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MANAGEMENT BUYOUTS: ARE PUBLIC SHAREHOLDERS GETTING A FAIR DEAL?

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I. Introduction

In management buyouts -- or "going private" transactions as they are also called -- do the current rules of the game adequately assure a fair deal for public shareholders?

In June 1983 Stokely-Van Camp mailed proxy materials to its shareholders, seeking approval of a cash buyout of all public shareholders by a group which included management. The buyout was to be accomplished through a merger with a newly formed private corporation which would borrow the necessary funds and secure that borrowing with Stokely's assets. The proposed purchase price of $55 per share was determined by an investment banking firm to be fair to Stokely's shareholders, from a financial point of view. The transaction was recommended, first, to the Board of Directors by a special committee of non-management directors, and, then, to the shareholders by the full Board, which concluded that the transaction was "fair and attractive."

Four weeks later Pillsbury made a cash tender for all Stokely shares at $62 per share. Yet Stokely's management did not embrace this higher bid. Three weeks later, Quaker Oats topped Pillsbury with a successful bid of $77 per share.

What does "fairness" mean, when management's idea of a "fair and attractive" price is increased in the marketplace by 40%. Of what value to shareholders are the blessings of management's opinion bestowed by investment bankers and non-management directors? These questions need to be addressed.

Of course, in Stokely, the ending was a happy one for the public shareholders. They got a higher price. But rather despite management's efforts than because of them. Fortuitously, the management group controlled only 22% of the outstanding stock, not enough to block a third-party bid. And both Pillsbury and Quaker Oats had done enough

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The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners or the staff. However, I am indebted to Linda C. Quinn, Associate Director of the Division of Corporation Finance, and D. Michael Lefever of my staff for their help in preparing this speech.

analysis of Stokely prior to its announcement to appreciate the inadequacy of its offer and move swiftly with bids of their own.

When management has a control block, the public shareholders may not be so lucky. Several weeks ago, while working on this topic, I got a call from an old college friend, whom I hadn't heard from for years. He is an investment adviser and was calling to complain about the management buyout of a corporation in which he and his clients were heavily invested. Having followed the company for many years, my friend believed the offer, while somewhat above the market, was substantially below true value. I suggested trying to find a third-party willing to make a higher bid. He had thought of that, but unfortunately the management controlled over 50% of the stock and was unwilling to sell.

He could go along, receiving what he believed to be an inadequate price, or exercise his appraisal rights under state law. He knew, however, that the appraisal route was costly and unlikely to be successful, because of the court's tendency to rely heavily on the pre-existing market price and the fairness opinions used by management to support its bid. He knew the market price was not indicative of the price a bidder would offer for the whole company, because it hadn't been for sale. Now it was, but only to management. Was it fair, he asked, for management to put the company up for sale, so arrange things that it was the only bidder, and then bless its own offer, with the help of friendly outsiders?

II. The Problem with Management Buyouts

In talking about these questions, it will help to define my terms. By "management buyout," I mean an attempt by the management of a public corporation, or some part of management, acting alone, or frequently with an investor group, to acquire all of the corporation's assets or all or enough of its stock to become a private company, free of the reporting requirements of the federal securities laws. This kind of transaction is also called a "leveraged buyout" or "LBO," when the company's assets collateralize loans used to finance the buyout.

For management, these transactions offer an opportunity to obtain a significant equity interest in its company. This enhanced stake in the enterprise may result in heightened productivity on the part of managers, achieving more efficient utilization of corporate assets and greater wealth

for the new investors.* Other reasons for going private include the avoidance of hostile takeover attempts, elimination of public disclosure requirements and other burdens under the federal securities laws, greater flexibility in management, including the chance to take greater risks, and, last but by no means least, the prospect of a bargain price.**

A management buyout also occurs when management of a division or subsidiary acquires that business from its parent corporation. Since this kind of buyout does not involve public shareholders, I do not intend to talk about it today.

LBOs have been the subject of widespread attention and debate since 1974, when A.A. Sommer Jr., then an SEC Commissioner, attacked the "going private" phenomenon in a seminal address at Notre Dame Law School.*** Following that speech, the Commission published for comment rules that would have imposed substantive fairness on management buyouts. Concerns about its authority to write such substantive rules forced the Commission to resort to an elaborate set of disclosure rules -- contained in Rule 13e-3 -- to address the problems identified by Mr. Sommer. This Rule was not finalized until the Summer of 1979. Since then, the volume of going private transactions, as measured by Schedule 13e-3 filings, has ranged from 133 to 169 transactions per year -- enough to warrant an assessment of how well the Rule is working. Perhaps of more significance, 1983 was at the high end of this range, confirming what professionals in the field see as a rapidly growing level of activity.****

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* Easterbrook & Fischel, <u>Corporate Control Transactions</u>, Yale L. J. 698, 705 (1982).

** <u>See</u>, <u>e.g.</u>, Brody, <u>Controversial Issue: A Leveraged Buy-out Touches Off a Bitter Dispute</u>, Barron's, at p. 15 (September 19, 1983) (describing the motivating factor of the Empire, Inc. buyout).

*** <u>"Going Private:" A Lesson in Corporate Responsibility</u>, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶80,010.

**** <u>See</u> Lederman, Citron & Macris, <u>Leveraged Buyouts -- An Update</u>, unpublished outline for presentation at the forthcoming 15th Annual Institute on Securities Regulation to be held on November 10-12, 1983 in New York, New York.

Recent transactions in which management's inherent conflict appears to be unsatisfactorily resolved reinforce the need for prompt assessment. Although the SEC's Advisory Committee on Tender Offers examined the adequacy of the SEC's regulatory system for takeovers in a report issued on July 8, 1983, it did not have time to undertake the needed assessment, nor did the report address the special problems of management buyouts.

What is special about a management buyout? It is simply this: management is acting on both sides of the transaction. In its fiduciary capacity, management is seeking to sell the corporation and, therefore, must have concluded that a sale is in the best interests of the shareholders. In its proprietary capacity, management is seeking to purchase the corporation, and must have concluded that it can do so at a price favorable to it. In short, management is dealing with itself.

Self-dealing problems have ancient origins. So too does the duty of loyalty evolved in response. Under venerable principles of common law, a trustee violated his duty of loyalty by purchasing trust assets for his own account, even with the consent of his beneficiaries, if, as the legal scholar Austin Scott puts it:

> "the trustee failed to disclose to the beneficiaries the material facts which he knew or should have known, or if he used the influence of his position to induce the consent, or if the transaction was not in all respects fair and reasonable."*

Of course, corporate law is not in every respect analogous to trust law, and management, while viewed as a fiduciary, is not a trustee in the classic sense. I submit, however, that the standard just quoted from Professor Scott's treatise on trusts expresses an appropriate policy by which to test a management buyout.

If we pass the current rules of play through this policy screen, we see that:

1. The need to have all material facts disclosed is addressed by the securities laws.

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* A. Scott, The Law of Trusts, Vol. 2, at 1298 (3d. ed. 1967).

2. The use of influence by management is handled, at least to some extent, through a committee of non-management directors and the fairness opinion of an investment banker.

3. It is the requirement that the transaction be "in all respects fair and reasonable" that poses the main dilemma.

If one turns to corporate law, one finds closely analogous principles among the leading cases. In Guth v. Loft, Inc.,* the Delaware Supreme Court said that "[t]he rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest." But Delaware law has not sought flatly to prohibit a self-dealing transaction, as some states have done by statute in the case of trusts. Instead, as the Delaware Supreme Court said recently in Weinberger v. UOP, "[w]hen directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain."**

In 1974 Mr. Sommers believed that fairness demanded a legitimate business purpose for going private. Public shareholders should not be deprived of their shares, absent such a purpose, even if they were paid an adequate price.

The theme of requiring a "legitimate business purpose" in order to justify a management buyout was blessed several years later by the Delaware courts. In Singer v. Magnavox,*** the Delaware Supreme Court held that a merger that eliminated minority shareholders constituted a breach of fiduciary duty to the minority unless it met the standard of "entire fairness" and did not have as its sole purpose a freeze-out of the minority. In other words, elimination of the minority had to be justified by a legitimate business purpose. Judicial scrutiny of whether a minority freeze-out serves an independent business purpose, however, was short-lived, at least in Delaware. In the 1983 case of Weinberger

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* 5 A.2d 503, 510 (1939).

** 457 A.2d 701, 710 (1983), citing Gottlieb v. Heyden Chemical Corp., 91 A.2d 57, 57-58 (1952).

*** 380 A.2d 969 (1977).

v. UOP,* the Delaware Supreme Court overturned the holding in Singer, reestablishing statutory appraisal rights as the basic remedy of a frozen-out shareholder:

> "In view of the fairness test . . ., the expanded appraisal remedy now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate, we do not believe that any meaningful additional protection is afforded minority shareholders by the business purpose requirement."**

This change seems to make sense. Motives are hard to probe. And there is social utility in promoting a free market for corporate control.*** The only reasonable expectation of a public shareholder should be that, if he is to be deprived of his interest, it be done in a procedurally fair manner and he receive fair value. The question remains whether the present rules adequately assure that the shareholder is given his due. Let's look at those rules more closely.

III. The Federal Level

At the federal level, the approach is chiefly one of disclosure. Rule 13e-3 requires management to express its "reasonable belief" as to whether the transaction is fair to public shareholders. While this requirement may prompt a somewhat better deal than might otherwise be offered, it by no means assures a fair deal. Indeed, given management's conflict of interest, one must question whether its "reasonable belief" as to the fairness of its own offer, or that of its group, provides any meaningful guidance for the seller. As Professors Brudney and Chirelstein have suggested, management will propose a price "as low as reasonable pessimism will allow."****

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* 457 A.2d 701 (1983).

** Id. at 715.

*** Easterbrook & Fischel, Corporate Control Transactions, 91 Yale L. J. 698, 705-8 (1982).

**** Brudney and Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 298 (1974).

Disclosure serves the goal of informed decision-making, which, in turn, rests on the notion that the decision-maker has viable alternatives. As my college friend quickly realized, in management buyouts, viable alternatives are sometimes lacking.

The disclosure approach provides no federal forum for contesting fairness.* If the material facts are disclosed, a dissenting shareholder will normally be limited to state law in seeking redress.

Rule 13e-3 also requires disclosure as to whether a fairness opinion was obtained, whether the non-management directors approved the transaction and whether ratification by a majority of unaffiliated shareholders is required. As so often is the case, these items of disclosure have tended to encourage the use of the practices required to be disclosed. This is no accident. When the Commission backed away from a substantive rule of fairness, it sought to achieve the same goal through the detailed disclosures required by Rule 13e-3. Perhaps ironically, these rules may have put the Commission's imprimatur on management buyouts, so long as these indicia of procedural due process are observed. The question, however, is whether, or to what degree, these procedures actually help to assure substantive fairness.

IV. The State Level

To deflect a successful legal challenge under state law, management typically employs a panoply of procedural protections, of which the three just mentioned are most prominent.

Fairness Opinions. The investment banking opinion serves as a keystone to this support structure. Reflecting the opinion of an independent entity with demonstrable expertise, it provides powerful support, both legally and practically, for the judgment of both the non-management

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* See Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 497 (1977) (holding that "manipulation" under Section 10(b) of the Securities Exchange Act of 1934, while "meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices," was not meant to cover instances of corporate mismanagement "in which the essence of the complaint is that shareholders were treated unfairly by a fiduciary.")

directors and the Board as a whole. Investment bankers do, on occasion, decline to render fairness opinions satisfactory to management. But this is more the exception than the rule. I do not question the good faith or professionalism brought to fairness opinions. The problem, as Stokely and other recent cases suggest, is simply that the range of fairness is too great to expect opinions to be a very good indicator of what a fair deal for shareholders might be. The proof is in the pudding. Or, in this instance, the market is the market.

This problem is exacerbated by the limitations that management often places on the investment banker's review. This practice may result in:

-- an excessive reliance on market price,

-- a failure to consider break up or liquidation values, and

-- a failure to shop the company to determine what a third party would pay.

For example, in one recent fairness opinion, the investment banker noted:

> "We were not requested to solicit and did not solicit other purchasers for [the corporation], the common stock of [the corporation] or the assets of [the corporation] as part of our engagement. If purchasers of [the corporation] were actively solicited or if the assets held by [the corporation] were liquidated in an orderly fashion, it is possible that a price in excess of the equivalent of $68 per share could be realized."

In another recent proxy statement, the fairness opinion of the investment banker stated:

> "However, in rendering this opinion we were not requested by [the independent committee] of the Board of Directors . . . to negotiate with [the private investors group] or to investigate or evaluate other alternatives to the Merger proposed by [the private investors group]."

This kind of disclosure, while theoretically useful to warn the shareholder that a higher price might be obtainable, is overwhelmed in the practical world by the professional's opinion that the price offered is, in fact, fair. This point emphasizes the problem with hinging so important a conclusion on what has become so imprecise a concept. Why shouldn't "fairness" in this context mean the highest price for the company reasonably believed by management and its outside advisors, after due investigation, to be obtainable?

I should point out that, in asking this question, I am aware of the fact that "shopping" can have serious adverse effects on the company, including the loss of key personnel and customers to competitors, who may be quick to point out that the company is "on the block." However, the management buyout proceeds from an initial decision by management that it is in the interest of shareholders to sell the company.

There is also at least the appearance of a problem in some cases, arising out of the method of compensating the investment banker. The fee may vary, depending upon who ultimately succeeds in a contested buyout, creating economic pressures to support management's judgment.

Outside Directors' Approval. Review by non-management directors also has defects. In the abstract this device ought to work. Outside directors, lacking a proprietary interest in the transaction, should be willing to look out for the interests of public shareholders. In practice, however, review by non-management directors often fails to give shareholders a fair deal. Outside directors are invited to serve, not by the shareholders who routinely vote for them, but by management or, in some cases, other outside directors. Often they have some business or personal connection with the corporation or its management. In any event, the relationship exerts on them a powerful force in support of loyalty to management. However subtle and implicit this force may be, its existence cannot honestly be denied. By the way, in speaking of loyalty, I am not suggesting a kind of wrongdoing, venality or anti-social behavior. Loyalty is a human quality -- one we typically applaud. Here it is simply a force to be noted.

If one adds to these tugs of loyalty the wide discretion accorded directors under the business judgment rule and the uncertain contours of the fairness concept itself, one must conclude that the blessing of non-management directors is not likely to assure substantive fairness to shareholders in management buyouts. And the evidence supports this conclusion.

Unaffiliated Shareholders' Ratification. A third procedural device is the vote of unaffiliated shareholders. In theory, giving the unaffiliated shareholders a right to reject an unfair deal ought to suffice. The Delaware Supreme Court has accepted this notion. In Weinberger v. UOP, it said: "[W]here corporate action has been approved by an informed vote of a majority of the minority shareholders, we conclude that the burden entirely shifts to the plaintiff to show that the transaction was unfair to the minority."*

But again, in reality, there are problems, derived in part from those just mentioned in regard to fairness opinions and outside directors' review. The vote of unaffiliated shareholders is effective only if they are in a position to evaluate the terms and have some viable option if they reject the deal. Of course, their evaluation will be heavily influenced by the fairness opinion, which, as we have seen, is not particularly effective in assuring them that management's deal is fair.

As for viable options, to date there have not been too many. The three devices I have been discussing will typically assure that management's self-dealing is measured, for all practical purposes, not by the rule of inherent fairness, but by the remarkably elastic rule of business judgment. In the absence of fraud, under state law a non-consenting shareholder is left with his right of appraisal, unless he can show that remedy to be inadequate. Appraisal is limited to a cash payment equal to "fair value." One can not seek injunctive relief or rescission. The remedy is expensive, and the expenses may not be broadly shared. And it is risky, in that one can end up with less than management offered in the first place. Recently, in Weinberger v. UOP,** the Delaware Supreme Court sought to broaden the factors to be considered in valuing a corporation, but it remains unclear to what extent that decision will enhance the shareholder's prospects. The appraisal route remains problematical, at best.

To summarize, the fairness opinion, the approval of non-management directors and the ratification by public shareholders are much more effective in protecting management than in assuring shareholders "the most scrupulous

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* 457 A.2d 701, 703 (1983).

** 457 A.2d 701 (1983).

inherent fairness of the bargain," as the Delaware Supreme Court put it. In many cases these indicia of procedural due process may prompt management to improve its offer from what it might have been without them. And to this extent the shareholders are better off. There is reason to believe, however, that often they do not sweeten the deal enough to make it fair.

V. Lock-ups in Management Buyouts

Management has enormous advantages over the shareholders in seeking to buy the corporation. To serve its proprietary interest in acquiring the corporation at a bargain price, management may use adroit timing and its vastly superior knowledge of the corporation's true value. In an apparent effort to add further advantages by discouraging competing bids, management used "lock-ups" in the recent case of Northwest Energy Company.

On August 8, 1983, Northwest announced its plan to merge with a new company to be owned by an investor group headed by Allen & Co. and including members of management. Northwest's public shareholders were to be cashed out at $31 per share. As part of the deal, Northwest granted Allen two options: one to acquire at book value its "crown jewel", Northwest Central Pipeline, and the other to acquire at $31 per share stock representing 18% of Northwest's then outstanding shares. The "crown jewel" option was exercisable whenever a third party acquired at least 45% of Northwest's outstanding stock, or the Northwest Board consented. In addition, Northwest agreed to indemnify its directors and management as well as Allen against claims arising out of the proposed buyout.

On September 12, 1983, The Williams Companies tendered for Northwest at $39 per share, conditioning its bid on the elimination of the lock-ups; it also brought suit to void them. After a skirmish or two, Northwest's Board agreed to the Williams tender offer, and Williams agreed to pay Allen $26.7 million for relinquishing the lock-ups.

In this case the marketplace operated effectively to give shareholders 26% more than management had offered. How much more might have been offered, by how many other bidders, had the lock-ups not been used, one will never know. We do know, however, that it cost an undeterred third party $26.7 million to shove them aside. It is not unreasonable to suggest the possibility that, but for the lock-ups, that sum might have been offered to the Northwest shareholders, adding almost $1.50 per share.

Whatever one may think of "lock-ups" in third party acquisitions, where they might be justified in order to attract a competing bid, they seem entirely out of place in a management buyout, where their only apparent purpose is to prevent a competing bid.

Judge Abraham Sofaer's thoughtful decision in Data Probe Acquisition Corp. v. Datatab, Inc.* may have cast a new cloud of uncertainty over the validity of "lock-ups" under the Williams Act. Judge Sofaer found that legislation to have the twofold purpose of providing public shareholders with all material information and guaranteeing them a fair opportunity to use it. He granted recourse under the Williams Act on a manipulation theory, where "lock-ups" impaired the operation of the marketplace and frustrated a shareholder's exercise of informed choice.** How this theory will play out in subsequent cases is hard to predict.*** But one can not read Judge Sofaer's opinion without gaining a sense of his frustration at the Commission's failure to take the lead in defining such words as "deceptive" and "manipulative" in the context of tender offers.**** Pointing to its legislative mandate under the Williams Act, Judge Sofaer expressed the expectation that the SEC "should eventually address the complex, new problems posed for shareholders by the obscure and sometimes coercive

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* [Current Binder] Fed. Sec. L. Rep. (CCH) ¶99,451.

** Id. at 96,569.

*** The very recent decision of the Second Circuit in Buffalo Forge Co. v. Ogden Corp., Nos. 83-7199, 83-7211 (2d. Cir. Sept. 22, 1983), may have already sapped Data Probe of much of its vitality as an authoritative interpretation of the Williams Act. Writing for a three judge panel, Judge Van Graafeiland, without mentioning Data Probe, stated that the Sixth Circuit's opinion in Mobil Corp. v. Marathon Oil Corp., 669 F.2d 366 (6th Cir. 1981) was an unwarranted extension of the Williams Act, which "was designed solely to get needed information to the investor" (citing Piper v. Chris-Craft Indus., Inc., 430 U.S. 1, 31 (1977)). However, it may prove important that Buffalo Forge did not involve options issued in a leveraged buyout structured to include equity participation by management.

**** [Current Binder] Fed. Sec. L. Rep. (CCH) ¶99,451 at 96,580.

nature of the financial terms that tender offers are increasingly assuming."*

I endorse his restrained exhortation. I should like to add, however, that, with the recommendation of the Advisory Committee on Tender Offers in hand, the time is now ripe for the Commission to act. The field is too complex to rely on case-by-case adjudication, although opinions such as Judge Sofaer's help to point the way. The Commission should do what it can under existing law. To the extent that a federal solution to these problems is presently beyond its authority to provide, the Commission should play a leadership role with the Congress and the states in fashioning a satisfactory solution through legislation.

VI. The Manipulation Problem

The problems with management buyouts that I have been discussing provide sufficient warrant for a careful assessment. These remarks would be incomplete, however, without mention of the potential for management to present its corporation to the public in a manner designed to facilitate a future buyout at a price favorable to it. In a word: manipulation. This idea has not only been advanced by scholars.** Several members of the Advisory Committee on Tender Offers, including practical, highly experienced CEOs, pressed the Commission to look at the problem, which they believed to be more than theoretical. As one investment banker on the committee put it at the final public meeting:

> "It's really ... an SEC enforcement problem. It's clear there is the smoke of such a problem out there."

It is obvious that there are a variety of techniques by which management can adversely affect the market price for its corporation's stock. They include the selection of accounting principles, the application of those principles, management's discussion and analysis in 10-Ks and in public statements and the nature and timing of its business decisions.

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* Id. at 96,580.

** See, e.g., Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 Cal. L. Rev. 1073, 1131-2 (1983).

Earnings can be adversely impacted, for example, by electing LIFO inventory valuation instead of FIFO, double declining balance depreciation instead of straight line or completed contract instead of percentage of completion contract accounting.

Large discretion is accorded management in the application of accounting principles, particularly if one seeks to be conservative. Loan loss reserves, allowance for uncollectable accounts, write-offs of obsolete inventory and accruals for various contingencies offer ample closet space in which to store both income and assets.

In its interpretations of past performance and projections for the future, management has great discretion, which it can exercise so as to encourage or discourage the purchase of stock. Its annual report can go from 50 pages of upbeat talk to one page of discouraging prognosis.

Business decisions can have an impact on stock values. Assets, including subsidiaries and divisions, can be sold to book a loss; opportunities can be postponed or even foregone. Dividends can be cut, debts paid off, advertising budgets employed, all with a view to strengthening the balance sheet and cash flow, but with the interim purpose and effect of depressing the stock price.

Accountants confirm that management can effect a downward manipulation much more easily than an upward one. Management's actions must pass muster with the outside accountants, whose bias is toward conservatism. Both these guardians and the accounting rules they administer are directed chiefly to preventing an unduly optimistic financial picture. The pessimistic view is a somewhat unguarded flank, exposed to the temptations of an unscrupulous management.

To my knowledge, the Commission has never brought a case alleging this sort of conduct. But we have been cautioned by knowledgeable players in the financial community that it may happen. Of course, there is no doubt that such behavior would constitute a fraud under the federal securities laws. Having been duly warned, the Commission will be especially watchful in reviewing management buyouts.

The best solution to this problem, as in all the others I have been discussing today, is to let the marketplace work. Given sufficient time to respond, third party bidders should be able to ferret out enough information to recognize an inadequate bid by the management group. Assuming no "lock-ups" to bar entry, third parties should be able to top

management's bid. We saw this process at work in Norton Simon, Stokely and Northwest, among others. Given management's irrefutable conflict, and the ineffectiveness of commonly used procedures to do much more than protect management, sound policy supports a marketplace solution. As regulators, we should strive to enhance the workings of a free market. Why, for example, shouldn't management -- once it has decided in the interest of shareholders to sell the corporation -- be required to resolve its conflict by remaining open to bids competitive with its own and willing to sell to the highest bidder? Why shouldn't management be willing to liquidate if higher values could be reasonably expected though this kind of sale?

I realize that management may lose its job if a third party tops its bid. But management initiated the process by concluding that it was in the interest of shareholders to sell the corporation. Once that decision is made, is it unreasonable to ask management to sell in a manner most advantageous to all the shareholders?

This question becomes harder to answer as management's ownership increases. If management has control before making its bid, it can deter third party bids by announcing its unwillingness to sell control to others. Whether, under these circumstances, it is fair to allow management to hold to itself alone the control premium is an exceedingly difficult question. If in liquidation, each shareholder would receive its aliquot share, why not equally so when management seeks to buy out the minority?

Some have argued that the minority is entitled to no more than market value, which takes into account the effects of a control block in the hands of management.* But, of course, the market value is simply a reflection of what the public is willing to pay for the corporation's shares, assuming it to be continuing as a public company with control in the hands of management. Once management decides on a buyout, circumstances will change. How they should change is a matter of corporate policy, to be worked out through public debate. It may be that, in management buyouts, a shareholder's expectation of sharing equally

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* See, e.g., Chazen, Fairness From a Financial Point of View in Acquisitions of Public Companies, 36 Bus. Law. 1439 (1981); Easterbrook and Fischel, Corporate Control Transactions, 91 Yale L. J. 737 (1982).

with others in the wealth of the enterprise should be given the force of law.*

VII. Conclusion

Let me now pull together some conclusions from this discussion:

1. In management buyouts, the current rules of the game -- both federal and state -- fail adequately to assure to public shareholders a fair deal -- that is, the highest current price reasonably obtainable, whether from management or one or more third party purchasers of stock or assets.

2. The indicia of procedural due process, such as fairness opinions, independent directors' approval and shareholder ratification, have become boiler-plated passkeys to an advantageous buyout, effective in protecting a conflicted management from successful attack, but inadequate to give shareholders full value for their shares. Requiring an independent business purpose would suffer from a similar infirmity.

3. Tighter procedural rules and substantive fairness determined in advance by a governmental agency are possible solutions to the problem, but neither approach seems likely to yield significant benefits, net of the new costs it would impose on the system.

4. Although some have argued for prohibiting management buyouts, this is too extreme a solution. These transactions can provide to shareholders an opportunity to realize higher values than available in the market. In addition, there is a widespread view that they often result in more efficient asset utilization and other public benefits.

5. Given a chance to work, the marketplace has proved to be the best protector of shareholder interests.

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* For a thoughtful discussion of this issue, see Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 Cal. L. Rev. 1073 (1983).

6. The role of government should be to prevent a conflicted management from frustrating the operation of the marketplace. How far to go in service to this goal is a hard question, worthy of wide debate. To get that debate started, here are some tentative proposals:

   (a) Management should be permitted to buy out the shareholders only after affording all potential bidders a reasonable opportunity to investigate the company and make alternative bids.

   (b) Management should be prohibited at any time from granting any option or using any other device to prevent a third-party bidder from competing fairly with management in a buyout attempt.

   (c) If management has a control block of stock, and elects to buy out the public shareholders, it should be willing either to match or top a higher third-party bidder or sell its block to the higher bidder.

If these proposals seem provocative, they are purposefully so. We see with increasing frequency the spectacle of a conflicted management surrounding itself with procedural shields to defend a deal widely believed to be substantively unfair to shareholders. Such behavior is threatening to tarnish the image of our corporate community -- to give corporate fiduciaries a bad name. The rules that govern what appears to some as little more than a charade should be re-examined.