. 1.

18. *See Forstmann Little Sets $2.7 Billion Fund for Buyouts*, Wall St. J., May 28, 1987, at 22, col. 2; Dannen, *LBOs: How Long Can This Go On?*, INST. INVESTOR, Nov. 1986, at 151, 154 (noting that a Forstmann Little buyout fund had earned an average annual return of 32.7% on subordinated debt and 95.2% on its equity investments).

19. Indeed, the investment advisors often seek out the managers, alerting bidders to attractive purchasing opportunities and alerting potential targets to rumors of bids in the offing. Some critics contend that much of the recent surge in merger and acquisition activity is attributable to feeseeking investment bankers fomenting takeovers for any company for which financing can be arranged. *See Investment Bankers Feed a Merger Boom and Pick Up Fat Fees*, Wall St. J., Apr. 2, 1986, at 1, col. 6; *see also* J. BROOKS, THE TAKEOVER GAME (1987); *cf. infra* note 23 and accompanying text.

20. *See, e.g.*, Plaza Secs. Co. v. Fruehauf Corp., 643 F. Supp. 1535, 1537 (E.D. Mich.), *aff'd sub nom.* Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986) (describing situation in which investment banking firm suggested buyout price of approximately $50 per share, while management wished to participate only at a price of $48 to $48.50 per share; buyout offer made at the lower management price without disclosure of investment bank's suggested price); *see also* Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1102 (Del. 1985). Some commentators have gone much further than the courts in suggesting that fairness opinions are simply a form of "deceit upon the investing public and upon the marketplace generally." Stein, *Investment Banking's Dirty Little Secret*, N.Y. Times, June 8, 1986, § 3, at 2, col. 3; *see also* McGough, *Fairness for Hire*, FORBES, July 29, 1985, at 52; Wander, *Special Problems of Acquisition Disclosure: Investment Bankers' Reports and Conflicts of Interest*, 7 INST. ON SEC. REG. 157, 158 (1976) (discussing the role of fairness opinions in influencing shareholder ratification of transactions).

21. Managers who completely give up the opportunity to obtain good outside advice increase their risk of error. But most managers who use made-to-order fairness opinions will informally seek outside advice. When a satisfactory agreement is negotiated, including limitations upon the scope of the opinion, the formal fairness opinion will then be presented to the shareholders.

only window dressing: managers dress up their positions with valuations by ostensibly fair-minded experts in order to hoodwink their shareholders.[22]

A hostile bid is invariably a threat to management's future employment. Managers may respond to such a threat by using fairness opinions to convince their shareholders to refuse to tender their shares. Alternatively, managers may use an opinion that the hostile bid is "grossly inadequate" to forestall the recriminations of angry shareholders when defensive programs—poison pill plans, litigation, or management buyout proposals, for example—are implemented causing stock prices to decline. On the other hand, when a bidder offers managers lucrative employment contracts or severance contracts contingent on the success of the tender offer, managers can use fairness opinions to convince their shareholders to tender their shares. The potential for abuse of fairness opinions is the most severe in management buyouts because the managers are the purchasers of the public's stock and have a direct stake in convincing their own shareholders to sell cheaply. While it is becoming increasingly rare for investment advisors who declare that the price offered by the buyout group is fair to also be equity participants in the buyout, firms rendering opinions still may be financing substantial amounts of debt for the acquisition.[23] Moreover, even

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22. Potential managerial misuse of fairness opinions varies with the context of a tender offer or huyout. The phenomenon is encountered most frequently in the defense of target corporations countering hostile offers. Target management almost invariably will obtain a statement from its financial advisors claiming that the offered price is "grossly inadequate," even though the offer exceeds the market price by 25% or more. While some offers carrying substantial premiums over market price may not reflect the absolute maximum justifiable purchase price, many of these offers are not "grossly inadequate." In the struggle for control of Fruehauf Corporation, for example, the target directors promptly rejected a suitor's offers of $41 and $42 per share simply on the oral advice of their investment bankers, even though the stock was trading in the mid-$20 range. *Plaza Securities*, 643 F. Supp at 1537; *see also* Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 177 (Del. 1986); *Gillette's Board Refuses Revlon's $47-a-Share Bid*, Wall St. J., Aug. 25, 1987, at 4, col. 1.

23. In addition to a possible equity stake in leveraged buyouts, investment banking firms will provide large, short-term loans to their clients to facilitate tender offers or major open market purchases. These loans are known as "bridge loans" because they provide a temporary bridge until longer term financing can be obtained. The investment banks, while taking significant risk, have profited handsomely from these transactions. *See, e.g.*, *Merrill Lynch Leads Wall Street's Buy-Out Business*, Wall St. J., Aug. 5, 1987, at 6, col. 1 [hereinafter *Merrill Lynch*]; *Deep-Pocketed Deal Makers*, N.Y. Times, Apr. 14, 1987, at D1, col. 1; *Owens-Illinois, in Going Private, Limits Right Of Junior Bondholders to Get Money Back*, Wall St. J., June 9, 1987, at 69, col. 3 (stating that Morgan Stanley earned an annualized 80% before taxes on its $300 million bridge loan to finance the buyout of Owens-Illinois); *Wall Street Deal Makers Take More Risk*, Wall St. J., Nov. 6, 1986, at 6, col. 1; *see also* Edelman v. Fruehauf Corp., 798 F.2d 882, 884-85 (6th Cir. 1986) (describing situation in which a buyout proposal included loans totaling $750 million from investment bank and commercial bank, $100 million stock repurchase by target, $10 to $15 million equity contribution from management participants, and $10 to $15 million equity from investment bank).

investment banking firms that are not involved in the financing may be acting under a fee arrangement that conditions payment on the success of the buyout; this inevitably clouds the objectivity of their advice to shareholders.[24]

Management buyouts are most notorious when shareholders sell a languishing firm to their own managers and then watch their former managers rejuvenate the firm and profit handsomely. The ex-shareholders develop a natural skepticism about the fidelity of their former fiduciaries.[25] After buyouts, target firm executives have earned staggering, immediate profits either through private resale of the assets of the firm or through something known as a "round trip," which involves restructuring the company before taking it public a short time later.[26] John Kluge, for example, took Metromedia private in 1984 and has already raised five times the purchase price through partial liquidation, giving him a personal profit of close to three billion dollars.[27] John Pomerantz took Leslie Fay private in 1982 for 58 million dollars. He then resold the company to the public in 1986 for 360 million dollars. In four years Mr. Pomerantz made an estimated 60 million dollars on an equity in-

24. For a description of these types of problems, see Stein, *Loss of Values: Did the Amsted LBO Shortchange Shareholders?*, BARRON'S, Feb. 16, 1987, at 8; Heineman, *How to Avoid Conflicts of Interest in the Takeover Game*, Wall St. J., Feb. 9, 1987, at 18, col. 3.

25. *See* Stein, *supra* note 24; Hector, *Are Shareholders Cheated By LBOs?*, FORTUNE, Jan. 19, 1987, at 98. Shareholders also may find that the buyout has been timed very opportunistically in order to allow management to buy the company at historically low prices. While this is a natural time for management to contemplate a buyout, it does give public shareholders good reason to question management's recent efforts on their behalf. *See Crazy Eddie Inc. Report Discloses an SEC Inquiry*, Wall St. J., June 18, 1987, at 4, col. 1 [hereinafter *Crazy Eddie*] (describing a situation in which a corporate founder proposed a buyout after selling millions of dollars of stock at higher price and stimulating market decline in stock through his withdrawal from the firm).

26. The time frame for most companies that are targets of buyouts to be brought public again or sold to new owners seems to be about five years, with some recent MBOs returning to the public equity markets in only about a year. *See Beatrice Buy-Out May Net Investors Eightfold Return*, Wall St. J., Sept. 4, 1987, at 5, col. 1 [hereinafter *Beatrice Buy-Out*]; *Many Firms Go Public Within a Few Years Of Leveraged Buyout*, Wall St. J., Jan. 2, 1987, at 1, col. 6 [hereinafter *Round Trips*]; *Wall St. Buys Into the Action*, N.Y. Times, Jime 19, 1986, at D1, col. 3. As investment banks commit larger amounts of their own capital to buyouts, we may expect to see even more pressure to return companies to public ownership so that the large equity investors can realize gains and recover needed capital. *See also* Ferenbach, *The IPO Market Welcome for LBOs in Transition*, MERGERS & ACQUISITIONS, Nov.-Dec. 1987, at 54 (discussing the market for re-offering private company shares to the public to complete the buyout transaction's life cycle); Miller, *LBOs: Now It's Time to Cash In*, INST. INVESTOR, July 1986, at 139; Dannen, *supra* note 18, at 158 (quoting Henry Kravis, of Kohlberg, Kravis, Roberts & Co., on why companies are quickly sold or taken public again: "The longer you hold [an LBO investment], the more your returns will decline").

27. Hector, *supra* note 25, at 99; *see also Metromedia Inc.'s Holders Approve $1.13 Billion Buyout*, Wall St. J., June 21, 1984, at 20, col. 3; Sloan, *Metromedia Revisited*, FORBES, Dec. 19, 1984, at 32.

vestment of one million dollars.[28] There are numerous other examples: of the thirty companies that went private after 1981 and subsequently were resold before the end of 1986, the average increase in value for the purchasing group was 150 percent.[29]

The enormous profitability of buyouts tbat often seem little more than a reshuffling of corporate assets and paper by managers raises serious questions for shareholders. Managers are on both the buy and sell sides of the buyout and face obvious conflicts of interest. Shareholders must question whether the managers, fiduciaries who were charged with protecting and furthering shareholders' interests, have not in fact picked their pockets or the pockets of other corporate constituencies.[30] Likewise, the chicanery of using made-to-order fairness opinions is probably widespread and will continue to be so unless investment advisors are more accountable to the shareholders, who are the true purchasers of their advice.[31]

This Article calls for a re-evaluation of the legal obligations of management buyout participants and investment bankers to shareholders and proposes procedural guidelines by which to govern the interrelationships of these parties in buyouts and, by implication, in all tender offers. Part II of this Article describes management buyouts and tbe role of investment bankers. Part III examines the problems courts face in resolving pricing disputes in management buyouts. The Article concludes with suggestions for strengthening tbe procedural safeguards afforded shareholders and for increasing the accountability of managers, directors, and independent investment advisors.

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28. Hector, *supra* note 25, at 99.

29. *Id.* at 104; *see also Merrill Lynch, supra* note 23 (reporting that Merrill and its partners sold Denny's Inc. for $220 million, more than quadruple its $45 million equity investment made only slightly more than two years earlier; and Merrill also sold Signode Corp. for $278 million after purchasing the company with an equity investment of $27.5 million four years previous); Ferenhach, *supra* note 26, at 54, 56. *But see* Loomis, *LBOs Are Taking Their Lumps*, FORTUNE, Dec. 7, 1987, at 64 (descrihing the financing trouhles many LBOs are facing in the wake of the October 19, 1987 stock market crash).

30. Professor John Coffee has shown that some of the profits from buyouts and takeovers come at the expense of other corporate constituencies such as bondholders and employees. *See* Coffee, *supra* note 10.

31. Cases and commentary addressing investment advisor liability in the context of a tender offer, cash-out merger, or management buyout are scant. *See, e.g.*, Weinberger v. UOP, Inc., No. 58,1981 (Del. Feb. 9, 1982), *withdrawn*, 457 A.2d 701 (Del. 1983); Note, *The Standard of Care Required of an Investment Banker to Minority Shareholders in a Cash-Out Merger:* Weinberger v. UOP, Inc., 8 DEL. J. CORP. LAW 98 (1983); Note, *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119 (1986) [hereinafter Note, *Fairness Opinions*].

II. Management Buyouts

A. *The Environment and Mechanics of Management Buyouts*

Large buyouts[32] are a recent phenomenon. Even though one hundred million dollar buyouts did not appear until the late 1970s,[33] such transactions are now commonplace. Of the top 200 deals by size in 1986—including all mergers, buyouts, restructurings, spin-offs, and cash-outs—approximately one-fifth were buyouts.[34] Ten of the twenty-five largest control transactions closed in 1986 were buyouts—each for an amount exceeding one billion dollars.[35] Large cash-outs, on the other hand, usually occur only as the second stage of a two-tier tender offer; the first stage consists of a cash tender offer for control, which may itself be part of a management buyout.[36]

In these "going private" transactions, a group of investors buys enough of the stock of a publicly held company to exempt the company from the Securities and Exchange Commission (SEC) registration requirement under Section 12 of the Securities Exchange Act of 1934.[37] The investors "take the company private." In a buyout, as distinguished from a cash-out or a take-out, the buyer does not begin with a controlling interest in the target company.[38] If the purchasing group in

32. These transactions may include LBOs or MBOs, effectuated through a self-tender offer or merger with a shell corporation. For discussions of many of the legal issues addressed in this Article, see Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. Rev. 630 (1985); Lowenstein, *Management Buyouts*, 85 Colum. L. Rev. 730 (1985); Note, *Leveraged Buyout, Management Buyout, and Going Private Corporate Control Transactions: Insider Trading or Efficient Market Economics?*, 14 Fordham Urb. L.J. 685 (1986). For articles addressing the mechanics of the transactions with particular emphasis on the various means of financing LBOs, see S. Diamond, Leveraged Buyouts (1985); Mancuso & Ferenbach, *The LBO: Financial Tool of the 80s*, Fin. Executive, Aug. 1984, at 20; Wallner, *Leveraged Buyouts: A Review of the State of the Art, Part I*, Mergers & Acquisitions, Fall 1979, at 4; Wallner, *Leveraged Buyouts: A Review of the State of the Art, Part II*, Mergers & Acquisitions, Winter 1980, at 16.

33. *See* DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & Econ. 367, 381 (1984); Ross, *How the Champs Do Leveraged Buyouts*, Fortune, Jan. 23, 1984, at 70, 74.

34. *The Top 200 Deals*, Bus. Week, Apr. 17, 1987, at 276; *see also The Top 100*, Mergers & Acquisitions, May-June 1987, at 47.

35. *The Top 100, supra* note 34, at 47-48. The largest transactions closed during the year included the buyouts of Beatrice at $6.25 billion, Safeway at $5.34 billion, and R.H. Macy at $3.50 billion. *Id.*; *see also 25 Largest Leveraged Buyouts of All Time*, Mergers & Acquisitions, Nov.-Dec. 1987, at 49 (since 1984 there have been 22 leveraged buyouts for over a billion dollars).

36. *See, e.g.*, Edelman v. Fruehauf Corp., 798 F.2d 882, 884 (6th Cir. 1986) (in response to a third-party offer, management buyout group negotiated a two-tier offer paying shareholders cash on the front-end and securities on the back-end of take-out merger); *see also* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 269 (2d Cir. 1986).

37. 15 U.S.C. § 78l(g) (1982).

38. In most of the large buyouts of the past two or three years, the management buyout group has held less than 10% of the stock of the corporation when the transaction was initiated.

a buyout includes members of the firm's management, the buyout is known as a "management buyout."[39] In a cash-out,[40] a majority shareholder eliminates all minority shareholders by forcing the public shareholders to surrender their stock for cash.

The purchasing group finances a management buyout by borrowing funds from commercial banks, insurance companies, investment banks, venture capitalists, and other institutional investors.[41] Some of these investors also may take an equity position in the now private corporation; a participating investment banking firm that assists in structuring the transaction, for example, often will purchase equity in the company at a low price.[42] The repayment of the firm's staggering new debt is usually accomplished through cash generated by future earnings and by the sale of some of the firm's assets and businesses.[43] This requires that the firm be a financially sound, mature company with steady earnings and saleable assets that are peripheral to the firm's main business. Senior management's participation in the buyout is also considered to be very important.[44]

This is a significant change from the smaller buyouts and cash-outs of the 1970s. *Cf.* DeAngelo, DeAngelo & Rice, *supra* note 33, at 383 (finding that for 72 going private transactions from 1973 to 1980 the mean proportion of stock held by management prior to the transaction was approximately 45%).

39. This Article addresses issues common to buyouts of entire corporations, the shares of which are publicly traded. Many MBOs involve divisions of large corporations. While there is potential for abuse on the part of the management team in divisional buyouts, the opportunities are much diminished and the corporate parent has a strong unified position from which to negotiate. Additionally, the purported benefits of divisional buyouts—primarily managerial autonomy and more direct compensation—are more intuitively appealing. *See* Lowenstein, *supra* note 32, at 755-56; *see also 1986 Profile*, MERGERS & ACQUISITIONS, May-June 1987, at 64 (listing the 25 largest divestitures of 1986).

40. For a further description of a cash-out, see Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987 (1974); Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072 (1983); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982).

41. *See* S. DIAMOND, *supra* note 32, at 43-91; Wallner, *supra* note 32.

42. *See, e.g.*, *Merrill Lynch*, *supra* note 23 (reporting that Merrill Lynch Capital Partners contributed 55% of the equity capital in the $2 billion buyout of Supermarkets General); *see also* Edelman v. Fruehauf Corp., 798 F.2d 882, 885 (6th Cir. 1986); *cf. supra* note 23.

43. *See, e.g.*, Waldman & Freeman, *Burlington Industries' Denim Plant Sale Catapults Old Rival to Near Top of Field*, Wall St. J., Nov. 9, 1987, at 7, col. 3 (a management buyout group that outbid Dominion Textile for control of Burlington Industries subsequently sold one of Burlington's leading plants to its competitor to finance the buyout); *Buyout of Burlington Industries Inc. May Force Firm to Become Much Smaller*, Wall St. J., May 22, 1987, at 6, col. 2; *Beatrice Buy-Out*, *supra* note 26.

44. While this has been the traditional wisdom, young or less financially stable firms increasingly are becoming the targets of MBOs. Additionally, in some buyouts senior management's participation may no longer be as essential as it once was. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 178 (Del. 1986) (management excluded from revised buyout proposal). In some cases former executives of the target firm have been coupled with management

In management buyouts, the management group's perception of the value of the firm as a private company must differ from the value of the firm as reflected by the public capital markets[45] and estimates made by potential third-party suitors.[46] Speculation on the reason for the disparity is what makes management buyouts so controversial.[47] A straight management buyout does not involve a major merger or management change;[48] therefore, the primary determinants of the firm's value are its assets[49] and its earning power with the existing senior management personnel substantially intact. In the public's eye, if managers conclude that the value of the assets and earning power of the firm exceeds the value as determined by the market, the managers must have inside in-

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buyout specialty firms to make bids for their former employers; usually to the exclusion of current senior executives from the buyout group, which gives rise to the term "hostile management buyout." In the buyout of Beatrice, Donald Kelly, the former CEO of Esmark Corp., which Beatrice had previously acquired, was brought in to lead a buyout of Beatrice along with Kohlberg, Kravis, Roberts & Co. *See Beatrice Buy-Out, supra* note 26; *see also Leveraged Buyout Set by Allegheny International Inc.*, Wall St. J., Mar. 10, 1987, at 3, col. 4 (initial buyout proposal without management participation approved by board of directors).

45. Booth, *supra* note 32, at 634-35. Professor Richard Booth suggests that this difference may reflect management's control over decision making in the corporation; *i.e.*, management "does not bear the risk of its investment being used in a manner with which it disagrees." *Id.* at 635. Professor Booth acknowledges, however, that this difference in valuation also may be due to an informational advantage which management may hold as against the market. *Id.* For a discussion of some of the insider trading problems arising in management buyouts, see *infra* notes 54-55 and accompanying text.

46. This may not be true, however, if the management buyout group is allowed to engage in blocking activity that is sufficient to thwart any third-party offers. *See infra* notes 111-26 and accompanying text.

47. *See, e.g.*, Sommer, *"Going Private": A Lesson in Corporate Responsibility*, Law Advisory Council Lecture, Notre Dame Law School, *reprinted in* [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,010, at 84,696; Stein, *Going Private is Unethical*, FORTUNE, Nov. 11, 1985, at 169; Stein, *supra* note 24; Thackray & Main, *Heading Toward Leveraged-Buyout Burnout?*, ACROSS THE BOARD, Dec. 1984, at 30; Longstreth, *New Controls for Leveraged Buyouts*, N.Y. Times, Nov. 6, 1983, § 3, at 3, col. 1; *Round Trips, supra* note 26.

48. In buyouts by outsiders, the determinants of value for the bidder are more varied and can include, for example, gains created by the special fit of the purchaser and target or by displacing the dominant management team in the target and replacing it with a better team. Managers participating in buyouts cannot use these common justifications because the buyout does not create a new combination of firms or a change in management personnel; there is only a change in the identity of the owners.

49. A large number of buyouts are dependent on the management buyout group selling off assets or complete businesses to pay off part of the debt load taken on in the buyout. *See, e.g.*, *Beatrice Buy-Out, supra* note 26. It is frequently the case that the estimated "bust-up value" per share of a target corporation in a control struggle is well in excess of the current price of the target's stock. *See, e.g.*, Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173, 177 (Del. 1986); *Dayton Hudson Stake Acquired By Dart Group*, Wall St. J., June 22, 1987, at 3, col. 1 (stating that "[a]nalysts have estimated Dayton Hudson's break-up value at $65 to $75 a share" when the stock was selling at $56.50); *see also* Booth, *supra* note 32, at 646-47 (noting potential benefits from deconglomeration); Gogel, *supra* note 2, at 28 (noting that "the market's view of management's capabilities may cause the price of the securities of the company as a whole to be less than the price which could be achieved in a piecemeal sale of the company's corporate assets").

formation. It is no surprise then that management buyouts have a tarnished reputation.

B. The Potential for Abuse

There are three common indictments of management buyouts when they prove to be prodigiously profitable for the purchasing group. First, management's use of buyouts involves the misappropriation of inside information.[50] Executives, particularly in languishing companies, have access to information which indicates that better times are ahead so they buy the company to enjoy the boon. Second, managers profit by doing things for which they were paid well to do and that they should have done before the buyout for the benefit of the former shareholders.[51] Shareholders, reading reports that the private company is run better than the public company they once owned, ask why the executives of the firm did not, as they now have done on their own behalf, float as much debt, fire those same incompetent or redundant subordinates, sell those same assets, or work those same twelve hour days when they worked for substantial salaries as the shareholders' agents. Indeed, the most cynical observers claim that executives will deliberately allow a company to degenerate for a period, or even distort the financial figures, in order to reduce the purchase price and maximize the profit from the management buyout.[52] And third, managers take too much of the negotiating pie in the purchase because there is no one aggressively representing the interests of the selling shareholders.[53]

The first charge, that managers' profits from playing the buyout game may be a function of improper use of inside information, is most troubling because it almost always will be true to some degree,[54] and because policing the use of inside information in such transactions is so difficult. While the buyout group is subject to the disclosure provisions of the federal securities laws in making its offer,[55] the importance of

50. *See* Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322 (1979); Note, *Corporate Morality and Management Buyouts*, 41 WASH. & LEE L. REV. 1015 (1984). *But cf.* Note, *supra* note 32.

51. *See* Stein, *supra* note 24.

52. *Cf. Crazy Eddie*, *supra* note 25; Thackray & Main, *supra* note 47, at 34.

53. *See, e.g.*, Stein, *supra* note 24; *cf. Oesterle I*, *supra* note 11; *Oesterle II*, *supra* note 11.

54. Managers will always have greater knowledge of and access to information concerning corporate affairs and opportunities regardless of the level of disclosure required. Much of this information may be "immaterial" in its individual quantum, *see* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976), but of great importance to a manager intimately familiar with its totality and its ramifications upon the corporation's operations. *See also* Field v. Allyn, 457 A.2d 1089 (Del. Ch.), *aff'd*, 467 A.2d 1274 (Del. 1983).

55. Securities Exchange Act of 1934, 15 U.S.C. § 78 (1982); Exchange Act Rule 13e-3, 17 C.F.R. 240.13e-3 and Schedule 13E-3, 17 C.F.R. § 240.13e-100 (see particularly items 8 and 9, requiring discussion of the fairness of the transaction and disclosure of appraisals); *see also* Plaza

new patents, investment opportunities, or changing competitive circumstances may not be disclosed or may be lost in the boilerplate language and intentional obfuscation that so often characterizes such disclosures. Likewise, when the benefits from such developments or opportunities accrue to the buyout group a few years later, searching the pudding for the proof that may establish liability to past or present shareholders may be murky and particularly unrewarding.

Managers may not only profit from the use of inside information, but they also may create opportunities to exploit inside information. For example, managers, in contemplation of a buyout, may repose while the corporation degenerates or may manipulate the flow of financial information from the corporation, which lowers the buyout price and raises management's potential profits. Once the buyout is consummated, management can correct the effects of their own acts and increase the value of the company.

The second charge is that managers who follow buyouts with dramatic business reverses must have been acting irresponsibly when they did not undertake the same measures on behalf of public shareholders that they subsequently have taken to bring success to their private company. Managers have significant discretion over the accounting policies employed by the firm[56] and even greater control over their own efforts on behalf of the corporation.[57] While it is understandable that the enormous stake which an individual executive may have in a now private corporation may encourage him or her to devote a bit more effort at the margin, the drastic changes seen in many buyout targets once private are not explained so easily. Furthermore, the changes in business procedure witnessed after a buyout are often within the realm

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Secs. Co. v. Fruehauf Corp., 643 F. Supp. 1535, 1544 (E.D. Mich.), *aff'd sub nom.* Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986). These disclosure requirements parallel those required for third-party tender offerors. Securities Exchange Act of 1934, Schedule 14D-1, 17 C.F.R. § 240.14d-100 (1987). *See generally* Going Private Transactions Under Rule 13e-3, Exchange Act Release No. 17,719, 46 Fed. Reg. 22571 (1981).

56. *See, e.g.*, Andresky, *Indecent Disclosure*, FORBES, Aug. 13, 1984, at 92; Andresky, *Setting the Date*, FORBES, July 16, 1984, at 90; Andresky, *Double Standard*, FORBES, Nov. 22, 1982, at 178; Greene, *Big Bath? Or a Little One?*, FORBES, Oct. 6, 1986, at 118, 120; Greene, *How to Owe Money Without Seeming To*, FORBES, May 26, 1980, at 54; Konrad, *Take Your Fees and Come Out Fighting*, FORBES, July 18, 1983, at 98; Smith, *Puddle Muddle*, FORBES, Oct. 8, 1984, at 92. *But see* DeAngelo, *Accounting Numbers as Market Valuation Substitutes: A Study of Management Buyouts of Public Stockholders*, ACCOUNTING REV., July 1986, at 400.

57. One story that makes the rounds in the halls of investment banks is the following: When approached by an investment hanker involved in the financing of a proposed buyout, a CEO, realizing the tremendous gains that could accrue to him in an MBO, claimed he could easily remove one billion dollars in needless assets and overhead off the company's books within three to six months after a buyout. Asked why he had not done it already, the CEO responded that he did not "want to rock the boat without need."

of management's abilities, and perhaps duties, prior to the buyout.[58]

The third charge, that no one adequately represents shareholders' interests in the negotiating of the buyout, stems directly from the conflicting roles of management and inside directors in the process of approving a management buyout. The charge is even stronger when one considers the close personal relationships that often exist between the inside directors, who will probably be equity participants in the buyout, and the "independent outside directors" who are charged with the primary responsibility for protecting the public shareholders' interests. Furthermore, because outside directors' knowledge of corporate affairs and financial information is almost invariably inferior to that of inside directors, the outside directors increasingly will tend to defer to the insiders' judgment.[59] To see the power of this charge, one need only consider several recent management buyout transactions in which the outside directors unanimously approved buyouts by management that were subsequently challenged by higher offers from third-party bidders, to which management quickly responded with higher offers of their own. In some cases management's bid was increased by ten percent or more when confronted by an outside bidder.[60] Why should these higher bids not have been forthcoming simply as a result of the negotiating efforts of the "independent outside directors" working with full access to corporate information?

These problems inspire many to advocate a quick fix: prohibit all management buyouts.[61] This quick fix, in addition to presenting severe definitional problems,[62] underestimates the benefits that may come

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58. With this in mind, the leveraged recapitalization would seem a more appropriate response to the exigencies that manager's claim justify the use of MBOs. Although managers in MBOs wax prolific on the advantages of debt financing, why did they not simply recapitalize the public company?

59. *See infra* note 177.

60. *See, e.g., National Amusements Wins Bidding War For Viacom With Its Offer of $3.4 Billion*, Wall St. J., Mar. 5, 1987, at 2, col. 3 (final offer from management buyout group of $3.3 billion); *Two Rival Suitors for Viacom Sweeten Bids Again; Fight Expected to Continue*, Mar. 3, 1987, at 5, col. 2 (management buyout group increased bid to $3.23 billion; outside bidder raised offer to $3.35 billion); *Managers Raise Bid for Viacom To $3.1 Billion*, Wall St. J., Feb. 27, 1987, at 4, col. 1; *Viacom Board Clears New Bid Of $2.97 Billion*, Wall St. J., Oct. 20, 1986, at 8, col. 1 (target's board unanimously approved bid by management-led buyout group).

61. See Brudney, *Efficient Markets and Fair Shares in Parent-Subsidiary Mergers*, 4 J. CORP. L. 63 (1978); Brudney, *A Note on "Going Private,"* 61 VA. L. REV. 1019 (1975); Brudney & Chirelstein, *supra* note 40, at 1366; *cf.* Lowenstein, *supra* note 32, at 779-84 (advocating regulations to create an auction market whenever management proposes a buyout).

62. What participation by how many managers of what rank will constitute a "management" buyout? What is the line between a large share repurchase plan and an MBO? For example, in the control struggle for Viacom International, management and the third-party bidder competed against one another primarily by upping the stake the public shareholders would continue to have in the successor corporation. *See National Amusements Wins Bidding War For Viacom with Its Offer of $3.4 Billion*, Wall St. J., Mar. 5, 1987, at 2, col. 3; *National Amusements, as Expected,*

from legitimate management buyouts.[63] Even those management huyouts that occur under suspicious circumstances give target shareholders abnormal returns on their capital investment because of the premium over market price offered for their shares.[64] At best the target corporation shareholders' argument is that the premium paid should be higher. Shareholders argue that, once the firm becomes a target in the market for corporate control, they should receive a premium based not on share prices that existed before the firm became a target, but on share prices determined by the market for control—a market in which substantial premiums are the norm.

The shareholders' argument has a grasping quality in those cases in which the management group's offer exceeds any outstanding offers from third parties. But the shareholders' complaint still may be valid under the circumstances if management has actively disabled other bidders,[65] or the management group has usurped the value of nonpublic information or has taken advantage of poor representation of shareholder interests in the price bargain. Thus a legitimate management buyout must meet each of three conditions: first, the management group must pay more than any other third-party bidder in a fair auction;[66] second, the management group must not be misusing inside in-

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Lifts Viacom Bid Again; Move Pressures Rival, Wall St. J., Mar. 4, 1987, at 7, col. 1; *Two Rival Suitors for Viacom Sweeten Bids Again; Fight Expected to Continue*, Wall St. J., Mar. 3, 1987, at 5, col. 2; *see also LBO Stubs Bid to Top Interest In Buyout Boom*, Wall St. J., Mar. 13, 1987, at 27, col. 3.

63. *See* Booth, *supra* note 32, at 645-49; Easterbrook & Fischel, *supra* note 11, at 1194-1204; Easterbrook & Fischel, *supra* note 40, at 705-11; Mancuso & Ferenbach, *supra* note 32, at 22; *see also infra* note 110.

64. *See* Jensen, *supra* note 2, at 325; Jensen & Ruback, *The Market for Corporate Control*, 11 J. FIN. ECON. 5, 9-16, 39-40 (1983).

65. Professor John Coffee argues that state law ought to allow a firm to favor MBOs over hostile bidders with limited financial assistance, because "its victory may minimize the economic losses, dislocation, and trauma experienced by nonshareholder constituencies" in hostile tender offers. *See* Coffee, *supra* note 10, at 91. The extent of this justification is unclear. For example, would Professor Coffee support MBOs that generate profits from the use of inside information when the buyout is in response to a hostile tender offer? In other words, can one argue that minimizing economic distortion for non-shareholder constituencies serves to legitimize otherwise illegitimate reasons for a management buyout? *See also* Gogel, *supra* note 2, at 30 (noting that management control of a restructuring or buyout may provide a controlled format for change, providing more efficient alteration of the corporation and a minimization of the trauma imposed on various corporate constituencies).

66. This assumes that the financing of any third-party bidder's offer is equally secure as management's. If the third-party financing is extremely speculative, this may give management adequate justification for rejecting a higher bid. Directors, and courts if necessary, must scrutinize very carefully any such claims by management when used as a justification for rejecting an ostensibly higher bid. *See, e.g.*, Edelman v. Fruehauf Corp., 798 F.2d 882, 885 (6th Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 179 n.7 (Del. 1986). *But see* Booth, *supra* note 32, at 642, 654 (arguing that management may be justified in making a lower bid and in rejecting a higher outside offer because of management's existing stake in the corporation and differing means

formation; and, third, the shareholders must have strong independent representation in the bargaining process.

C. *Explaining the Premium Price in Management Buyouts*

The question remains, however, even if a management buyout meets these conditions for legitimacy, how can the purchasing group afford to pay a large premium over market price for the company's shares? What can the managers do privately that they could not or should not have done as salaried executives of a publicly held company? Unless there is some explanation for the premium that is not tied to one of the abuses, perhaps the quick fix is sound—management buyouts should be eliminated. Six responses with varying degrees of persuasion, however, may justify management buyouts.[67]

First, private companies are not subject to the many burdens imposed by the Securities Exchange Act of 1934 and other governmentally imposed regulations on public companies. Private companies, for example, do not have to file with the SEC or circulate periodic reports and proxy materials to public shareholders in order to comply with detailed SEC and associated accounting rules and regulations.[68] Stock exchange and broker-dealer regulations are likewise no longer of concern. One wonders, however, how substantial these savings are; it seems highly unlikely that these savings can explain the millions of dollars in profits

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of valuing stock). The scope of Professor Booth's argument is limited, however, by his implicit assumption that management owns a significant amount of the target's stock. While this may have been true of the smaller buyouts in the 1970s, it is no longer true of the large buyouts that are so controversial today. *See supra* note 38.

67. We have omitted a seventh possible argument—that non-shareholder constituencies are better off—for several reasons. First, to the extent that managers are the non-shareholder constituency in issue, their position is discussed in the text accompanying *infra* notes 110-14. Second, for other constituencies like nonmanagement employees, creditors, and local residents, the evidence which indicates that they are better off after an MBO than after a hostile takeover by an outside bidder is very speculative. Many MBOs often effect restructurings that mimic what a hostile bidder would do if it was able to buy control of the firm; parts of the firm are sold, some of the management team released, firm facilities are closed, and so on. Moreover, even if nonmanagement constituencies are better off after buyouts, if their gains come at the expense of the shareholders and are a justification for such buyouts, can other corporate decisions (*e.g.*, the decision to build a new factory) be justified by the same calculus? Once the primacy of shareholders' interests is dismissed, a wide array of traditionally unacceptable corporate actions can be justified as furthering some corporate constituency's interests. Finally, nonmanagement constituencies can, *ex ante*, accommodate the risk of LBOs in their arrangements with the firm. Bondholders, for example, can demand higher yields or can demand veto power in bond indentures. That bondholders lose money in LBOs is not by itself an indication that they were treated unfairly; they knowingly may have taken a risk and lost just like the holders of long positions in a bear market.

68. *See* DeAngelo & DeAngelo, *Management Buyouts of Publicly Traded Corporations*, FIN. ANALYSTS J., May-June 1987, at 38, 44 (noting that the savings from LBOs includes salaries and overhead for stockholder relations departments and the valuable time management must spend dealing with stockholders, financial analysts, and the financial press).

earned by members of the purchasing groups.[69] Moreover, these savings would seem to be more than offset by the fees paid to the investment bankers who structure the buyout. Large-scale buyouts typically generate a minimum fee of ten million dollars, and the fees can exceed fifty million dollars.[70]

Second, assuming that no material, nonpublic information is involved, the management group simply may have a forecast of the firm's future different than that held by the public market. The management buyout group may believe, for example, that the firm's cash flow from earnings is stronger and more stable than is believed to be the case by public investors. In other words, the management buyout group may believe that the firm is undervalued by the market. Adherents of the semi-strong or strong version of the efficient market theory would scoff at this claim, for, according to those theories, the public market price best incorporates the value of all public information.[71] In other words, the management purchaser group paying a premium over market for undervalued stock is more likely to be wrong than right.[72] This is not to say, however, that the firm's shareholders should be prohibited from enjoying the benefits of their managers' foolishness. The theory does suggest, however, that if false perceptions of undervalued stock are the dominant reason for legitimate management buyouts, then the number of management buyouts should diminish as managers themselves learn of their poor odds. But in fact, the number of buyouts continues to grow rapidly.[73]

An important variation of this justification is that managers have an estimate of the firm's future value given some radical change in its business operations that is higher than the valuation they estimate will appear in the public market once the change in course is announced.[74] Rather than announce a major business restructuring before the success of such a plan is more evident and risk having the stock price plummet (with its consequential problems including shareholder litigation, an increase in financing costs, and the like that may defeat the restructuring), the managers buy the company and complete the restructuring

69. *See supra* notes 26-29 and accompanying text.

70. *See* Lowenstein, *supra* note 32, at 757 n.98; *see also Merrill Lynch, supra* note 23 (reporting that Merrill's fees for the buyouts of Supermarkets General and Fruehauf Corp. totaled $52 million and $40 million, respectively); *Kohlberg Kravis Fee, supra* note 17; Dannen, *supra* note 18, at 153.

71. For a discussion of the efficient market theory, see Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

72. Because tbe purchasers have only a 50-50 chance of beating the market, tbe greater the premium paid over market the more likely the loss.

73. *See supra* notes 33-35 and accompanying text.

74. *See* Booth, *supra* note 32, at 634-35.

before re-offering the company to the public market for evaluation. Likewise, managers may assert that the company has very bright long-term prospects but that the market has taken a short-term perspective and thus undervalues the company.[75] Management buyout participants argue that as a private company they will not be subjected to the short-term whims of the market and can better implement long-term investment projects. Once again, this argument really boils down to an assertion that management of a target is a better judge of a firm's worth than the stock market. If the market places a much lower value on a company's future earnings stream than on the maximization of the company's present earnings, it is because the collective judgment of market participants has valued the future earnings using a higher discount rate. A higher discount rate may be a consequence of high real interest rates or expected inflation, or because the market is using a lower probability measure of the future earnings actually occurring. In either case, there is simply no reason that managers should not act to maximize stock prices given shareholders' preferences for higher current earnings rather than increased future earnings.

Third, until the Tax Reform Act of 1986,[76] management buyouts provided unique and substantial tax advantages. Indeed, the tax savings may have been the single most important factor in the early buyout boom.[77] Managers, in essence, would create and then split the tax savings with their shareholders. The tax savings came from two events: first, the sale re-established a high tax basis in depreciated or depleted assets held by the firm; and, second, the firm enjoyed substantial interest deductions on the debt financing. Changes in the 1986 Tax Code, however, have nullified the first tax advantage, while the second advantage by itself has never sufficed as an explanation for management buyouts. Congress eliminated the first tax benefit, that of re-establishing a tax basis in depreciated or depleted assets, by taxing the firm at sale for the increased basis received by the purchasers.[78] Thus

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75. For examples of this viewpoint, see Drucker, *Corporate Takeovers—What Is To Be Done?*, 82 PUB. INTEREST 3 (1986); Fogg, *Takeovers: Last Chance for Self-Restraint*, HARV. BUS. REV., Nov.-Dec. 1985, at 30; Williams, *It's Time for a Takeover Moratorium*, FORTUNE, July 22, 1985, at 133. *But see* Pound, Lehn & Jarrell, *Are Takeovers Hostile to Economic Performance?*, REGULATION, Sept.-Oct. 1986, at 25 (suggesting that empirical data do not indicate economic detriment attrihutable to short-term perspective of securities markets).

76. Tax Reform Act of 1986, Pub. L. No. 99-514, § 631(a), *reprinted in* 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2271 (to be codified at 26 U.S.C. § 337).

77. *See* Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 171 (1983); Stoney & Zonana, *Tax Considerations in Leveraged Acquisitions*, in LEVERAGED BUYOUTS, 393 CORP. L. & PRAC. HANDBOOK 41 (PLI 1982); Lowenstein, *supra* note 32, at 759-64; *Big Tax Advantages Prompt Rise in Leveraged Buyouts*, Wall St. J., Oct. 12, 1983, at 31, col. 1.

78. *See* Batchelar, *M & A and the Tax Act of 1986*, BUYOUTS & ACQUISITIONS, May-June 1987, at 39; Solinga, *LBOs, Junk Bonds and the New Tax Laws*, BUYOUTS & ACQUISITIONS, May-

the purchasers obtain a new tax basis in the assets, but buy a corporation with a substantial tax obligation that will usually more than offset the value of the depreciation deductions.[79] Moreover, the interest deduction, which is often advanced as a significant motivation for buyouts, is not unique to buyouts. A firm's existing management can recapitalize the company without selling it in order to take advantage of the interest deduction. Without demonstrating that buyouts are a substantially cheaper method of acquiring large interest deductions than floating more debt securities or adopting stock repurchase programs, which also increase the debt-equity ratio, the interest deduction cannot, by itself, be a justification for management buyouts.

The only remaining tax benefits associated with buyouts hinge on the questionable legal status of "mirror" transactions.[80] The mirror transaction was devised to compensate for the repeal of the *General Utilities* doctrine[81] and if valid, creates tax gains in certain specialized

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June 1987, at 33; Wood, *General Utilities Repeal: Injecting New Levies into M & A*, MERGERS & ACQUISITIONS, Jan.-Feb. 1987, at 44.

79. The taxable gain is equal to the basis adjustment and is due immediately, while the depreciation deductions on the basis increase can be taken only over time and therefore do not offset the immediate tax obligation.

80. The transaction depends on a technical reading of Treasury Regulation § 1.1502-34 (as amended in 1966), which qualifies some liquidations for nonrecognition treatment under § 332. The Department of Treasury has threatened that it might change the rule to stop the practice. *See* Sheppard, *Mirror Transactions Go Forward*, 35 TAX NOTES 1057 (1987) [hereinafter Sheppard, *Go Forward*]. In Revenue Proceeding 87-23, 1987-21 I.R.B. 18, the Treasury announced that it will not rule on mirror transactions until it has studied the matter further. *See Treasury Refuses to Take Position on Tax Treatment of Mirror Subsidiary Transactions*, 33 TAX NOTES 1073 (1986) (Letter from Treasury Secretary James Baker to chairmen and ranking minority memhers of the Senate Finance Committee and the House Ways and Means Committee); Sheppard, *Treasury Punts on Mirror Transactions*, 33 TAX NOTES 988 (1986). The Chairman of the House Ways and Means Committee, Dan Rostenkowski, also believes that mirror transactions are taxable. *See* Sheppard, *The Mirror Cracked*, 34 TAX NOTES 538 (1987); *see also* Sheppard, *Room Full of Mirrors: Enforcing General Utilities Repeal*, 33 TAX NOTES 281 (1986) [hereinafter Sheppard, *Room Full of Mirrors*]; *Corporations Jump into Tax Debate Defending Mirror Subs*, INVESTMENT DEALERS' DIG., Nov. 16, 1987, at 48. For a general discussion of mirror transactions, *see infra* notes 81-86 and accompanying text.

Shortly before publication of this Article, even the use of mirror transactions was curtailed sharply by the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203 100 Stat. 1330 (codified in scattered sections of 26 U.S.C.), which restricts the utility of this technique. *See* Prentice Hall's Complete Guide to the Tax Law of 1987, Fed. Taxes (P-H), at ¶ 33 (Jan. 7, 1988). Coopers & Lyhrand, *An Overview of the Principle Provisions of the 1987 Tax Act*, 38 TAX NOTES 67, 70 (1988).

81. For a discussion of the repeal of the *General Utilities* doctrine, see J. EUSTICE, J. KUNTZ, C. LEWIS & T. DEERING, THE TAX REFORM ACT OF 1986: ANALYSIS AND COMMENTARY ¶ 2.03 (1987); *see also* Lobenhofer, *The Repeal of* General Utilities *For Corporate Liquidations—The Consequences of Incomplete and Unexpected Tax Reform*, 4 AKRON TAX J. 153, 181-84 (1987) (also discussing the role of mirror transactions as a replacement for the *General Utilities* doctrine); Shube, *Corporate Income or Loss on Distributions of Property: An Analysis of* General Utilities, 12 J. CORP. TAX'N 3 (1985) (discussing *General Utilities* doctrine); Willens, General Utilities *Is Dead: The TRA of '86 Ends an Era*, J. ACCT., Nov. 1986, at 102.

transactions. The size of the gain offered is substantial, which leads buyout groups to accept the risk that the deal may not work, even though lawyers will not sign opinion letters on the legality of such deals. Mirror transactions are tax-driven restructurings effected when the buyout group forms subsidiaries of a holding company to mirror operating subsidiaries of the target corporation. The buyout group contributes capital to the mirror subsidiaries in proportion to the fair market value of the operating subsidiaries to be sold. The mirror subsidiaries also own, in proportion to the same fair market values, all stock of the shell corporation used to acquire all the target's stock. After the acquisition, which uses the shell corporation's stock as consideration, the target is then liquidated into the mirror subsidiaries.[82] Stock of selected mirror subsidiaries is sold to third parties, and no one recognizes the built-in gain in the assets held by the mirror subsidiaries because stock and not assets are sold.[83]

Unlike pre-1986 transactions, however, which could be motivated solely by a tax basis readjustment, mirror transactions allow only a deferral of tax gains in the sale of appreciated assets. Moreover, they require a new intermediate purchaser. Thus, mirror transactions favor new buyers over existing management when the firm decides to sell appreciated assets to a third party. The new buyers in a leveraged buyout can defer the gain while the corporation itself cannot.[84] In a recent buyout of Owens-Illinois for 3.6 billion dollars, the tax benefits resulting from the use of mirror subsidiaries could have been as much as 750 million dollars because the company's assets had a tax basis of approximately 1.6 billion dollars.[85] The risk is that if mirror transactions are held to be taxable, buyout groups would owe tax equal to the immediate recognition of all built-in gain in the target's assets at the time of liquidation.[86]

Fourth, management buyouts may be justified because top manag-

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82. This is the controversial stage. Treasury Regulation § 1.502-34 ostensibly allows the mirror subsidiaries to aggregate their ownership of the target corporation for the purpose of qualifying under the 80% ownership rule of § 332.

83. The purchaser may not completely escape the tax burden because tbe purchaser does not get a stepped-up basis in the purchased assets. The recognition of the gain is simply postponed and shifted to the purchaser.

84. Sheppard, *Room Full of Mirrors*, *supra* note 80, at 281 (quoting Rep. Dan Rostenkowski of Illinois, chairman of the House Ways and Means Committee, who believes this favoritism of new owners should cause Congress to eliminate mirror transactions).

85. *See* Sheppard, *Go Forward*, *supra* note 80, at 1057; *New Tax Bill Threatens To Kill Most Debt-Financed Takeovers*, INVESTMENT DEALERS' DIG., Oct. 19, 1987, at 16 (noting that taxation of mirror transactions would be accomplished by applying the Treasury's deferred intercompany transaction regnlations to the merger of the target's asset into the mirror subsidiaries—these regulations have not previously been applied to mirror subsidiaries).

86. *See supra* note 80.

ers recognize that a particular firm is suffering substantial agency costs or, in other words, that the management team is performing marginally because of an ineffective corporate monitoring process. A management buyout, which will give managers a more substantial equity stake in the corporation, will induce the management team to perform more faithfully the goal of maximizing the worth of the business. The unadorned agency cost position, however, is not very satisfying. If a firm has shirking managers, an alterative way of encouraging better management performance is to increase the amount of compensation contingent on corporate performance through, for example, option plans or stock appreciation rights.[87] Since managers themselves have a good deal of control over their own compensation plans, management buyouts carried out to improve the monitoring process seemingly involve a taking of corporate opportunity—the opportunity to motivate managers—for personal gain. This situation is not materially different from undertaking a management buyout with more conventional kinds of inside information such as the discovery of a valuable ore field under the obsolete factory, for example. The position provides a legitimate reason for management buyouts only if there is no less costly method for reducing agency costs; that is, substantial agency costs are inherent in the firm if it is publicly held.[88] If so, then these firms should undergo round trips periodically,[89] as managers (or outsiders) take the firms private, trim

87. However, as the market crash of October 19, 1987 has made clear, options plans are not a panacea. The problems that the market crash caused are only one example of the complexities of designing and implementing effective compensation plans, but are illustrative of the difficulties surrounding such plans in the face of volatile markets. The market crash substantially reduced the value of many executive compensation packages created during the last two years. Furthermore, public shareholders who have seen their stock portfolios slashed in value by the crash may be angered particularly by corporations which quickly extend new option packages to executives at post-crash prices.

88. Much of the recent business literature that endorses buyouts as valuable transactions points to the increased incentives and motivation of managers as the key to successful leveraged buyouts. *See, e.g.*, Ferenbach, *supra* note 26, at 59; Glynn, *The Joy of Going Private*, INST. INVESTOR, Dec. 1986, at 111, 114; Selby, *supra* note 3, at 118. Fiduciary duties to the firm's former public shareholders are seldom mentioned in these glowing descriptions of the super manager who becomes a multimillionaire through ownership of his former employer's firm. If indeed the value of the employee-managed firm can differ so dramatically from the highly leveraged, owner-managed firm, the fundamental question of absentee ownership of America's corporations is again ripe for rethinking. *Cf.* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

89. The market crash has substantially reduced the stock prices of many companies that have only recently returned to public ownership following a buyout. At these low market prices the companies again are being considered for buyouts by insiders. *See* Smith, *Market's Depressed Prices Are Breeding a Variation of the Leveraged Buy-Out*, Wall St. J., Jan. 25, 1988, at 42, col. 3. Because the buyout group typically has retained a large stake in the company when it was reoffered to the public, a second buyout appears to be much easier and cheaper to execute. This may make periodic round trips or "re-LBOs" a common solution to the problems that may develop in publicly held companies, including agency cost problems that may be a function of corporate over expansion or risk aversion.

the fat and shape them up, and then re-offer them to the public.[90] With each buyout, the gains from reducing agency costs are split between managers and the firm's shareholders (the shareholders get a premium over market price on the sale), presumably gains that the shareholders are themselves unable to realize. This scenario, even though arguably in the best interests of the shareholders, is disturbing because the managers, who ideally already should be acting in the best interests of the shareholders, seem to profit from their own lack of allegiance. It is not hard to sympathize with the frustration of public shareholders: "Our CEO makes two million a year in salary and he will only work 'til six if he owns the company?!"

In an extreme case, it seems that management buyouts could create a moral hazard. The opportunity for management buyouts may encourage managers of publicly held firms to shirk their responsibilities, allowing managers strategically to increase their personal profits from successful buyouts. Of course, the countervailing pressure from outside bidders ought to eliminate such temptations because excessive shirking ought to attract outside bidders as well. Perhaps the most favorable gloss that can be put on this form of the agency cost argument is that management buyouts (if they are the first to bid for control of the firm, that is, the bid is not in response to an outside bid) will encourage outsiders to bid for the firm. The resulting auction between the outsiders and the management group will maximize the public shareholders' slice of any gains attributable to the owner-managers' success at reducing overall agency costs after the buyout. In other words, management buyout proposals may signal to the market that a firm is a prime takeover target. This pressure from outside bidders, however, may be neutralized if the board of directors can favor management buyouts over third-party offers for control.

Fifth, because owner-managers do not have to discount the value of the corporation for the possibility of agency unfaithfulness and public shareholders do (even if agents have been faithful up to this point), the value of the company is higher in the hands of managers than in the hands of public shareholders. Professor Richard Booth argues that managers assume less risk than public shareholders in owning a particular firm.[91] Public shareholders must discount the value of their owner-

90. Round trips will be beneficial if gains in reducing agency costs exceed tbe transaction costs of the buyout and sufficiently change the risk/reward framework for the buyout group to allow the managers to share with shareholders the gains of reducing agency costs tbrough a premium priced offer. Taking the company public again will be profitable if the benefits from diversification of risk, and an expanded capital base to facilitate growth, outweigh the marginal expansion of agency costs once these costs have been minimized through private ownership.

91. Booth, *supra* note 32, at 635.

ship interest for the possibility of shirking or opportunistic behavior by their managers, while managers who are owners do not. As a consequence, managers can pay a market premium for the ownership of a publicly held corporation without sacrificing the potential gains available to them.

Public shareholders undoubtedly must discount the value of the shares to account for the risk of unfaithful agents. At issue, however, is the size of the discount and how compelling an explanation it is for management buyouts. Before an assessment of its merits, the argument needs some refinement. For some firms, the shareholders' discount for agency costs is overshadowed by advantages in the capital markets of selling equity versus debt; otherwise no companies would ever be public. The argument must be then that some firms are mistakenly in the wrong category; they are public and should be private because the discount for agency unfaithfulness is no longer offset by advantages in the capital markets. The managers of these firms rectify the mistake through a management buyout.

Refined in this way, the argument does not seem to be a compelling justification for buyouts. As noted in the discussion on the agency cost position, compensation packages and penalties for managers' performance that are tied to stock prices can reduce the risk of unfaithful managers and, therefore, reduce the discount associated with the company's stock. Since finding sound compensation packages is one obligation of the managers of publicly held companies, accepting agency unfaithfulness as a justification for management buyouts seems to sanctify or even encourage poor performance by managers in public firms. It is difficult to believe that any discount for management unfaithfulness that is inherent to public corporations, once appropriate compensation packages and penalties are in place, explains the size of the premiums in management buyouts, which on average exceed forty percent.[92] Moreover, and probably more importantly, because many management buyouts are soon followed by the firm going public at a price far in excess of the buyout price,[93] it is hard to attribute the buyout premium solely to the benefits of eliminating a discount for potential management faithlessness.[94]

The final justification is a more refined version of the agency cost problem. While the fourth justification focuses primarily on lazi-

92. *See* Jensen, *supra* note 2; DeAngelo, DeAngelo & Rice, *supra* note 33 (discussing premiums paid to shareholders).

93. *See, e.g., Round Trips, supra* note 26; *Beatrice Buy-Out, supra* note 26.

94. The argument is reduced to the advantages of reducing the risk of agency unfaithfulness for some major corporate restructuring during the transition phase, which is not a very satisfying explanation.

ness—managers work harder when they are owners—this justification focuses on the risk preferences of typical managers. Managers are confronted with a high risk business decision that they are unwilling to take as agents of a public corporation but are willing to take as owners.[95] In other words, managers will not accept the risk unless they are compensated with a larger slice of the return per dollar invested than they would receive if they undertook the gamble in their current positions as salaried executives. Almost all management buyouts involve radical changes in the business. Recapitalizations that double or triple debt, major adjustments in the management team, the sale of major assets, or the bust-up of the firm itself carry substantial risks. Buyout groups demand substantial returns for assuming substantial risks.[96]

Modern finance theory postulates that managers are more risk averse than most shareholders because managers cannot diversify their

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95. Oftentimes this business opportunity may take the form of selling off several divisions of the firm. The divestment of businesses may be an integral part of the buyout proposal, or it may be a response to competitive pressures in financing higher bids in an auction contest. *See, e.g.*, *Buyout of Burlington Industries Inc. May Force Firm to Become Much Smaller*, Wall St. J., May 22, 1987, at 6, col. 2. Many companies have been enormously successful in executing a buyout and financing the transaction through such sales. *See Beatrice Buy-Out*, *supra* note 26. This sum-of-the-parts-greater-than-the-whole result may be a consequence of the failed diversification efforts of many firms for which their stock prices have been penalized, resulting in substantial profit opportunities from removing the misfitting pieces. *See* Coffee, *supra* note 10, at 30-35 (stating that excessive corporate expansion creates profitable divestiture opportunities); Main & Thackray, *The Logic of Restructuring*, PLANNING REV. May-June 1987, at 5, 6; *Diversification Blues*, MERGERS & ACQUISITIONS, May-June 1987, at 13 (summarizing study by McKinsey & Co. which indicates that most firms' attempts at diversification by merger are failures); Brooks, *Some Concerns Find that the Push to Diversify Was a Costly Mistake*, Wall St. J., Oct. 2, 1984, at 33, col. 4. Additionally, undertaking a series of divestitures as a private company does not leave the seller open to hostile offers as it accumulates cash from the proceeds of tbe sales of the divisions. In order for managers to maintain the same degree of safety in a similar sell-off of divisions of a publicly traded corporation, managers might be forced to resort to erecting various blocking devices of which recent court decisions have taken a dim view.

96. For a description of several situations in which the risks associated with a highly leveraged capital structure have threatened the stability of LBO transactions, see Loomis, *supra* note 29.

An alternate explanation to the risk/reward trade-off portrays managers as more benevolent. With so much money at stake, however, one should be immediately skeptical of self-laudatory claims of benevolence in MBOs; such claims are not often made, but they deserve some attention. Managers claim that they are reluctant to change so radically the riskiness of the firm without the explicit, well-educated assent of all the participants. Fairness dictates that those public shareholders that bought stock before the decision, most likely assuming that the firm would continue to act in a more routine fashion, should be cashed out at a premium over market and the firm left in the hands of a sophisticated small group of investors who understand and are explicitly willing to take the risk of the radical change in the firm. Of course, all shareholders could sell on the announcement of a major business change regardless of a buyout, and in the end the managers best claim is only the protection of those few shareholders who sit on their hands (not bothering to monitor the firms' business) unless jolted to attention by a one time premium over market price to get out. But do such shareholders deserve protection? They have factored the costs of inattention into an equation that favors other uses of their time.

investment of human capital in an employing firm;[97] that is, managers cannot work for a diversified group of twenty firms.[98] Moreover, much of their compensation is firm-specific as well, consisting of stock option plans and other corporate fringe benefits.[99] Most managers do not have enough other investment wealth to diversify adequately their concentrated investment in their employing firm. As a consequence, managers suffer firm-specific risk (unsystematic risk) that other shareholders can avoid more easily by maintaining a diverse investment portfolio, although shareholders must pay managers to accept such risks. Moreover, managers, within broad boundaries imposed by the monitoring capability of the shareholders, faced with specific business choices will favor alternatives that sacrifice expected value for less variance in outcome, to the detriment of the interests of their shareholders.[100] The conflict is the most pronounced when the choice on the table is dramatic; that is, when it involves a radical deviation from past business practices. The choice is a high risk, one-time gamble with high stakes.

How do shareholders encourage their managers to take the high risk gambles that hold positive expected values? The best choice is a redivision of the gains from the gamble so that managers get a larger return per dollar invested. Shareholders get less than they would get if the managers would take the gamble as salaried employees without a redivision of the gains, but managers may refuse to do this for the high risk business decisions. However, if shareholders are willing to accept some redistribution of gains, they still may get more than they would if the managers do nothing and the gains are never realized, which is the more likely scenario for the high risk gambles.[101] The redivision of gains

97. For a summary of this position, see Coffee, *supra* note 10, at 15-23. Of course, this lack of diversification is exacerbated by stock purchase programs and option plans—and is taken to the extreme in MBOs.

98. There are a variety of reasons for the development of firm-specific labor investments (which also explain why firms hire employees rather than use independent contractors for some functions). One important reason is tbat many employees are most valuable when they specialize; that is, they develop firm-specific knowledge on the job. Firm loyalty created by allegiance to one master often has advantages as well. *See generally* Jenson & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537 (1981).

99. *See* Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J.L. & ECON. 375, 389-90 (1983).

100. *See* Marcus, *Risk Sharing and the Theory of the Firm*, 13 BELL J. ECON. 369, 373-75 (1982); Note, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147, 1174 (1985).

101. A simple numerical example, which ignores the time value of money and assumes public shareholders have diversified unsystematic risk out of their portfolios, clarifies the point of redividing the gains from a radical change in firm's businesses. Managers in a publicly held corporation, which has one million common shares outstanding each priced at $2, note that a restructuring and partial liquidation adding suhstantial debt to the company's capital structure has a 55/45 chance

can be accomplished in a variety of ways; but management buyouts are currently a popular method of paying managers specially to accept, and even to seek out, the risk of major business restructurings, which suggests that buyouts are often the most efficient method of redividing gains.[102]

of making or losing $1 per share. The shareholders' expected value of the restructuring is a positive, $0.10 per share (55% x $1 minus 45% x $1), and the restructuring should be undertaken (assuming there are no alternative investments with an equal or greater return which are equally or less risky). The managers, however, are more risk-averse than the corporation's shareholders because they are undiversified; their income or wealth is entirely a function of the corporation's fortunes (assume, for example, that management's salary and bonuses are a function of stock price with income increasing or decreasing $100,000 for every dollar of increase or decrease in stock price). If, because of risk aversion, managers attach greater importance to the loss of $100,000 than they do to a gain of an equal amount (assume that in terms of the current probabilities for success the loss is viewed subjectively as $125,000) managers will perceive the restructuring differently than shareholders. When management calculates its private expected value of the restructuring (with the loss seen as $125,000 and the gain only $100,000) it finds that it is a loss of $1250 (55% x $100,000 minus 45% x $125,000). Obviously management will not wish to undertake the restructuring. If, however, shareholders could agree to pay managers an additional $10,000 from their gains if the restructuring succeeds, the expected value for shareholders would still be a positive $0.095 per share, while the expected value for the management team would be a *gain* of $4250 (even with the potential loss weighted at $125,000) (55% x $110,000 minus 45% x $125,000). If this type of gain sharing is allowed to take place, it is much more likely that a transaction that benefits public shareholders will be undertaken. In many situations there will be a range of side payments that could he made from shareholders to managers that may leave both groups better off.

102. To continue the example from the previous footnote, the managers offer to buy the 1,000,000 shares held by the public for $2.20 per share, or $0.20 over the current market price. Assume the managers have aggregate savings of $200,000 to invest in the firm's stock. The financing for the proposed buyout is to come from unsecured debt in the amount of $2,000,000 (purchase price of $2,200,000 less a $200,000 equity investment) with interest at 20% annually. After management has purchased the public's shares, the corporation's debt-to-equity ratio will be much higher and both positive and negative financial results from the restructuring and partial liquidation will be magnified. If the restructuring succeeds and the value of each share of the firm increased by $10, management now owns a corporation with a value of $3,000,000 ($3, multiplied by 1,000,000 shares). If, at this time, management were to complete the liquidation of the corporation, the debt of $2,000,000 could be repaid, along with $400,000 interest, leaving the owner-managers with $600,000. Subtracting their $200,000 equity investment, managers find that the buyout restructuring combination gives them a 55% chance of earning a net $400,000. On the negative side, if the restructuring fails (a 45% chance), managers may now lose their $200,000 equity stake in the firm. Calculating the expected value of the buyout restructuring transaction we find that management expects to earn $130,000 (55% x $400,000 minus 45% x $200,000). By executing the buyout, however, managers become less diversified and more risk averse. Because of the relative sizes of the potential gains and losses, managers may more than double the subjective weight attached to the negative outcome (a failed restructuring with the resulting loss of the $200,000 equity investment now has a subjective value of a negative $400,000, for example) and still find that they have a positive expected value ($40,000 in this example). Recall that in the previous note risk aversion was reflected in a 25% increase in the subjected value of the loss. Even though the managers are less diversified (they have a greater percentage of their assets invested in the firm after the buyout than before), and are therefore more risk averse, they will effect the buyout and, through the private firm, undertake the restructuring. The managers' expected value for the restructuring, even adjusted for increased risk aversion, is positive. Because most managers are risk averse, and risk preferences are personal and nonlinear functions, an exact calculation of the risk/reward trade-off necessary to effect a buyout beneficial to both management and public shareholders cannot be

In management buyouts top executives get a higher rate of return and assume a higher risk (they put a higher percentage of their personal assets at risk in the firm), but presumably the degree of the increase in return exceeds the degree of the increase in risk for an enhanced expected value per dollar of investment. Shareholders get some positive returns for selling the firm to the managers, because the managers will act and the shareholders assume no risk for the success of the act, which is better than holding shares in a corporation which does nothing at all that is risky. In other words, shareholders are better off selling the firm to their managers and collecting a slice of the gains created in extraordinary transactions than collecting nothing. The argument works at the margin, creating gains when managers will not make major business changes unless offered a better rate of return than what they would receive as salaried executives for accepting the considerable risk of some major business transformation. The justification suggests that management buyouts will depend on the risk preference curves of the managers, that is, their attitudes toward high risk, high return opportunities.

This theory of management buyouts also explains why so many recapitalizations and other major business restructurings occur in response to the threats of third-party hostile tender offers. The appearance of a hostile bidder, willing to buy the firm and undertake

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made a priori by outside observers. *See* R. HAUGEN, MODERN INVESTMENT THEORY 155-65 (1986) (discussing the capital asset pricing model and risk return trade-offs faced by investors). We wish to show only tbat tbe benefits to management of executing a buyout may exceed the costs in the form of increased risk, and that buyout transactions may produce gains for both the buyout group and the public sbareholders.

An MBO may be more efficient than a straight side payment from sbarebolders to managers because of tbe coordination costs for shareholders and, perhaps, in particular situations, because the institutional investors that purchase the junk bonds sold to finance the restructuring may have greater risk spreading ability for tbe radical business change than the shareholders (one can speculate about why—did the debtholders deliberately assume the risk that shareholders may not have contemplated?). Consider tbe process necessary to effect a side payment. In our example, when the restructuring and partial liquidation opportunity arises, assume the firm is operating normally with conventional compensation for its managers. For the shareholders to effect a side payment that induces managers to undertake the project, the shareholders must inform themselves of the opportunity a free rider situation, meet and decide on a payment, and negotiate with their managers over the payment terms. In addition to the practical problems there is tbe political problem of convincing shareholders that they should pay their own managers "extra" for exploiting a firm opportunity. One could counter, perhaps, with an argument that some type of *ex ante*, contingent bonus provision in an employment contract would seem to be more efficient because a firm could tbereby avoid shifting risk onto a more risk averse party such as managers. Yet the difficulty of fine tuning such a general bonus provision to cover optimally particular opportunities may be insurmountable. That is, a general bonus provision may encourage too much or too little risk taking given a specific opportunity. Therefore, as an alternative to a shareholders meeting and discussing a bonus for *a specific* opportunity (incurring huge transaction costs), the managers are permitted to buy the firm.

some major corporate restructuring that the managers themselves are reluctant to do, alters the target managers' risk calculations. In this new environment, if target managers do nothing their firm-specific human capital may be devastated by their ouster from the corporation. Managers in this situation have three possible means of protection. First, they can attempt to thwart a hostile takeover through defensive antitakeover measures. These measures, however, are currently disfavored by the courts and in many cases have been of limited effectiveness.[103] Second, managers may attempt a buyout of the company by offering a higher price to shareholders; in effect, the one-time, high risk gamble has been forced upon managers by putting their investment in human capital at stake. Or third, managers may undertake a recapitalization to increase share prices, while simultaneously thwarting the hostile bidder and preserving their positions.[104] The restructuring alternative carries less risk than a buyout but still presents a significant change that would be unpopular with risk averse managers unless they were pressured into the transaction. The evidence indicates, however, that even the radical restructurings undertaken by managers in defense of takeovers increase stock prices.[105] Unless target managers are successfully shielding the market from the true nature of the risk of these restructurings, which is a doubtful assertion,[106] shareholders must not consider the newly assumed risks from the restructurings to be excessive.

III. Court Regulation of Management Buyouts

The tarnished reputation of management buyouts makes litigation over pending deals inevitable and investor groups now routinely expect and prepare for court tests of their transactions. The courts have accepted the responsibility for evaluating the fairness of the investor group's treatment of the public shareholders and have demanded both proof of procedural fairness in the price negotiations and proof of the fairness of the price itself.[107] Courts recognize that the potential for

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103. *See supra* notes 11-12 and accompanying text.

104. *See supra* note 2.

105. The stock market has responded favorably to financial restructurings that are target managers' defense to unwanted takeovers. Jensen, *supra* note 2, at 325; *see also* Magnet, *Restructuring Really Works*, Fortune, Mar. 2, 1987, at 38 (reporting that a study by a Morgan Stanley & Co. economist concludes that recent restructurings have increased productivity).

106. Moreover, if the argument hinges on managers hiding the true facts from the market, this is something that target managers presumably could do without a radical business change.

107. This two-pronged analysis stems from the now famous case of Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). Commentary on the *Weinberger* case has been extensive. *See, e.g.*, Berger & Allingham, *A New Light on Cash-Out Mergers:* Weinberger *Eclipses* Singer, 39 Bus. Law. 1 (1983); Herzel & Colling, *Establishing Procedural Fairness in Squeeze-Out Mergers After* Weinberger v. UOP, Inc., 39 Bus. Law. 1525 (1984) [hereinafter *Herzel & Colling I*]; Herzel & Colling, *Squeeze-Out Mergers in Delaware-The Delaware Supreme Court Decision in* Weinberger

abuse comes from the managers' greater access to information concerning the firm, their ability to color the disclosed information, their ability to time the offer opportunistically, and their dominance in setting the ultimate price for the buyout.

In recognition of potential abuse on the part of a management buyout group, and the difficulty of ascertaining a "fair price," courts have placed greater reliance on the market system's ability to establish a fair price for the public shareholders.[108] Courts have facilitated this pricing mechanism by attempting to stimulate auctions, or at least arm's length negotiations, for target corporations through procedural mechanisms.[109] These efforts have focused primarily on striking down blocking activity that places third-party bidders at a disadvantage to the management buyout group. With barriers to price competition removed, courts can be more comfortable with even an unopposed man-

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v. UOP, Inc., 7 CORP. L. REV. 195 (1984); Payson & Inskip, Weinberger v. UOP, Inc.: *Its Practical Significance in the Planning and Defense of Cash-Out Mergers*, 8 DEL. J. CORP. L. 83 (1983); Prickett & Hanrahan, Weinberger v. UOP: *Delaware's Effort to Preserve a Level Playing Field for Cash-Out Mergers*, 8 DEL. J. CORP. L. 59 (1983); Thompson, *Squeeze-Out Mergers and the "New" Appraisal Remedy*, 62 WASH. U.L.Q. 415 (1984); Weiss, *Balancing Interests in Cash-Out Mergers: The Promise of* Weinberger v. UOP, Inc., 8 DEL. J. CORP. L. 1 (1983) [hereinafter *Weiss I*]; Weiss, *The Law of Take Out Mergers:* Weinberger v. UOP, Inc. *Ushers in Phase Six*, 4 CARDOZO L. REV. 245 (1983); Note, *Approval of Take-Out Mergers by Minority Shareholders: From Substantive to Procedural Fairness*, 93 YALE L.J. 1113 (1984).

108. Courts are wary, as well they should be, of examining the intricacies of corporate valuations. *See, e.g.*, Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 280 (2d Cir. 1986). For an overview of some of the complexities involved in corporate valuations, see V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 1-78 (2d ed. 1979). Unfortunately, courts that have ventured into the valuation quagmire have done so without sufficient navigational tools to find their way to a financially sound result—often using dated valuation methods or approaches that do not conform to the norms of the investment community. While the Delaware Supreme Court made a significant move toward eliminating the rather arbitrary and primitive "Delaware Block" valuation method in *Weinberger*, 457 A.2d at 708, courts have continued to apply this method for lack of much additional guidance. Moreover, parties anticipating litigation continue to adopt the "Delaware Block" method as a safe means of valuation. *See, e.g.*, Rosenblatt v. Getty Oil Co., 493 A.2d 929, 934 (Del. 1985).

While this Article proposes emphasizing procedural aspects to allow as great a role as possible for the market mechanism to function in setting a transaction price, *see infra* text accompanying notes 110-26, it is of even greater importance to encourage the investment banking community to render unbiased and diligently prepared fairness opinions both to protect shareholders and, so far as possible, to remove from the courts the burden of actual corporate valuations. This proposal seeks to create a mechanism to accomplish this objective and to establish the court's role as one of evaluating the reasonableness and comprehensiveness of a challenged valuation rather than revaluing the company *ab initio.*

109. In *Weinberger* the court, in addressing the aspects of procedural fairness, noted among the relevant factors to consider: the timing of the offer, how the offer was initiated, how it was structured, how it was negotiated, and how the offer was disclosed. 457 A.2d at 711; *cf.* Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264 (2d Cir. 1986); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); *see also Weiss I, supra* note 107, at 49 (argning that arm's length negotiations may be most effective means by which to arrive at a fair price).

agement proposal because one can argue that potential competitors stayed away simply because they could not meet the management group's price.

A. *Removing Barriers to Price Competition*

Management buyout transactions have proven very useful in stimulating auction markets for corporate control under circumstances in which they might not otherwise have occurred.[110] However, several of these auction contests have been tainted by a board of directors' attempting to give the buyout group a heavy advantage in the bidding through lock-up options,[111] no-shop clauses,[112] break-up fees,[113] and other defensive devices. Managers claim the favoritism is necessary to protect non-shareholder interests in the firm or to create the highest financially secure bid. The second rationale can be either strategic, *i.e.*,

110. *See, e.g.*, *Revlon*, 506 A.2d at 177-79; *Morgan Stanley Raises Burlington Bid to $78 a Share, Topping Hostile Offer*, Wall St. J., June 11, 1987, at 4, col. 2; *Bilzerian Lifts Pay 'N Pak Bid To $220 Million*, Wall St. J., June 10, 1987, at 18, col. 3; *Offer Is Lifted For Burlington Industries Inc.*, Wall St. J., May 28, 1987, at 10, col. 1; *Fruehauf Gets Sweetened Bid From Edelman*, Wall St. J., June 27, 1986, at 3, col. 4; *see also* Lowenstein, *supra* note 32, at 735-39 (noting that examination of 28 recent management buyout proposals revealed that the target's shareholders benefited from an auction market for control of the company, and that the benefit increased significantly with the introduction of multiple bids).

111. Lock-ups are structured most frequently as an option for a bidder to purchase a business or division of the target at a bargain price should the option holder fail to acquire the target as a result of a higher bid by another suitor. Courts have frowned upon these arrangements in several important instances because they have deemed the option price too low to justify the increase in the favored suitor's bid price, or because the agreements have been undertaken without knowledge or investigation on the part of the directors as to what an appropriate price should be. *See Hanson Trust PLC*, 781 F.2d at 271 (describing situation in which Merrill Lynch/management group refused to increase buyout bid in the absence of a lock-up option; court held directors did not undertake adequate investigation of pricing prior to granting option); *Revlon*, 506 A.2d at 179-80; *see also* Note, *Lock-Up Options: Towards a State Law Standard*, 96 HARV. L. REV. 1068 (1983); *Storer Board Accepts $2.51 Billion Bid From Kohlberg Kravis Spurns Comcast*, Wall St. J., July 31, 1985, at 2, col. 3 (lock-up granted to management buyout group despite higher competing offer).

112. No-shop clauses are agreements entered into between a favored bidder and the target's board of directors that prohibit the directors from actively seeking other bids as alternatives to the buyout group. The clauses are usually phrased so as to limit the directors' assistance to alternative bidders to the minimum necessary to avoid breach of the directors' fiduciary duties to the shareholders. *See, e.g.*, *Edelman*, 798 F.2d at 891; *Revlon*, 506 A.2d at 179. *See generally* Bryer & Vlahakis, *Enforcement of No-Shop Clauses*, N.Y.L.J., Dec. 10, 1984, at 33, col. 6.

113. Break-up fees (also called "goodbye kisses") are fees paid to investment bankers, who structure and arrange financing for MBOs, upon the failure of the buyout attempt. Buyout participants urge that tbese fees are necessary in order to induce investment bankers or leveraged buyout specialists to undertake the expensive process of putting together a buyout bid wben another suitor is already pursuing the target corporation. *See* Lowenstein, *supra* note 32, at 742. While such break-up fee arrangements are now quite common, some courts have found them abusive when undertaken in conjunction with other measures designed to assist a management buyout group. *Edelman*, 798 F.2d at 885 (court invalidated break-up fees of $30 million); *Revlon*, 506 A.2d at 181 (court invalidated cancellation fee of $25 million).

the favoring device is necessary to stimulate a bid that otherwise would not be made, or protective, *i.e.*, the favoring device protects shareholders against bidders with shaky financial backing.

Observers of tender offers should be immediately suspicious of the justifications for favoritism by the target's board of directors toward the management buyout group. If any of these justifications is sincere, one should expect to see firms favor third-party bidders over management buyout groups, particularly when a third party promises superior protection for non-shareholder interests, when incentives are necessary to stimulate higher third-party bids, or when the management group's financing is inferior to the financing of third-party suitors. Yet the management group is invariably the recipient of the target board's preferences. Moreover, in several notable instances the board's favoritism has been bestowed upon the buyout group for minimal additional consideration. As a consequence, most courts have not hesitated to strike down arrangements that privilege the management buyout group.[114]

Support for the courts' skepticism of board behavior that favors management buyouts goes beyond a disbelief in the sincerity of the justifications for board favoritism. The arguments, even if sincere, are problematic. The notion that a management buyout better protects the interests of non-shareholder constituencies such as labor, creditors, and local citizenry simply does not comport with the evidence. Management buyouts are typically the opening salvo in a process of major corporate restructuring. Creditors dread the heavy debt burden management

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114. In *Hanson Trust PLC* the court granted a preliminary injunction against a lock-up option that was to entitle the buyout group to buy two highly valued divisions of the target at bargain prices. While the court acknowledged that an inherent part of a lock-up is a bargain price, the court still found that the directors had breached their fiduciary duties, not by receiving too little consideration in the form of a higher bid—though the court made it clear that it believed this to be true—hut rather because the directors lacked any adequate basis upon which to conclude one way or the other that the price was within the range of fair values. *Hanson Trust PLC*, 781 F.2d at 275, 282-83. The court also concluded that the directors breached their fiduciary duties by using the lock-up tactic to foreclose further bidding without considering the ramifications of their actions. *Id.* In *Revlon* the target's board of directors ended an auction contest for control between a hostile bidder and a management buyout group by granting a no-shop clause and a lock-up option on one of the company's most valuable assets. *Revlon*, 506 A.2d at 176-79. Following the reasoning of *Hanson Trust PLC*, the court found that the directors had shut down the auction in return for only a slight increase in the management buyout groups' bid, and had done so when the board had reason to believe that the hostile suitor would still top the most recent management buyout bid. *Id.* at 183. *Edelman* follows this same line of reasoning in holding that once the company is up for sale, directors have a duty to maximize the price paid to shareholders and may not cut short an auction contest by granting a lock-up without adequate consideration being added to the buyout groups' bid. *Edelman*, 798 F.2d at 885. Further, the board granting the lock-up must hold a reasonable belief that no higher bids would otherwise be forthcoming in the absence of the lock-up. *Id.*

buyouts create.[115] Employees are released,[116] divisions are sold,[117] plants are relocated,[118] and parts of the firm are taken public again.[119] In short, there are no guarantees that a management buyout will protect non-shareholders' interests that are not consistent with management's interests.[120] Moreover, even if non-shareholder interests get protection,

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115. *See* Bleiberg, *Bondholders, Unite!: Issuers Are Getting Away with Highway Robbery*, BARRON'S, Nov. 24, 1986, at 9, col. 1; Farrell, *Takeovers and Buyouts Clobber Blue-Chip Bondholders*, BUS. WEEK, Nov. 11, 1985, at 113 (stating that 27% of Moody's 134 downgrades of corporate bonds in 1985 resulted from takeovers).

116. *See* Merwin, *The Price*, FORBES, June 17, 1986, at 106 (indicating that three-quarters of Thatcher Glass's 4400 employees were fired during course of failed management buyout).

117. *See, e.g.*, Sloan, *A Manager Rescues the Money Movers*, FORBES, Dec. 17, 1984, at 50, 58; Waldman & Freeman, *supra* note 43 (buyout group finances transaction by selling the company's most efficient plant).

118. Sloan, *supra* note 117, at 58.

119. *See Round Trips*, *supra* note 26; *Beatrice to Take Its Non-Food Lines Public, Sources Say*, Wall St. J., May 7, 1987, at 37, col. 1.

120. Professor John Coffee supports limited assistance to management buyout groups in competition with third-party hidders as a method of protecting deferred compensation earned under an "implicit contract" between the company and the management team. Coffee, *supra* note 10, at 90-91. Professor Coffee argues that hostile tender offers make possible involuntary wealth transfers from managers to shareholders. When the new owners release the target corporation's managers and pay target shareholders a handsome premium for the privilege, the target shareholders, in essence, are breaching "implicit" compensation agreements under which managers sacrifice current income for long-term security and deferred payments. Faced with the loss of this deferred compensation, the target managers will seek to buy control of the firm. Professor Coffee notes that managers can protect themselves *ex ante* with a variety of possible contract covenants (*e.g.*, severance agreements), but suggests that the best protection may be an *ex post* "settling up" through a management buyout. Coffee, *supra* note 10, at 85. He concludes that financial assistance to a management buyout group, perhaps in the form of break-up fees promised to investment bankers structuring the deal equal to the allowable severance pay that otherwise could be offered the entire management team, should not be offensive.

We have several reservations about this argument. First, Professor Coffee seems to overvalue the efficiency of *ex post*, open-ended "settling up" procedures as a method of protecting against a breach of obligation. *Ex post* "settling up" procedures themselves, if not carefully conditioned *ex ante*, provide occasion for opportunistic behavior that may be only marginally related to the breached obligation. *Ex post* behavior does not depend on unenforceable *ex ante* agreements; it depends solely on the possibilities for opportunistic hehavior in the *ex post* setting. Specifically, all managers, even those who are not disadvantaged by breaches of implicit compensation agreements, will take advantage of whatever leniency the law gives them in leveraged buyouts. Even those managers who have not reached an implicit bargain for deferred compensation (that is, they have been paid their full value for as long as they have been with the corporation) or those managers who have adequate severance pay packages will make use of rules favoring a management buyout if a hostile bidder appears and if they are better off in the future as owner-managers, regardless of the effect on shareholders. On the other hand, not all managers are included in MBOs and some managers who are victims of a breach of an implicit contract may not be aided by an MBO (indeed, they may be made worse off). In sum, *ex post*, open-ended "settling up" procedures can be very crude devices; they can be used by those who are not deserving, and if not controlled *ex ante*, they can provide one party an opportunity for gain out of proportion to any losses suffered. Sbareholders, given the choice, would seem to be foolish to prefer such open-ended "settling up" procedures to more concrete severance provisions.

Second, Professor Coffee relies on an impressive empirical study to support his argument that managers defer compensation early in their careers in hope of collecting large salaries in later which constituencies are protected? There are no assurances that one non-shareholder constituency will not align itself with management to the disadvantage of other non-shareholder constituencies. In the end, alternate forms of direct protection—retraining subsidies for unemployed workers, for example—are preferable and more predictable salves for any economic dislocation caused by corporate restructurings.

The second principal argument for devices that disadvantage third-party bids is that favoritism towards the management buyout group is in the best interests of the shareholders. Target boards can block one bidder when its financing is shaky or assist other bidders who will not bid at all absent the encouragement. Whether a justification for favoritism based on one bidder's shaky financing ought to be persuasive depends on, first, how often the argument is misused to front simple greed and, second, whether the shareholders can protect themselves. Informed shareholders may choose not to tender their shares if an offer has poor financial backing, and target managers have the opportunity to publicize their views on the financing behind any of the bids. Moreover, shareholders can sue after the fact if a tender offer promises more value than it delivers.

Furthermore, the strength of a justification for blocking one bidder or assisting another as a strategic measure to stimulate an auction depends on whether such strategies succeed more often than they fail, which is the frequency of error given conscientious managers.[121] Argua-

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years. Assuming this to be true, however, there are two explanations: The first is offered by Professor Coffee, that managers have a reasonable expectation for claiming deferred income. The second explanation is, we submit, more realistic. Young managers accept undercompensation because they are buying into a form of lottery. They realize that they will not all become CEOs, executive vice-presidents and the like, and that some will not be able to cash-in their tickets. But the prospect of a huge payoff itself has value, and young managers are willing to exchange some current salary for it. If they lose, it is not a breach of a promise but rather the harsh result of the employment lottery. At most, one could argue that the terms of the lottery may be changed by a takeover or MBO, but this assumes that managers "buy" their tickets with no appreciation of the pace of change in management theory in American business. In the history of American business this year's optimal management structure is last year's stifling, inefficient bureaucracy; to expect these rules of promotion to remain fixed over time is foolhardy.

121. Ideally, managers will use the assistance of a friendly buyout group, or a blocking mechanism, to slow a hostile suitor and gather negotiating strength necessary to stimulate a higher bid for the company. Such intervention by managers has historically proven beneficial to shareholders in the form of higher premiums paid upon an actual takeover. However, the full abnormal returns earned by shareholders hold only through the realization of failure if an offer is unsuccessful and dissipates thereafter. If target management successfully deflects all offers for the firm—whether hostile or friendly—shareholders will lose the premium that had attached to the target's stock price upon announcement of a bid for the company. Bradley, Desai & Kim, *The Rationale Behind Interfirm Tender Offers: Information or Synergy*, 11 J. FIN. ECON. 183, 189-98 (1983) (noting that stock returns to its pre-offer price within two years after a tender offer has been defeated); *cf.* Comment & Jarrell, Two-Tier Tender Offers: The Imprisonment of the Free-Riding Shareholder 2 (Mar. 1, 1986) (unpublished manuscript) (in interpreting SEC data, authors found premiums in

bly, lock-ups and leg-ups and the like can induce higher bids if these devices are offered at opportune moments. These moments occur when a potential bidder balks because it must incur additional costs before it can decide whether to bid, and the probability of getting outbid is high. In theory, by favoring the reluctant bidder, the seller can reduce the new, would-be bidder's risk of losing the costs associated with making the bid, which induces the new bidder to make an offer for the target and perhaps participate in a potential auction.[122] The strategy has the most merit when a potential bidder has not yet entered a bid at all, rather than when all bidders are in the contest and the bidding has stopped. It is more likely that in the latter case the costs are "sunk,"[123] and the bidder needs no more encouragement to bid because it has simply reached its reservation price.[124] Thus, if there are no net transaction costs to further bidding—and the possibility of making profits on stock bought in anticipation of the tender offer can make this true for all the bidders—then the strategy of favoring any one bidder is a waste of resources.

Even in situations that might otherwise call for management intervention, the strategy of blocking or assisting bidders in order to stimulate an auction still has three substantial drawbacks. First, the target board must make an accurate assessment of the willingness of the existing high bidder to rebid. The most powerful incentive to bid is a total lock-out of any other bidders because this, in essence, fixes the price of winning. Before the target board can make a lock-out offer, however, the board must be convinced that no other bidder is willing to outbid

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excess of 50% for negotiated offers and even higher premiums for contested offers); Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 15-16 (1983) (summarizing studies). Thus, from the shareholders' viewpoint, resistance by management should be favored so long as managers are not successful in defeating the bid entirely; although if a leveraged recapitalization is the result of a defeated bid, shareholders may also fare well. *See supra* note 2.

122. *See* Carney, *Two-Tier Tender Offers and Shark Repellents*, 4 MIDLAND CORP. FIN. J. 48, 50 (1986) (discussing reluctance of the second bidder to incur costs).

123. Once costs associated with an investment have heen incurred, they are "sunk" and are no longer relevant to a forward looking investment decision. For example, if Company X spends $10 gathering information to help it decide whether it should bid to buy Company Y, and finds that its gains from acquiring Company Y will be only $5, it should not net the informational costs against the potential gain and reject the investment. The information costs have been incurred and are now irrelevant. As long as the acquisition will produce positive gains (disregarding costs of capital and other financing considerations), Company X should purchase Company Y. Likewise, once a bidder has entered into an auction contest to buy another company by making an initial bid, most of its information gathering costs are sunk costs, and the incremental costs of raising its bid—payments directly to shareholders plus future investment banking and legal fees—are the only costs relevant in determining whether to continue in the contest for control.

124. *See Oesterle I*, *supra* note 11, at 152.

the reluctant bidder's new offer.[125] Moreover, the need for a lock-up occurs only if the reluctant bidder believes it will be outbid, and thus the target board and the reluctant bidder must be in disagreement over the willingness of the current high bidder to rebid. Second, the availability of devices that favor bidders encourages strategic bluffing on the part of all bidders, which places a premium on the board's ability to discriminate between fact and fiction.[126] A second bidder willing to bid should always attempt to play the role of the reluctant bidder to gain assistance in the auction. And third, if boards are able to use lock-ups and leg-ups to encourage second bidders, the prospect of encountering these devices may discourage first bidders as well. First bidders also must decide whether to invest in discovering and evaluating takeover candidates, and they may underinvest if there is the threat that target boards will give significant aid to potential competitors; an auction may mean that the first bidder would never recoup its initial investment costs.

In sum, the courts appear to have adopted a sensible approach towards management buyouts. They appreciate the difficulty of discriminating between a bidding strategy sincerely aimed at upping the bid by favoring a reluctant bidder and a bidding strategy that amounts merely to self-serving favoritism. Courts also appreciate the likelihood that even a sincere board frequently will misplay given the opportunity.

B. *The Independent Negotiating Committee*

If competing bids are not present then the board of the corporation whose management has proposed a buyout has more discretion in approving the transaction. In most firms the management team holds a sizable position on the corporation's board of directors, which means that uncontested management buyout transactions, along with more traditional cash-out mergers, always raise a significant possibility for improper self-dealing on the part of management.[127] In these circum-

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125. Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 275, 282-83 (2d Cir. 1986) (holding that plaintiffs had shown a likelihood of proving that the target board had breached its duty of care both by failing in its duty to investigate the pricing of the lock-up option and by using the lock-up option to foreclose additional bidding); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

126. *See Oesterle I*, *supra* note 11, at 152.

127. In Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), the Delaware Supreme Court set forth the foundation for evaluating transactions in which directors' judgment may be impaired by divided loyalties:

> When directors of a Delaware corporation are on botb sides of a transaction, they are required to demonstrate their utmost good faith and tbe most scrupulous inherent fairness of the bargain. The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, be has the burden of establisbing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.

stances the courts have fashioned an important role for the "disinterested outside director."[128]

Initially, courts were willing to certify management buyouts with a showing that the transaction was approved by a board consisting of a majority of "disinterested outside directors" or through the establishment of an independent negotiating committee to act exclusively on behalf of the public shareholders.[129] While in practice little difference may exist between the deliberations of outside directors and those of an independent negotiating committee, the independent committee can have important advantages in minimizing the influence of buyout group participants by creating a formal barrier between full board deliberations and committee deliberations. Placing squarely on the shoulders of committee members the responsibility for the decision of whether to approve a buyout may also minimize the committee's deference to the opinions and expertise of inside directors. Furthermore, establishing an independent committee may encourage committee members to retain independent investment and legal counsel. Independent negotiating committees are not a panacea, however, and may even serve shareholders far worse than more informal decisions by outside directors if the formation of a committee causes courts to relax their scrutiny of committee decisions.

While the independent negotiating committee as currently envisioned by the courts is a positive development, its employment has lacked substance in some transactions that recently have made their way to court.[130] By their very nature, independent committees, as currently constructed, are probably not well suited to put up a tough fight for shareholder interests. The outside directors who comprise the committee are invariably friends of the insider directors, and the committee members have very little to gain from fighting hard for a higher buyout

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Id. at 710 (citations omitted).

128. A comparable role for outside directors exists when management is accused of using takeover defenses as entrenchment devices. Courts look to the deliberations of the board of directors in approving the defense when evaluating the extent of management's conflicting interests. *See, e.g.*, Polk v. Good, 507 A.2d 531 (Del. 1986); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

129. Like the two-pronged test of the fairness of management buyouts, much of the significance that attaches to independent negotiating committees can be traced to the Delaware Supreme Court's opinion in *Weinberger* and the subsequent analysis hy commentators. In the course of finding that a majority shareholder had not dealt fairly with the minority shareholders in a cash-out merger, the court noted in dicta that "[a]lthough perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors." 457 A.2d at 709 n.7. For a discussion of the role of the independent negotiating committee and suggestions for refining the composition of such committees see *infra* notes 165-81 and accompanying text.

130. *See, e.g.*, Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986).

price.[131] Furthermore, in some of the closer cases involving management buyouts, it is entirely uncertain exactly what weight the presence of the currently formulated negotiating committees will carry, if any, beyond a prima facie meeting of the preliminary duty of good faith and reasonable investigation.[132]

Courts should look for five specific events in their evaluation of the performance of any independent committee of outside directors: first, the absence of blocking behavior;[133] second, the willingness of the committee to solicit outside bids; third, the committee's reliance on expert advice; fourth, the committee's access to all information material to a proper valuation of the corporation; and fifth, evidence of serious deliberations by the independent committee.[134]

131. Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1106 (Del. 1985) (questioning "quick surrender" hy special committee when price was at low end of range advised as fair by separately retained investment advisors); *cf. Herzel & Colling I, supra* note 107, at 1534-37; *Weiss I, supra* note 107, at 50-53.

132. *Compare Weinberger*, 457 A.2d at 709 n.7 *and Rabkin*, 498 A.2d at 1106 n.7 *with* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 938 n.7 (Del. 1985) (court oddly referred to a three member team that included two members of management as an "independent bargaining structure" in context of a cash-out merger and added that "such a committee is not essential to a finding of fairness").

133. *See supra* notes 110-26 and accompanying text.

134. This monitoring can be overdone, however, encouraging committee meetings to become choreographed shibboleths. In Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985), a class action brought by shareholders of the target of a cash-out merger, the Delaware Supreme Court held that the deliberations of directors were not adequate to inform them of the merits of the transaction that they subsequently approved. The directors' judgment was not wrong; rather it just was not exercised, and thus, the court held the directors personally liable to the shareholders. The directors were not afforded the protections of the business judgment rule because their decision was held to be "not the product of an informed business judgment." *Id.* at 864. While the facts of the case are not entirely clear, the court's interpretation and holding put a premium on formalism in the boardroom. *See* Manning, *Reflections and Practical Tips on Life in the Boardroom After* Van Gorkom, 41 BUS. LAW. 1 (1985) (listing the do's and don'ts for directors in evaluating proposed control transactions as implied by the *Van Gorkom* opinion). There should not be a magical number of hours directors must spend in deliberations nor a specific minimum quantity of documents they must read. Courts need to keep in mind that the decision to act without information is itself a business decision that involves balancing costs and benefits. Overly rigid criteria, like time spent in meetings, do not aid analysis and create dysfunctional behavior. On the other hand, the case does much to encourage directors to obtain fairness opinions from independent financial advisors (unfortunately the encouragement comes in the form of an *in terrorem* threat of personal liability to directors). *See Trans Union Corp.'s Ex-directors to Settle Suit for $23.5 Million,* Wall St. J., Aug. 2, 1985, at 18, col. 3.

An article by Professor Daniel Fischel termed the case "one of the worst decisions in the history of corporate law." Fischel, *The Business Judgment Rule and the* Trans Union *Case,* 40 BUS. LAW. 1437, 1455 (1985). The article makes light of the one positive effect the case may have: "Firms will have no difficulty finding an 'expert' who is willing to state that a price at a significant premium over the market price in an arm's-length transaction is 'fair.' (I wish someone would pay me several hundred thousand dollars to state that $55 is greater than $35.)". *Id.* at 1453; *see also* Herzel & Katz, Smith v. Van Gorkom: *The Business of Judging Business Judgment,* 41 BUS. LAW. 1187 (1986). Some value may be salvaged from the case, however, if, through the use of specially formulated negotiating committees and clearer standards of accountability for investment advisors,

C. *The Management Buyout Group's Obligation to Disclose its Reservation Price*

In *Revlon v. MacAndrews & Forbes Holdings, Inc.*,[135] a bidding war broke out between the hostile suitor, Pantry Pride, and a buyout group consisting of Revlon management and Forstmann Little & Co. Each bidder raised its offer to shareholders three times before the court ended the bidding war. With each subsequent bid, the buyout group justified its offer as "fair" to the shareholders. This is not uncommon.[136] The buyout group probably was following the normal bargaining procedure of not putting its reservation price on the table so that it could maximize its profits by purchasing the company as cheaply as possible.[137] Thus the buyout group walks the line between making offers that are "fair," while not revealing what it ultimately is willing to pay. Shareholders, of course, demand that their managers disclose their ultimate valuation of the company; from the shareholders' perspective, the valuation is inside information, gathered from superior access to corporate data.[138]

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the fairness opinions now so essential to such transactions can be given more substance than they currently carry.

135. 506 A.2d 173, 177-78 (Del. 1986).

136. *See, e.g.*, Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d. 264 (2d Cir. 1986); *see also supra* note 60 (regarding the bidding for Viacom International, Inc.). In the buyout of National Gypsum, Inc., management's initial offer was for $1.1 billion—30% above the market price. Wickes countered the management bid with its own offer of $1.46 billion. Just as quickly, however, management topped the Wickes price with a bid of $1.64 billion—a 50% increase over its original bid. Gogel, *supra* note 2, at 31. If management can easily raise its bid for a billion dollar company by 50%, it is very difficult to see how the original bid could have been "fair" to shareholders.

137. The bids of other parties can also change the buyout group's reservation price—the buyout group may increase its estimate of the firm's value after they know why others think it is valuable.

138. The general rule is that whenever a corporation or its insiders buy stock from the firm's shareholders, the buyers must disclose to the sellers all information on the firm that a reasonable investor would view as significant in his deliberations. *See* TSC Indus., Inc., v. Northway, Inc., 426 U.S. 438 (1976) (defining materiality under proxy disclosure requirements). *But see* Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540 (2d Cir. 1967) (holding that in a cash tender offer an outside bidder did not have to disclose to other stock purchasers facts it deduced from published information about the target and its plans for using the target's resources). One could argue, perhaps, that reservation prices are simply predictions of a firm's future performance and, as such, are more misleading than helpful. The SEC's position on the disclosure of "soft" information and projections has changed substantially in the last ten years. *Compare* Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972) (stating that the SEC's position is that projections and other soft information are likely to mislead investors) *and* Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222 (1971) *with* Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5,992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756 (Nov. 7, 1978), *rescinded in* Sec. Act Release No. 33-6384 (March 3, 1982) (guidelines for disclosure of projections); Note, *The SEC Safe Harbor for Forecasts—A Step in the Right Direction?*, 1980 DUKE L.J. 607; *see also* Note, *Mandatory Disclosure of Corporate Projections and the*

The issue is interesting because it tests the limits of the definition of inside information. The traditional generic descriptions of the term, based on the source of the information and whether or not the information is "material," are not very satisfying. Protecting reservation prices from disclosure, for example, with a claim that they are not "material" to investors does, at minimum, a gross injustice to common sense and the English Language. Yet if courts hold that shareholders are entitled to the management group's reservation price, two undesirable side effects will result. First, management groups will lose much of their incentive to discover and fund management buyout opportunities if they can make only break-even bids for a firm. As a consequence, shareholders will lose the benefits of selling to management groups or to the other bidders that appear in response to a management buyout. Second, management groups will have a heavy incentive to cheat; that is, to find ways of creating and supporting false reservation price positions with legitimizing documentation and other evidence. One wonders about the power of courts to wander through these carefully constructed mazes.

On the other hand, the management group should not be able to shield certain information that is clearly material to the size of the management group's bid, such as new corporate advances in technology, growth in market share, or other material developments. The corporation's shareholders or their representatives are commonly understood to have a right to know this kind of information and to share in the profits this information generates. Between not disclosing a reservation price and disclosing hard information are some very difficult questions. For instance, does the management group have to disclose soft, buyer-specific information such as its predictions of the firm's earnings potential or its estimates of asset values? One could argue that all management analysis, including an actual reservation price, should be disclosed, or, on the other hand, that standards should be set that create larger areas of privileged information. For example, two supportable positions are: (1) that any management analysis of the firm as a publicly held corporation should be disclosed, while any management analysis of the firm as restructured after the buyout (the buyout plans) is privileged; or (2) that all management analysis is privileged. Whatever standard is cho-

Goals of Securities Regulation, 81 COLUM. L. REV. 1525 (1981). Securities Act Rule 175, 17 C.F.R. § 230.175 (1987), and Exchange Act Rule 3b-6, 17 C.F.R. § 240.3b-6 (1987), create a safe harbor for forward looking statements if the issuer makes the statement in good faith and with a reasonable basis. Projections that are overly optimistic still will trigger liability, however. *See, e.g.*, Eisenberg v. Gagnon, 766 F.2d 770 (3d Cir. 1985), *cert. denied*, 474 U.S. 946 (1985); Goldman v. Belden, 754 F.2d 1059 (2d Cir. 1985). Yet the argument that the information is a possibly misleading prediction overlooks the real value of a reservation price. The fact that the bidder has established a firm reservation price usually is more important to sellers than the predictions inherent in the price. The seller, knowing the buyer's reservation price, can extract maximum value.

sen, its application to specific facts will be inherently difficult.

The conceptual difficulties of defining disclosure obligations in many management buyouts stems from their hybrid nature; a management buyout has some of the characteristics of an issuer repurchase and an outside bid. In issuer repurchases, the consensus seems to be that there are heavy disclosure obligations because the issuer should not be able to strike opportunistic deals with its own shareholders, that is, deals that take advantage of asymmetric information about the firm itself. In bids by outside parties, however, the disclosure obligations are less demanding, although there is no consensus on how much less demanding. The bidder has spent funds to acquire valuable information, information that the sellers themselves often could also acquire (as shareholders or through their agents, the firm managers). To deprive the bidder of the fruits of its efforts would deter bidders from investing in the collection of information on potential targets and reduce the number of beneficial buyouts. A management buyout, however, has elements of both an issuer repurchase, because members of the buyout group are fiduciaries and have superior access to firm information as a result of their privileged position, and an outside bid, because the buyout group is a new entity purchasing control of the firm, often in competition with other bidders and, perhaps, even an existing control group. The legal history of the SEC's treatment of issuer repurchases and tender offers by outside bidders illustrates a hazy, and intermittent recognition of management buyouts' relationship to the basic conceptual dichotomy.

The SEC, sensitive to the problems of defining proper disclosures in issuer repurchases, attempted both in 1975 and 1977 to assume the authority to prohibit going private transactions through issuer or issuer affiliate repurchases that the SEC deemed "unfair."[139] Faced with criticism that the Commission had no authority to promulgate such a rule, the SEC adopted in 1979 a substitute rule, Rule 13e-3, that specifically requires the disclosure of itemized information and generally requires the disclosure of all material inside information.[140] The Rule applies to issuer or issuer affiliate repurchases if the effect of the repurchase is to eliminate a firm's reporting obligations under the 1934 Act. The rule

139. Notice of Public Fact-Finding Investigation and Rulemaking Proceeding in Matter of "Going Private" Transactions by Public Companies and Their Affiliates, Exchange Act Release No. 11,231, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,104 (Feb. 6, 1975); Going Private Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 14,185, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,366 (Nov. 17, 1977).

140. Rule 13e-3, 17 C.F.R. § 240.13e-3 (1987); Schedule 13E-3, 17 C.F.R. § 240.13e-100 (1987). Suspension of Duty to File Reports upon Termination of Registration, Exchange Act Release No. 16,078, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,168 (Aug. 2, 1979).

also requires, for example, the issuer/purchaser or buyout group to state whether it believes the transaction to be "fair or unfair."[141] In its instructions on substantive fairness, the rule lists several factors as relevant to determining whether the transaction price is fair, although the rule notes that the importance of these factors will vary with the particular transaction. The list includes the following factors: Current market prices, historical market prices, net book value, going concern value, liquidation value, price paid by managers in recent stock purchases, opinions or appraisals by outside parties, and recent offers by other buyers. A reading of the list permits the interpretation used by most investment bankers, which is that a "fair price" does not necessarily have to be the bottom line price of the buyout group. Moreover, there is no requirement that a fair price be "close" to the bottom line price.

Rule 13e-3 may have a limited application to management buyouts, however. The Rule applies only to issuer repurchases or repurchases by an "affiliate" of the issuer.[142] An affiliate is a person who "controls, is controlled by, or under common control" with the issuer.[143] The SEC bas noted that determinations of control are a question of fact and are "not limited to control obtained through ownership of equity securities."[144] Presumably, a CEO leading a management buyout group would qualify the group as an affiliate. If less powerful members of the management team participate in the buyout without the CEO, or the CEO is not a major participant in the buyout group, the group may not have the status of an affiliate.[145] Absent affiliate status, only in specialized cases, such as an asset sale followed by an issuer repurchase of all of its shares using the proceeds of the sale, will management buyouts by such groups require the filing of a Schedule 13E-3.[146]

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141. Schedule 13E-3, Item 8(a), 17 C.F.R. § 240.13e-100 (1987); *see* Comment, *Regulating Going Private Transactions: SEC Rule* 13e-3, 80 COLUM. L. REV. 782 (1980). Comment, *Rule 13e-3 and the Going Private Dilemma: The SEC's Quest for a Substantive Fairness Doctrine*, 58 WASH. U.L.Q. 883 (1980).

142. Rule 13e-3(a)(3), 17 C.F.R. § 240.13e-3 (1987).

143. Rule 13e-3(a)(1), 17 C.F.R. § 240.13e-3 (1987). The Rule also only applies to companies that report under §§ 12 or 15(d) of the Securities and Exchange Act. Repurchases by issuers and affiliates can also raise market manipulation problems under §§ 9 and 10 of the Exchange Act. Rule 10b-18 provides a safe harbor from the antimanipulation rules depending on trading volume and price.

144. Going Private Transactions by Public Companies of Their Affiliates, Securities Act Release No. 6101, Investment Co. Act No. 10806, Exchange Act No. 16076 (Aug. 2, 1979) (LEXIS, Fed Sec library, release file).

145. For example, after stating in the Release that affiliates of the seller can become affiliates of the purchaser through means other than equity ownership in multi-step asset sale transactions, the SEC notes, however, that it "would not view a person as an affiliate of the purchaser soley because such person enters into or agrees to enter into a reasonable and customary employment agreement or is elected . . . as an executive officer or director of the purchaser." *Id.* at n.6.

146. *Id.*

If the buyout is structured as a tender offer, however, the buyout group must comply with Rule 14d-1 and file a Schedule 14D-1,[147] if it is not an affiliate, or must comply with Rule 13e-4 and file a Schedule 13E-4 (in addition to a Schedule 13E-3) if it is an affiliate.[148] In sum, there are no specific disclosure schedules for management buyouts by nonaffiliates that do not involve a tender offer. Moreover, management buyouts by nonaffiliates that do involve tender offers are subject to the same specific disclosure schedules as tender offers by third-party bidders. Since the possibility of abuse of insider information and position by management buyout goups that are not technically "affiliates," although slightly less severe on average, approaches the potential problems in issuer repurchases, one would expect the SEC to give managment buyouts by nonaffiliates more individualized attention.

In any event, the major differences between Schedules 13E-3 for issuer repurchases and Schedule 14D-1 for third-party tender offers is in items 8 and 9 of Schedule 13E-3; these items have no specific corresponding disclosure requirements in the Schedule 14D-1. Item 8 of Schedule 13E-3 requires a statement on the fairness of the transaction with supporting rationale and includes a reference to item 9 that requires the disclosure of all reports or appraisals from outside parties "materially relating" to the fairness of the offer. In Schedule 13E-3, the issuer, as a fiduciary to the selling shareholders, must, in essence, disclose all its valuation information while outside bidders, using Schedule 14D-1, can presumably be more secretive. The courts, however, may not be sensitive to the difference, and may apply the same definition of "material" to both situations. The United States Court of Appeals for the Third Circuit, for example, has held that asset appraisals commissioned by an outside bidder should be disclosed, if the appraisals are made by unbiased experts after a thorough investigation.[149] If there is a

147. Rule 14d-1, 17 C.F.R. § 240.14-1 (1987); Rule 14d-100, 17 C.F.R. § 240.14d-100 (1987) (Schedule 14D-1).

148. Rule 13e-4, 17 C.F.R. § 240.13e-4 (1987); Rule 13e-101, 17 C.F.R. § 240.13e-101 (1987) (Schedule 13E-4). If the issuer is responding to a third-party tender offer with a share repurchase offer, then Rule 13e-1, 17 C.F.R. § 240.13e-1 (1987), also applies.

149. In the context of corporate control transactions regulated under the Securities Exchange Act of 1934, fair market value of assets may be a type of soft information that buyers must disclose. Flynn v. Bass Bros. Enters., Inc., 744 F.2d 978 (3d Cir. 1984) (Williams Act section 14(e) requires disclosure of asset valuations made by experts if material; more informal valuations by non-experts are not material and need not be disclosed). *But see* Radol v. Thomas, 772 F.2d 244, 253 (6th Cir. 1985) (asset appraisals need not be disclosed by bidders even though included in a Schedule 13E-3 filing—the court did not decide, however, whether the same reports *had* to be disclosed in the Schedule 13E-3); Starkman v. Marathon Oil Co., 772 F.2d 231 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986) (highly speculative valuations need not be disclosed by target in Schedule 19D-9 filing).

The argument tbat these nonexpert appraisals or overly "speculative" expert appraisals are real difference in the schedules, however, management buyouts may enjoy the luxury of the more lenient standard in Schedule 14D-1, depending on the composition of the buyout group and the structure of the transaction.

Neither a judicial approach, based on a unitary definition of "material" in all control contests, nor the SEC's approach, placing emphasis on control of the firm by the dominant members of the buyout group, is very satisfying. To the extent that a management buyout group acts on inside information and without serious intervention by nonparticipating managers or directors on behalf of the firm's shareholders, the buyout poses the same dangers as a large issuer repurchase of shares. If the buyout group acts largely on public information and is contested vigorously by a group of outside directors acting on behalf of shareholders, the buyout resembles a third-party offer. The SEC, and the courts, should focus on the specific character of the buyout process before deciding which disclosure obligations to apply to the particular transaction. There are many indications that the present disclosure tools are too crude. What follows is a discussion of identifying characteristics for buyouts that should be accompanied by disclosures under an issuer repurchase standard as opposed to a third-party tender offer standard.[150]

IV. Better Methods of Protecting Target Shareholders

A. *Increasing the Accountability of Investment Advisors*

The weak link in the protections afforded shareholders in management buyouts is the misuse of fairness opinions from investment advisors. The buyout group has an obvious interest in legitimizing low bids

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not material is unconvincing; reasonable investors would enjoy knowing about the appraisals in each case—both because of the informational value of the appraisals and because inside managers also have access to and may be relying on such appraisals. The courts seem enamored not with materiality but with the likelihood that investors will misunderstand and misuse the soft data disclosed. This explains why "informal" or "speculative" appraisals are considered suspect. The courts have not explained, however, why investors cannot be trusted to look out for their own interests and appropriately discount the more questionable appraisals.

More important, however, is that courts have missed the issue. Required disclosure of all formal detailed studies by experts commissioned by the outside bidder gives shareholders the value of the studies for free at the bidder's expense. The bidder will cease commissioning formal studies that calculate reservation prices in favor of informal, oral opinions and will instead commission general "fairness" studies based upon some generic concept of value when the transaction is finally brought before the shareholders. These latter studies have value to the buyout group in that they satisfy SEC rules and help convince shareholders that they should sell. Indeed, this accurately describes current practice.

150. In fairness, it should be noted that some buyout groups may file botb 13E-3 and 14D-1 schedules to avoid potential liability from making an improper choice between the two disclosure schedules.

as fair bids and will shop for formal letters of support from accommodating investment advisors.[151] Investment advisors, interested in fees that are often contingent on the success of the buyout,[152] compete with each other to satisfy their clients, the investor group. As a consequence, the fairness letters do not protect shareholders from overreaching by their managers; indeed, the fairness letters may be part of the fraud. Moreover, the harm goes beyond affirmative fraud, because shareholders also lose their single most important protection: access to honest and fully informed valuations of the corporation by reputable experts. The value of a diligently prepared fairness opinion goes beyond good advice on price; a conscientious expert will demand and analyze the kind of information it knows is material to a proper valuation. Therefore, the independent expert will act as an investigating agent who makes it more difficult for managers to conceal material inside information that may underlie the management group's offer.

Before discussing how fairness opinions should be used in management buyouts, there is an initial question of whether the market will itself negate the importance of misleading investment opinions solicited by management groups. One could argue that if management convinces unsophisticated shareholders to undervalue their shares in a buyout, two types of well-informed investors will appear. First, arbitrageurs, who profit from constant market vigilance, will appear and take positions in the stock anticipating a more active and more lucrative negotiation with the buyout group. The unsophisticated shareholders enjoy the

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151. Fairness opinions can provide both a back end and a front end rationalization for self-serving boards of directors. At the front end, the board can use a favorable opinion to convince shareholders that the leveraged buyout offer is reasonable. At the back end, the board can use the fairness opinion to defend shareholder lawsuits, relying on statutory language of the type contained in most corporate codes that shield directors and officers from liability when they reasonably rely on expert opinions. The provision in Tentative Draft No. 4 of the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations* is illustrative:

> § 4.02. Reliance on Directors, Officers, Employees, Experts, and Other Persons
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> In performing his duty and functions, a director or officer who acts in good faith, and reasonably believes that his reliance is warranted, is entitled to rely on information, opinions, reports, statements (including financial statements and other financial data), and decisions, judgments, or performance . . . prepared, presented, made, or performed by:
>
> . . . .
>
> (b) Legal counsel, public accountants, engineers, or other persons whom the director or officer reasonably believes merit confidence.

PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, 76-77 (Tent. Draft No. 4, Apr. 12, 1985). The defense of reliance on an expert is not absolute, but it is strong evidence that the board acted reasonably. *Cf.* Longstreth, *Reliance on Advice of Counsel as a Defense to Securities Law Violations*, 37 BUS. LAW. 1185, 1187 (1982); Sherrard, *Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases*, 62 VA. L. REV. 1, 7-8 (1976). Presumably, those directors who affirm a leveraged buyout offer are entitled to the protections of the statute, but those officers and directors who are participants in the LBO are not.

152. *See, e.g.*, Stein, *supra* note 24.

price increase created by the arbitrageurs' purchasing activity and, therefore, are relatively protected from management fraud. Second, other buyers will appear to compete with the management group in an auction for control of the firm. The auction will drive the sale price to appropriate levels regardless of the misleading fairness opinion. The argument assumes, however, that arbitrageurs and other potential purchasers can create accurate valuation reports on their own, which in turn assumes that they have access to all material information on the worth of the firm at the time of the buyout.[153] Since managers who are members of the buyout group have a substantial interest in blocking others from obtaining accurate valuation information, such an assumption is likely to be incorrect. Important is the recognition, however, that normal market activity can be a mechanism for protecting shareholders that supplements other more formal devices like independent negotiating committees.

In sum, the cornerstone of procedural fairness and price fairness in management buyouts is honest, informed, and complete[154] fairness opinions. If all management buyouts must be accompanied by honest, informed, and complete fairness opinions, the following developments will results: Arbitrageurs and potential alternate purchasers will have the data to form their own assessments of the company's stock—even if they reach different conclusions; independent committees, if formed, will better represent the interests of the shareholders; and finally, managers in the buyout group will be subject to a higher level of accountability, even absent an independent negotiating committee.

To insure procedural and price fairness in management buyouts, all buyout proposals should be accompanied by at least one fairness opinion, drafted by reputable financial advisors who are paid without respect to the success of the buyout and who have no financial stake in the buyout itself. The opinion should contain not only a price evalua-

153. As the pricing of takeover bids and MBOs has become more competitive, there have been increasing calls from bidders to provide equal information to all serious offerors. A bidder may offer one price if no nonpublic information is provided, that is, the offer is based only on publicly disclosed financial reports, and a higher price if tbe target opens its books to inspection by the bidder and provides more detailed information not previously disclosed to the public. *See, e.g.*, Gibson & Kotlowvitz, *Jacobs's Minstar Proposes to Purchase Borg-Warner for as Much as $3.8 Billion*, Wall St. J., Nov. 26, 1986, at 2, col. 3 (indicating that tender offer price level contingent on target showing bidder accounting information).

154. "Complete" in this context means that management must not only make an offer judged "fair" by its investment bankers, but must also disclose the information underlying the opinion and the circumstances leading up to the rendering of the opinion. *See infra* notes 155-69 and accompanying text; *see also* Kohn v. American Metal Climax, Inc., 458 F.2d 255, 268-69 (3d Cir.) (investment bankers failed to disclose conflict of interest in rendering fairness opinion), *cert. denied*, 409 U.S. 874 (1972); Berkman v. Rust Craft Greeting Cards, Inc., 454 F. Supp. 787, 791-93 (S.D.N.Y. 1978) (investment bankers used only data supplied by management).

tion but also a detailed explanation of the data and assumptions behind the estimate, as well as the methodology employed.[155] Since there is the danger that fairness opinions can be so general and so qualified that they convey no information (*i.e.*, "one could find a fair price between five and one hundred dollars per share depending on one's view"), the drafters of the opinion should be pushed ultimately to a "yes" or "no" recommendation on any one price.[156] Finally, the opinion should be made public a week or so in advance of the commencement of the management buyout tender offer so that the firm's shareholders and other potential bidders have time to digest and respond to the information.

To insure that the fairness opinion is legitimate, the drafters of the opinion should be liable to the corporation, as fiduciaries, for any opinion that is drafted under a conflict of interest[157] or without adequate investigation or thought.[158] The creation of a fiduciary obligation (to

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155. In a competitive market tbe underlying data for tbe evaluation may be much more important than the rendering of a single price figure as the valuation process can be extraordinarily complex and very subjective. *See, e.g.*, Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RES. J. 875, 890-93 (discussing complexities of the valuation process). Accordingly, two or more investment advisors, working diligently and in good faith, can arrive at quite different valuations for a corporation. *See* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 271 (2d Cir. 1986). It is thus of primary importance to alternate bidders, sbareholders, and courts if called upon, to work with as equal as possible financial statements and reports to set prices or to evaluate diligence and fairness. *Cf.* Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986). Indeed, much of the controversy in Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), stemmed from an internal study, which found that a price of up to $24 in a cash-out of the minority shareholders would be a good investment for the majority, that was not disclosed to directors who approved a $21 cash-out price. *Id.* at 709.

156. This recognizes, however, that liability should attach only for those opinions that are found to be flawed for lack of comprehensiveness or unsound methodology. Investment bankers would be given some leeway around any one price affirmation as a consequence of the difficulty in arriving at a single price for a target corporation, so long as a showing of reasonable investigation into the facts is made and a sound methodology is employed. For a description of some of the complexities in performing valuations in the buyout context, see Golz, *Valuation and LBOs*, BUYOUTS & ACQUISITIONS, Sept.-Oct. 1986, at 41.

157. *See supra* notes 20-22 and accompanying text. These conflicts of interest should include fees contingent on the success of the buyout, equity participation in the buyout group, and placement or underwriting of debt to finance the buyout. Evidence that management had promised to direct unrelated future business to the investment banking firm if the opinion conformed to management's specifications would also constitute a basis for finding that the fairness opinion was tainted by a conflict of interest. *Cf. Weinberger*, 457 A.2d at 712 (stating that disclosure of circumstances leading to rendering of investment bank's opinion is relevant in determining fairness of price).

158. In the absence of information revealed through pre-trial discovery that expressly conflicts with the analysis of the investment advisors' fairness opinion, the standard would he one of negligence—that is, reasonable diligence and use of a methodology recognized as proper for valuing a company in a given industry by other members of the investment banking or appraisal community. *See Hanson Trust PLC*, 781 F.2d at 275, 278 (describing case in which methodology employed for valuing a business recognized as improper by other investment banking firms); Joseph v. Shell Oil Co., 482 A.2d 335, 344 (Del. Ch. 1984) (citing questionable methodology employed in rendering valuation). Likewise, investment bankers must have some responsibility for determining

supplement the contractual obligation) recognizes a higher primary duty of the investment advisors to the corporation and allows for the application to advisors of established doctrines of duty of loyalty, duty of care, and waiver of liability. Damages for a breach of an investment advisor's fiduciary duty should be equal to the shareholders' loss attributable to the negligently rendered fairness opinion, limited, perhaps, by a percentage of the total firm value.[159] Moreover, the rendering of a defective fairness opinion should provide grounds for appropriate injunctive relief. Suit can be brought by the board or by the shareholders in a classic shareholder derivative suit—simultaneously providing shareholders with a monitoring mechanism while still retaining an established means for separating strike suits from legitimate claims of shareholders on behalf of the corporation.[160]

Consistent with recent developments in officer and director liability, waiver or indemnification of liability provisions[161] should be applicable to the board's purchase of the fairness opinion, but only under tightly controlled circumstances. First, the board of directors cannot agree in contracts with the advisors to waive the advisor's duty of loy-

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the reasonableness and accuracy of the data upon which the fairness opinion is based.

159. The effect that this liability standard would have upon the investment banking fees necessary to procure a fairness opinion is uncertain. Investment bankers are aware of the increasing importance of fairness opinions and have seen the amount of litigation surrounding all other aspects of merger and acquisition activity increase. A rational response to these changing conditions would seem to dictate that fairness opinions be priced with respect to both the costs of gathering and analyzing information, as well as the risk of litigation. A formal standard for liability, or at least a more enforceable standard, would probably increase the risk premium incorporated into the price of the fairness opinion. In any event, relative to the total fees involved in structuring and financing a large management buyout, the price of obtaining a fairness opinion will remain small.

160. Some commentators have suggested that a fiduciary duty be created running from the investment bankers rendering the fairness opinion directly to the corporation's shareholders. *See, e.g., Fairness Opinions, supra* note 31, at 121 nn.11 & 13. This would apparently allow any individual shareholder to sue if they believed the fairness opinion to be defective. We believe that the balance struck between the strike suits that the establishment of this fiduciary duty would trigger and the greater monitoring that might be available through more broad based shareholder monitoring of buyouts cuts in favor of using the traditional derivative suit procedures to screen shareholders' claims for relief. Litigation already is rampant in the area of management buyouts. Increased independence and power for shareholders' negotiating agents on a special committee, coupled with the possibility of shareholder derivative suits, should be sufficient to police adequately the merits of fairness opinions. *See* Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745 (1984) (the derivative action is a cost-effective means of deterring opportunistic behavior by agents, most significantly nonrecurring "one shot" breaches of fiduciary duty).

161. The traditional approach was to separate indemnification and waiver issues, but commentators now recognize that these approaches to limiting or shifting liability costs can be equivalents. *See generally* Oesterle, *Limits on a Corporation's Protection of its Directors and Officers from Personal Liability*, 1983 WIS. L. REV. 513.

alty[162] or to indemnify advisors for breaches of their duty of loyalty. Second, consistent with the modern view that a firm can waive a director's duty of care or indemnify a director for breaches of such duty,[163] a firm should be able to waive or indemnify advisor breaches of the duty of care under select conditions. Shareholders themselves can assent to waiver or indemnification.[164] The assent of the shareholders should be obtained for a specific transaction and not as a preliminary matter to all negotiations—that is, the board should not be able to seek a vote on a general waiver of liability for any and all future transactions that might affect corporate control. Absent a shareholder vote, only a "special negotiating committee" composed of disinterested directors[165] be able to execute waivers or indemnification agreements on the firm's behalf. Whenever the committee executes a waiver it should do so only on a specific finding that members of the committee have sufficient expertise and access to information to monitor the investment bank's rendering of the fairness opinion.[166] Whenever an advisor is rendering a fairness opinion under a waiver or indemnification of duty of care liability, specific and *conspicuous* disclosure of the waiver should still be presented to shareholders in the materials soliciting the tender of their shares to the buyout group.

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162. REVISED MODEL BUSINESS CORP. ACT § 8.31 (1984).

163. *See, e.g.*, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17, Limitation on Damages for Certain Violations of the Duty of Care 29-42 (Tent. Draft No. 7, Apr. 10, 1987); *see also* Pease, *Outside Directors: Their Importance to the Corporation and Protection From Liability*, 12 DEL. J. CORP. LAW 25 (1987).

164. If shareholders are to assent to a transaction with inherent conflicts of interest, such as a management buyout, a similar standard should govern approval of waiver or indemnification provisions associated with an instrumental part of the transaction such as obtaining a fairness opinion. The percentage of shareholder votes required for approval of such provisions would in fact determine the usefulness of the waiver or indemnification alternative. A good rule of thumb might be to require the same degree of shareholder assent as is required for approving director conflicts of interest. The Revised Model Business Corporation Act establishes the approval level for director conflicts of interest as a simple majority of shares entitled to vote. *See* REVISED MODEL BUSINESS CORP. ACT § 8.31(d) (1984).

165. For purposes of this proposal, we differentiate between an "independent negotiating committee" and a "special negotiating committee." The "independent committee" is composed simply of outside directors. The "special committee" we propose, *see infra* notes 177-81 and accompanying text, recommends adding additional shareholder-elected representatives to the traditional independent negotiating committee. The following discussion concerning the requisite disclosure and use of fairness opinions by a management buyout group, however, is generally applicable to buyouts carried out with or without either type of negotiating committee.

166. A disinterested board still might be liable for making negligent findings if it failed to exercise an informed business judgment.

B. *Strengthening the Independent Negotiating Committee Versus Requiring More Disclosure by the Buyout Group*

Two further recommendations to achieve fairness in management buyouts depend on the existence of a specially formed negotiating committee. First, absent the formation of a special negotiating committee, managers have an obligation to disclose to their shareholders the buyout group's final price evaluations[167] and their future plans for the firm. Second, managers have an obligation to dismantle all structural barriers to third party bidders—lock-ups, poison pills and the like—unless they are erected by a special negotiating committee. The managers' full disclosure obligation—in essence they must reveal their reservation price[168]—stems from their dual role as personally interested management buyout participants and as shareholder fiduciaries, and the supremacy of their fiduciary obligations. If managers want negotiating room, that is, if they want to be able to conceal and improve their bottom line position, managers must completely delegate their role as fiduciaries. Thus, if a special negotiating committee is established, then the purchasing managers do not have to release their final price evaluations or their plans for the firm once they have bought it, as long as the negotiating committee has all the material information relevant to a valuation other than the buyout group's plans for the firm.[169]

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167. While this might appear to discourage auction contests, the phenomena of a management buyout group continually increasing its bid in the face of competition for control by a third-party indicates that management's initial bid was less than that which might have been offered to shareholders if all available relevant information were disclosed. In any event, we would allow for an increase in the management buyout group's bid over any initial offer if a special negotiating committee were first established. The purpose of the rigid bidding position to be established for management buyout groups is, after all, simply a means of stimulating the formation of truly independent committees to negotiate on the shareholders' behalf prior to any buyout offer. The establishment of such a committee would then entitle management to withhold their plans for the firm's future and to reap any gains that might accrue from the implementation of superior management strategies.

168. There clearly is no such obligation under current state laws, even in the case of a majority shareholder cashing out the minority shareholders. *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 939 (Del. 1985); *cf. Herzel & Colling I*, *supra* note 107, at 1533-34. It is as yet unclear what standard will be used to scrutinize disclosures under the federal securities laws that call for inclusion of an opinion as to fairness and disclosures of appraisals and reports pertaining to valuation. *See* Schedule 13E-3, 17 C.F.R. § 240.13e-100 (1987).

169. If those plans should have been undertaken when the firm was publicly owned, the shareholders should have an after-the-fact remedy in a lawsuit for breach of fiduciary duty. Since these plans will inevitably become clear after the buyout, there is no need to disclose them on the eve of the buyout.

This Article's proposal envisions a role for committee members that apparently is greater than that currently played by many outside directors. *See generally* Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984). Accordingly, a system of compensation designed both to stimulate committee members to maintain a watchful eye over the firm and to ensure that committee members retain their independence would

The proposal has as one of its primary purposes the elimination of generic fairness opinions that exclude any evaluation of the particular situation of the buyout group. If there is no special committee, the buyout group must disclose its bottom line; it cannot hide behind a generic fairness opinion which claims that a substantially lower price is fair. If a special committee is established, on the other hand, there is no need for mandatory disclosure rules that require the buyout group to reveal its full negotiation range. The special committee can protect the shareholders' interests by soliciting independent fairness opinions from unbiased advisors. But the fairness opinion written for the committee by investment advisors financially unconnected to the buyout group should include an evaluation of the buyout group's negotiating posture, including inferences about the group's reservation price, based on whatever evidence about the buyout group is available. Although the buyout group is entitled to shield their individual reservation price, the special committee, and their advisors, have a duty to the shareholders to make recommendations that take into consideration estimates of the buyout group's particular negotiating situation.[170] It is nonsense for the committee's investment advisors to hide, as they currently do, behind general market evaluations of price when a specific buyer or buyers are in the picture and more specific evaluations of the buyers' plans for the firm are available.

The special negotiating committee should encourage third-party bidders in most cases, maintaining structural blocking devices only to

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need to be devised. Possible committee memhers who would already have an interest in the firm's affairs and yet might be suitably independent would include institutional investors, securities analysts, and business or economics academics.

170. While some might assert that any price paid to shareholders that includes a substantial premium over market price is "fair," we believe this unduly shortchanges the negotiating position of shareholders. If you are selling your car and locate a would-be buyer offering to pay a price at a premium over "fair market value" and subsequently learn that this potential buyer may be willing to pay even more than his initial offer because the car was once owned by his father, you are not likely to accept his initial offer simply because the price exceeds a "market value." Likewise, if shareholders believe that managers' premium-priced offer is at the low end of the range of prices management would be willing to pay for the corporation, shareholders should have a negotiating mechanism that allows them to try and obtain a price closer to the top of the range. Simply stated, "fair value" is dependent on the particular negotiating posture of the parties, not on whether the offering price is at a premium over market price.

Apart from a misunderstanding of what shareholders "should be happy with," a rule that disables shareholders from claiming full value for their shares has serious costs. The heaviest cost will come from the shareholders' own efforts to extract full value, using whatever techniques they can, to avoid the rules (the equivalent of the creation of a gray market in a time of price control on retail goods). Shareholders will spend up to the lost value of their property in order to extract full value for their shares. This is a heavy social cost. For example, target shareholders that are prohibited from holding out for higher offers from bidders in tender offers will erect pre-bid defenses that divert bidders away from tender offers into other forms of negotiated mergers. *See Oesterle I*, *supra* note 11, at 126 n.43.

stimulate further bidding. Thus, structural blocking devices are not per se illegal, unless they are used to favor one bidder over another without significant increases in the favored offeror's bid.[171] Even blocking activity that is used to favor one bidder over another is not illegal when the activity is used to stimulate an increased bid by an auction participant when such a bid would not otherwise be forthcoming and when suitable consideration in the form of an increased bid is given for the advantage afforded the bidder.[172]

This framework is designed to balance bid incentives with the shareholders' right to the benefits of management's inside information. Current state law governing the negotiating process in management buyouts, when combined with the federal securities law disclosure system applicable to transactions under the Securities Exchange Act of 1934 Rules 13e-3[173] and 14d-1,[174] is inadequate because the information disclosed for the benefit of shareholders does not seem to be used in negotiating their payment in the buyout.[175] If the required SEC disclosures were effective in conveying to shareholders the values management hopes to produce from a buyout, shareholders would not leave large piles of money laying on the negotiating table—as they indeed appear to have done.[176] If the disclosure made in a management buyout is to be truly useful to shareholders, negotiating representatives who can and will use this information are needed. This fact points to the creation of special negotiating committees that are not merely composed of outside directors, but also include specially elected shareholder representatives. Unless shareholders' perceptions that they are being victimized by buyouts are changed through the establishment of a credible negotiating process, management buyouts may be legislated into

171. The quality of financing may be a grounds for favoring one bidder, althougb a better solution may be to inform the shareholders of the differences in financing and allow shareholders to make the ultimate decision at the tender offer stage.

172. *See supra* note 114 and accompanying text. The value of blocking behavior in stimulating further bids is vastly overrated and may itself create opportunities for strategic behavior by bidders. *See Oesterle I, supra* note 11, at 152.

173. Rule 13e-3, 17 C.F.R. § 240.13e-3 (1987).

174. Rule 14d-1, 17 C.F.R. § 240.14d-1.

175. Indeed, in many of the most controversial transactions, it appears that the outside directors read very few documents let alone securities filings. *See, e.g.*, Edelman v. Fruehauf Corp., 798 F.2d 882, 886 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisitions, Inc., 781 F.2d 264, 270-71 (2d Cir. 1986); *cf.* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). *See generally* Manning, *supra* note 169. Perhaps courts should investigate, in their evaluation of the role of outside directors in approving a management buyout, whether the outside directors have any familiarity with the SEC disclosures relevant to the transaction. If the answer is no, either courts must continue to scrutinize closely such transactions or the SEC should rethink the disclosure system governing buyouts.

176. *See supra* notes 26-29 and accompanying text (discussing the phenomenal profitability of many recent management buyouts).

obscurity. Both shareholders at large and the would-be owners of the public companies that would otherwise be taken private would suffer as a result.

Ultimately, whether a special negotiating committee will function properly will depend on how it is structured and compensated. Since several specific structural alternatives and compensation systems may be workable, the following is a possible combination. A special negotiating committee could include members other than outside directors who are initially appointed with the approval of the firm's chief executive officer.[177] The committee could consist of specially elected representatives, nominated by a committee of shareholders and elected by shareholders, who have no function other than to act in the event of major changes in corporate control. The optimal committee would consist primarily of members who owe no allegiance to the existing management team and who understand their role to be one solely of maximizing the value of stock prices in the event of a change in control.[178] The committee's ultimate compensation could depend upon a bonus system tied to the premium over market price that they negotiated for shareholders.[179]

Such a special negotiating committee would be encouraged to hire separate investment advisors, and legal counsel if necessary, to act

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177. Judge Richard Posner of the United States Court of Appeals for the Seventh Circuit viewed the prohlem as follows:

> When managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds, they have a clear conflict of interest, and it is not cured by vesting the power of decision in a board of directors in which insiders are a minority. . . . No one likes to be fired, whether he is just a director or also an officer. The so-called outsiders moreover are often friends of the insiders. And since they spend only part of their time on the affairs of the corporation, their knowledge of those affairs is much less than that of the insiders, to whom they are likely therefore to defer.

Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987).

178. The benefits of well-formulated special negotiating committees have been vividly demonstrated in several recent transactions. *See, e.g., Becor Western Gets Rival Bid by Lynch Corp.*, Wall St. J., June 3, 1987, at 22, col. 2 (competing management buyout transaction proposed after rival bidder approached by outside directors and their independent financial advisors); *BP Increases Bid For Standard Oil By $450 Million*, Wall St. J., Apr. 29, 1987, at 2, col. 2 (noting that a special committee of British Petroleum's board hired independent financial advisors and negotiated price of $7.9 billion in cash-out merger); *see also Purolator Board Member Quits to Solicit Bids*, Wall St. J., Mar. 13, 1987, at 9, col. 1; *How to Avoid Conflicts of Interest in the Takeover Game*, Wall St. J., Feb. 9, 1987, at 18, col. 3; *Owens-Illinois, in About-Face, Will Meet with Kohlberg and Any Other Suitors*, Wall St. J., Jan. 20, 1987, at 8, col. 2; *Owens-Illinois Officers, Outside Directors Said to Be Split Over Kohlberg Kravis Bid*, Wall St. J., Jan. 15, 1987, at 7, col. 1. This proposal is intended to bring these types of benefits to all transactions by formalizing the negotiating relationship between corporate management, outside directors, and shareholders in management buyouts and other control transactions that may be tainted by possibly abusive self-dealing.

179. *See Oesterle II*, *supra* note 11, at 67 (suggesting appointment by target shareholders of a special agent to negotiato with outside bidders in tender offer situations).

solely on behalf of the shareholders.[180] Formation of a properly functioning committee, and the committee's subsequent approval of a transaction, would entitle the board of directors approving the bid to the full protections of the business judgment rule.[181]

V. CONCLUSION

The increased frequency and size of management buyout transactions have given them new significance as a means of transferring corporate control. Along with this increased prominence, however, has come a greater awareness of the conflicts of interest that buyouts create for the management participants and their investment advisors. The problems have been highlighted in transactions in which management and other buyout participants have made millions of dollars on small investments during short periods of time. Shareholders naturally are led to believe they may have been shortchanged when they sold the company to their former fiduciaries.

This Article has proposed procedural changes in the execution of

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180. The objective of this proposal is not to add another group of investment bankers to the parade through the witness stand in the event of litigation, but to make sure that there is a qualified party available to committee members—whether they be truly "independent" or merely outside directors—to evaluate the financial merits of management's proposals. *See* Friedman, Gordon & Brown, *Representing the Public Company in a Going-Private Transaction, in* GOING PRIVATE 1984, 453 CORP. L. & PRAC. HANDBOOK 105, 108-110 (PLI 1984). Most outside directors that bave been found by tbe courts to have breached their duty of care were probably not acting in bad faitb, but rather did not appreciate the gravity of the decision they were employed to make, were not given information, did not understand the information given to them, or simply did not have the time to carry out properly their responsibilities to target shareholders given other obligations to tbeir full-time employers. *See* Manning, *supra* note 169. Creating strong incentives for the formation of a truly independent committee and for the subsequent retention of a second group of investment advisors will provide shareholders with at least a minimum required negotiating strength that may alleviate many of the problems that have come to the fore in recent cases.

181. The implementation of the business judgment rule into the analysis of transactions that raise the potential for self-dealing is now a function of establishing the board of directors' "good faith and reasonable investigation" prior to approval of antitakeover measures or control transactions. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986) (concluding that implementation of antitakeover measures creates potential conflict of interest which calls for preliminary test before business judgment rule will protect directors); Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (noting that when there is a potential conflict of interest, initial burden will lie with directors); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (noting tbat possible self-dealing creates an enhanced duty on part of directors that requires threshold test of "good faith and reasonable investigation" before protection of the business judgment rule is granted); *see also Hanson Trust PLC*, 781 F.2d at 273. This is a preliminary burden of proof that has been attached to corporate transactions with potential for abusive self-dealing that, when met, will leave the plaintiffs to establish their case in chief. This preliminary burden currently can be met by the board through a showing that the transaction was approved by a board consisting of a majority of "disinterested outside directors" or through the establishment of a special negotiating committee to act exclusively on behalf of the public shareholders. *Id.* at 274.

management buyouts to help assure shareholders' interests are represented adequately when a buyout is proposed and to provide more useful valuation information to shareholders' negotiating representatives. These changes will increase the strength of shareholders' negotiating position vis-a-vis the management buyout group. Providing a more formal process for buyouts with better representation for shareholders not only will allow shareholders to continue to realize the benefits of buyouts, but also will increase the accountability of investment advisors and management buyout participants.