Washington and Lee Law Review

Volume 41 | Issue 3 Article 6

Summer 6-1-1984

Corporate Morality and Management Buyouts

CORPORATE MORALITY AND MANAGEMENT BUYOUTS

In response to a perceived opportunity for corporate management to share in the success of their companies,[1] management groups have been increasingly active in acquiring ownership of public companies through the use of management buyout transactions.[2] A management buyout transaction is any process by which the management of a public corporation acquires enough of the corporation's outstanding shares to convert the formerly public corporation into a private company.[3] By using the corporation's assets as collateral for loans to finance the buyout, corporate management alone or with other investors can leverage[4] a buyout of the corporation without risking substantial personal assets.[5] Leveraged buyouts, therefore, are particularly attractive to management as a technique for acquiring significant equity interests in the companies for which they labor.[6] In addition to providing management with an attractive method of acquiring corporate ownership, management buyouts frequently result in gains in corporate performance by creating greater incentives for

---

1. *See Why Leveraged Buyouts are Getting So Hot*, Businessweek, June 27, 1983, at 86 [hereinafter cited as *Getting Hot*] (prospect of spectacular returns prompts management buyout attempts); Wantuck, *When Managers Become Owners*, Nation's Business, August, 1983, at 60 (prospect of quick returns to investors is prime attraction of leveraged buyouts).

2. *See Private Lives*, Time, June 20, 1983, at 62 [hereinafter cited as *Private Lives*] (going private transactions are increasing in popularity). According to W.T. Grimm & Co., a Chicago merger and acquisition consultant, management buyouts increased from 47 in 1980 to 115 in 1982. *See Getting Hot*, *supra* note 1, at 86; *see also* Longstreth, *Fairness of Management Buyouts Needs Evaluation*, Legal Times, October 10, 1983, at 15, col. 3 (at least 169 management buyouts occurred in 1983).

3. *See* Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1073, 1091 (1983) (management buyout is process for eliminating corporation's public shareholders). The term management buyout may also include situations in which the management of a subsidiary company purchases the subsidiary from the parent corporation. *See* Longstreth, *supra* note 2, at 15, col. 2. This article will not address subsidiary management buyouts, however, because subsidiary buyout transactions do not directly involve public shareholders and raise different financial concerns. *See generally* Gupta, *The Alchemists of Public Buyouts*, Venture, October, 1983, at 50 (discussing benefits of subsidiary buyout transactions).

4. *See* W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 221 (1980) (leverage occurs when investor finances investment by borrowing from other investors); *Private Lives*, *supra* note 2, at 62 (leveraged buyout maneuver involves purchasing company with loans which company's assets secure).

5. *See* Wantuck, *supra* note 1, at 60 (investors in leveraged buyout put in small amount of cash and borrow rest of purchase price against company assets); Hill & Williams, *Buyout Boom*, Wall St. J., December 29, 1983, at 6, col. 2 (buyers in leveraged buyouts do not have to contribute much personal equity because of company's large borrowings).

6. *See* Ross, *How The Champs Do Leveraged Buyouts*, Fortune, January 23, 1984, at 70 (top managers receive significant equity interests in buyout transactions); Brody, *Controversil Issue: A Leveraged Buyout Touches Off A Bitter Dispute*, Barrons, September 19, 1983, at 15 (company's future profits motivate managerial interest in buyout transactions); *Getting Hot*, *supra* note 1, at 86 (management buyout provides opportunity for managers to acquire equity interests in company).

managers and benefit a corporation's shareholders by offering a premium for publicly held shares.[7] Despite the benefits of management buyouts for management and public shareholders, critics of management buyout transactions have raised serious questions concerning the propriety of the management buyout process.[8]

Critics of management buyouts contend that management buyout transactions violate the Securities and Exchange Act of 1934's ('34 Act)[9] prohibitions against insider trading[10] and otherwise provide management an unfair informational advantage in purchasing public companies.[11] Insider trading occurs when an individual or group of individuals trade for personal gain on the basis of confidential corporate information to which the corporation possesses an exclusive right.[12] Critics of management buyouts assert that management's ability to bid against outside investors for the corporation at which managers hold positions is an exploitation of inside information because management has access to information concerning the value and future earnings of public companies not available to the general public.[13] The charge of insider trading becomes more egregious when the management group owns a controlling block of corporate shares prior to a buyout transaction and can unilaterally set the price which outside investors will receive for minority shares.[14]

---

7. *See* De Angelo & De Angelo, *The Numbers Show Everyone Profits*, N.Y. Times, Jan. 22, 1984, at D-2, col. 2 (shareholders generally receive significant premium above market prices in management buyout transaction); Hill & Williams, *supra* note 5, at 6, col. 2 (leveraged buyout permits buyers to offer premium to public shareholders); *infra* notes 52-57 and accompanying text (private ownership creates incentive for managers to increase corporate performance), 174 and accompanying text (premiums in management buyouts are equivalent to premiums that shareholders receive in public tender offers).

8. *See infra* notes 10-20 and accompanying text (management buyouts raise questions concerning insider trading and management's fiduciary duty to public shareholders).

9. *See* 15 U.S.C. 78 (1976) (Securities & Exchange Act of 1934).

10. *See id.* § 78p(b) (Securities Exchange Act of 1934 prohibits corporate insiders from using corporate information for personal gain). An insider is a director or officer of a company whose equity securities are registered on a national securities exchange. *Id.* Inside information is advance information which is not generally available to public shareholders. *See* Rheem Mfg. Co. v. Rheem, 295 F.2d 473, 475 (9th Cir. 1961) (insider trading is breach of fiduciary duty to company); *infra* notes 11-14 and accompanying text (management enjoys insider advantage in valuing companies at which management holds positions).

11. *See* Hetherington, *When The Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 235 (1979) (management's access to more complete and accurate corporate information renders management less likely to err in valuing shares); Thomas, *A Free Ride for Management Insiders*, N.Y. Times, Jan. 22, 1984, at D2, col. 1 (figures that represent corporatin's real value and earnings are in management's exclusive possession).

12. *See* Dolgow v. Anderson, 438 F.2d 825, 828 (2d Cir. 1971) (corporate officers and directors may not use confidential corporate information for personal gain); *infra* notes 13-14 and accompanying text (allegations of insider trading apply to management buyout transactions).

13. *See* Brudney, *supra* note 3, at 1095 (access to information concerning firm's improving prospects induces management to take company private); Thomas, *supra* note 11, at D2, col. 4 (management exploits confidential corporate information in displacing public shareholders for personal gain).

14. *See* Address by Commissioner A.A. Sommer Jr., *"Going Private"*: A Lesson in Cor-

Additionally, management buyout transactions may violate management's fiduciary obligation to administer corporate affairs for the exclusive benefit of the corporation and the corporation's shareholders.[15] At common law, corporate officers and directors owed a fiduciary duty of loyalty to the corporation and the corporation's shareholders to act in the best interests of the company as opposed to the personal interests of management.[16] Management's fiduciary duty, therefore, requires that management conduct corporate affairs in the best interests of every shareholder.[17] Management buyout transactions, however, undermine management's undivided loyalty to the corporation by placing management as an interested party on both sides of the sale and repurchase transaction.[18] Even when going private is in the best interests of a cor-

---

porate Responsibility, at The Notre Dame Law School, November, 1974, *reprinted in* SEC. REG. & L. REP. (BNA), No. 278, § D, at 3-4 (attacking morality of process by which managers take companies private); *infra* notes 22-33 and accompanying text (procedures by which management may divest company of public shareholders).

15. *See* United States v. Byrum, 408 U.S. 125, 137-38 (1972) (majority shareholders and corporate directors owe fiduciary duty to all shareholders not to misuse power by promoting personal interests); Manufacturers Trust Co. v. Becker, 338 U.S. 304, 312 (1949) (courts must apply to corporate fiduciaries standard of loyalty that will prevent conflict of interest from arising); SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943) (Court insists on scrupulous observance of management's fiduciary obligations). State law generally governs the fiduciary obligations of corporate officers. *See* Wilshire Oil Co. v. Riffe, 409 F.2d 1277, 1281 (10th Cir. 1969) (state law determines fiduciary obligations within corporations); Hausman v. Buckley, 299 F.2d 696, 702-03 (2nd Cir.) (court refers to laws of state of incorporation to determine fiduciary obligations), *cert. denied*, 369 U.S. 885 (1962). States have construed strictly statutes mandating management's fiduciary duty to the corporation and the corporation's shareholders. *See, e.g.*, Herald Co. v. Seawell, 472 F.2d 1081, 1094 (10th Cir. 1972) (corporate officers under Colorado law function as agents of corporation and thereby occupy quasi-fiduciary relation to shareholders); Talbot v. James, 190 S.E.2d 759, 764 (S.C. 1972) (officers of corporation stand in fiduciary relationship to shareholders); Shermer v. Baker, 2 Wash. App. 845, ____, 472 P.2d 589, 593-94 (1970) (fiduciary duty of corporate officers requires utmost good faith and undivided loyalty to corporation and every shareholder). Some states have therefore codified the duties and obligations of corporate officers. *See, e.g.*, ALA. CODE § 10-2A-76 (1980) (nothing shall impair or modify the fiduciary obligations of corporate directors, officers, and controlling shareholders); N.Y. BUS. CORP. LAW § 717 (1977) (corporate officers and directors shall discharge duties in good faith with degree of diligence which prudent men would exercise in similar circumstances and like positions); PA. STAT. ANN. tit. 15, § 1408 (Pruden 1968) (officers and directors stand in fiduciary relation to corporation).

16. *See* A. BERLE & G. MEANS, *The Modern Corporation and Private Property* 196-98 (rev. ed. 1968) (common law imposed fiduciary obligation on management to ensure that separation of ownership from management in public companies did not allow management to exploit corporate assets for personal gain).

17. *See supra* note 15 and accompanying text (corporate officers and directors owe fiduciary duty to corporation and corporation's shareholders).

18. *See* Pepper v. Litton, 308 U.S. 295, 311 (1939) (fiduciary may not utilize corporate entity to violate ancient precept against serving two masters); 2 A. SCOTT, THE LAW OF TRUSTS 1298 (3rd ed. 1967) (trustee violates fiduciary duty if he uses his position to influence beneficiary to acquiesce in trustees' purchase of trust assets); Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987, 1017-18 (1974) (going private is kind of ultimate conflict-of-interest transaction); Note, *Going Private*, 84 YALE L.J. 903, 914 (1975) [hereinafter cited as *Going Private*] (management's power of coercion during buyout transaction conflicts with

poration's public shareholders, management's dual role as buyer and seller is suspect because management's interest in acquiring the corporation for the lowest possible price conflicts with management's duty to obtain the highest possible price for public shareholders.[19] Moreover, management's conflict of interest is especially clear when management can unilaterally determine the sale and repurchase price.[20]

Management often can unilaterally set the price that shareholders will receive for the corporation's shares in buyout transactions by employing one or a combination of several going private techniques.[21] One going private technique which is particularly useful when management possesses a controlling block of corporate shares prior to a buyout transaction is the one-step merger.[22] The one-step merger, permitted in all states,[23] allows a controlling group of shareholders to transfer corporate shares to a newly formed shell corporation wholly owned by the controlling group.[24] When management does not possess

---

management's fiduciary duty to public shareholders). In questioning the propriety of management buyouts, critics assert that management's purchase of corporate assets potentially compromises management's duty to public shareholders. *See* Longstreth, *supra* note 2, at 15, col. 3-4 (management buyouts present self-dealing problems).

19. *See* Brudney, *A Note On Going Private*, 61 VA. L. REV. 1019, 1029-30 (1975) [hereinafter cited as *Note On Going Private*] (going private provides fiduciaries classic temptation for self-dealing); Sommer, *supra* note 14, at D-4 (management buyouts present clear conflict of interests).

20. *See* Sommer, *supra* note 14, at D 3-4 (management uses cash merger statutes to divest minority shareholders at price which management sets in merger agreement).

21. *See* Longstreth, *supra* note 2, at 15, col. 1-2 (management may unilaterally determine price shareholders will receive for minority shares during buyout transaction in certain circumstances); *infra* notes 22-33 and accompanying text (commonly used techniques for taking companies private).

22. *See Note On Going Private*, *supra* note 19, at 1021-22 (discussing use of one-step merger to force minority shareholders out of company); *Going Private*, *supra* note 18, at 909-10 (examining one-step merger involving Barbara Lynn Stores).

23. *See* 8 Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 166.01, at 166-2 (1983) (all states give business corporations power to merge or consolidate); *see, e.g.*, ALASKA STAT. § 10.05.390 (1968) (corporations may merge upon the affirmative votes of two-thirds of all shares of all corporations involved in merger transaction); DEL. CODE ANN. tit. 8, § 251(c) (1983) (statutory merger requires favorable vote of majority of outstanding shares of both corporations seeking to merge); KY. REV. STATE § 271A. 365(2) (1972) (majority of outstanding shares of both corporations intending to merge must vote in favor of merger agreement to consummate merger transaction). In addition to state statutory merger procedures that require the approval of shareholders of the merging companies, all but a few states provide parent corporations owning a requisite percentage of subsidiary corporate shares a short form merger procedure for merging the subsidiary corporation into the parent without the approval of either of the merging companys' shareholders. *See, e.g.*, DEL. CODE ANN. tit. 8, § 253(a) (1983) (parent company may effect short-form merger of subsidiary company if parent company owns 90% of subsidiary's outstanding shares); MD. CORPS. & ASS'NS CODE ANN. § 3-106(a), (c) (1976) (parent corporations may merge 90% owned subsidiary companies without shareholder approval); VA. CODE § 13.1-76 (1975) (any corporation owning 90% of outstanding shares of another corporation may merge subsidiary corporation into itself without approval of either corporation's shareholders). *But see infra* note 28 and accompanying text (not all states allow acquiring companies to divest minority shareholders of acquired company with cash payment as opposed to security interests in surviving company).

24. *See* Sommer, *supra* note 14, at D-3 (controlling shareholders may transfer controlling block of corporate shares to newly formed corporation which controlling group wholly owns).

a controlling block of corporate shares prior to a buyout transaction, management may conduct a two-step merger transaction.[25] In a two-step merger, management makes a tender offer for a controlling block of the corporation's shares and then transfers those shares to a management-owned shell corporation.[26] Pursuant to both the one-step and two-step merger techniques, management next causes the wholly owned shell corporation to merge with the original corporation leaving the shell corporation as the surviving or acquiring company.[27] Management finally completes the one or two-step merger by forcing minority shareholders to receive cash in place of shares in the acquired company in accordance with cash merger statutes which in leading commercial states permit acquiring companies to compel acquired company shareholders to relinquish their shares in exchange for cash.[28] The merger thus

25. *See* Hetherington, *supra* note 11, at 233 (first stage of going private transaction is often tender offer for publicly held shares); *Going Private, supra* note 18, at 910 (tender offers do not require shareholder approval); *infra* note 26 and accompanying text (tender offer regulation).

26. *See* Smallwood v. Pearl Brewing Co., 489 F.2d 579, 596-97 (5th Cir.) (discussing components of tender offers), *cert. denied,* 419 U.S. 873 (1974). A tender offer normally consists of an offer to purchase all or a portion of a target company's outstanding shares at a premium price. *Id.* at 597 n.22. Although a tender offeror will frequently extend an offer to purchase a company's shares for a limited period of time, the tender offeror normally conditions the premium offer on receiving favorable responses from a specified number or percentage of the target company's shareholders. *Id.* State law generally governs tender offer procedures for corporate acquisitions within the respective state. *See, e.g.,* KAN. STAT. ANN. § 17-1276 to 17-1284 (1974) (procedures for conducting tender offers in Kansas); N.J. REV. STAT. § 49:5-1 to 49:5-19 (1977) (New Jersey statutes regulating tender offer procedures); TENN. CODE ANN. § 48-2102 to 48-2114 (1976) (Tennessee tender offer provisions). Federal law also governs the conduct of tender offers through the Williams Act which Congress added to the Securities & Exchange Act of 1934 ('34 Act) on July 29, 1968. *See* Cattlemen's Invest Co. v. Fears, 343 F. Supp. 1248, 1251 (W.D. Okla. 1972) (Williams Act insures that public investors have truthful information to base investment decisions upon); 15 U.S.C. § 78n(d), (d)(1) (1976) (Williams Act); *see also* Wolfson, *A Critique of Corporate Law,* 34 U. MIAMI L. REV. 959, 978 (1980) (management may pursue goal of going private through tender offer for minority shares).

27. *See* Weiss, *The Law of Takeout Mergers: A Historical Perspective,* 56 N.Y.U. L. REV. 624, 624 (1981) (majority shareholders may eliminate minority shares by transferring corporate shares to newly formed shell corporation and by merging old corporation into shell); Sommer, *supra* note 14, at D-2 (typical pattern for buyout transaction involves insiders placing shares in shell corporation and merging old corporation with shell).

28. *See* 8 Z. CAVITCH, *supra* note 23, § 166.06, at 166-43 (minority shareholders of acquired company may either accept merger price which management establishes in merger agreement or resort to state appraisal remedy); *infra* notes 67-82 and accompanying text (discussion of appraisal remedy). In merging the old corporation into the newly formed shell corporation, however, management must give minority shareholders of the old corporation shares in the surviving corporation rather than cash in a minority of states which restrict the consideration which management use to displace minority shareholders in merger transactions. *See* 8 Z. CAVITCH, *supra* note 23, § 166.02[1], at 166-9 to -10 (several jurisdictions do not regard cash as good consideration for transfers of shares in merger transactions). *See, e.g.,* CAL. CORP. CODE § 1101(e) (1977) (acquiring companies may only convert common shares of acquired companies into nonredeemable shares of surviving company when acquiring company owns 50% or more of acquired company prior to merger transaction and does not use short-term merger procedure); NEV. REV. STAT. § 78.455 (1983) (directors must specify in merger agreement basis for converting shares of acquired corporation into shares of surviving corporation); VT. STAT. ANN. tit. 11,

results in vesting management with ownership of the newly gone private company and divesting minority shareholders of ownership in the newly merged corporation at a price that management has set in the merger agreement.[29] One and two-step mergers which displace public shareholders are known as freezeout or takeout mergers since the mergers enable management to compel minority shareholders to receive cash instead of an equity interest in the newly formed corporation.[30] Although freezeout mergers are legal by statute and court decisions in the states in which most public companies are incorporated,[31] management's proprietary interest in purchasing minority shares conflicts with management's fiduciary duty to ensure that shareholders receive fair value.[32] Management buyouts, therefore, present a conflict between management's duty to minority shareholders and management's self-interest in acquiring companies.[33]

Some critics of management buyouts contend further that fair treatment of displaced shareholders in going private transactions requires that displaced shareholders receive a proportionate share of the increased value to the new company which is attributable to the merger transaction.[34] Courts have recognized that corporate acquisitions frequently produce increased value for

---

§ 1951(b)(3) (1971) (statute requires board of directors of merging corporations to stipulate in merger agreement basis for converting shares of merging corporations into shares of surviving corporation).

29. *See* Sommer, *supra* note 14, at D-3 (result of buyout transaction is to make controlling shareholders of old corporation only shareholders of new corporation); *Note On Going Private, supra* note 19, at 1020 (insiders become exclusive or predominant owners following process of forcing out minority shareholders).

30. *See* Note, *Delaware Corporation Law*: Weinberger v. UOP, Inc.—*A Limitation On* Singer *Fairness Standards?*, 42 U. PITT. L. REV. 915, 915 (1981) (majority shareholders force minority shareholders to receive cash in place of shares in typical freeze-out merger); Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1357 (1978) (essence of freezeout is majority's displacement of public shareholders for cash or senior securities).

31. *See* Bryan v. Brock & Blevins Co., 490 F.2d 563, 569 (5th Cir.) (Georgia merger statute permits majority shareholders to force minority shareholders to accept cash in full payment for shares), *cert. denied*, 419 U.S. 844 (1974); *In re* Jones & Laughlin Steel Corp., 263 Pa. Super. 378, 390-92, 398 A.2d 186, 191-92 (1979) (Pennsylvania merger statute permits controlling shareholders to liquidate minority shareholders at unfairly low prices); David J. Greene & Co. v. Schenley Indus., 281 A.2d 30, 35 (Del. Ch. 1971) (Delaware merger statute permits freezing out of minority interests); *supra* note 23 (state statutes which provide business corporations power to merger and consolidate). *But see supra* note 28 (a minority of states require that shareholders of acquired companies receive shares of surviving company as opposed to receiving cash in freezeout mergers).

32. Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 298 (1974) [hereinafter cited as *Fair Shares*] (unilateral action by parent corporation in acquiring minority interests presents classic self-dealing problem).

33. *See* Longstreth, *supra* note 2, at 15, col. 3 (recent transactions prove that management's conflict in purchasing public companies warrants legal supervision).

34. *See Note On Going Private, supra* note 19, at 1025, 1037 (efficiency gains which transpire from internal rearrangements of corporation during management buyout transactions belong in part to public shareholders); *Fair Shares, supra* note 32, at 319-20 (gains attributable to going private transactions belong to both inside and outside shareholders in relation to respective investments in corporation).

public companies because synergistic benefits accrue to acquiring companies.[35] Synergistic benefits encompass all of the factors which make a company's shares more valuable to purchasers of an entire company than the shares had been worth to the company's previous public shareholders.[36] Management buyout transactions create synergistic benefits for the newly merged corporation by eliminating SEC filing requirements,[37] increasing earnings prospects,[38] enhancing corporate productivity,[39] and protecting the corporation from future takeover attempts by outsiders.[40] Although synergistic gains from buyout transactions are often speculative,[41] negotiated arms-length transactions can automatically account for synergistic post merger gains because public shareholders are under no compulsion to relinquish their shares in such a transaction.[42] Shareholders therefore will insist on exacting a premium for minority shares to reflect a portion of the synergistic benefits which accrue to the corporation and the corporation's inside shareholders as a result of the buyout transaction.[43] Involuntary divestments of public shareholders such as freezeouts mergers, however, may permit management insiders to appropriate gains at the expense of minority-shareholders because minority shareholders do not have the opportunity to bargain for fair value among competing purchasers.[44] To the extent that legal safeguards are inadequate to ensure that minority shareholders receive fair value for minority shares in management buyout transactions, minority shareholders must accept whatever price management determines minority shares are worth in the merger agreement.[45]

---

35. *See* Mills v. Electric Auto-Lite Co., 552 F.2d 1239, 1248 (7th Cir.) (merger produces synergistic effect causing merged corporation to be worth more than sum of merging corporations), *cert. denied*, 434 U.S. 922 (1977); Harriman v. E.I. DuPont de Nemours & Co., 411 F. Supp. 133, 154 n.117 (D. Del. 1975) (court supports idea that acquiring corporations should share post-merger gains with acquired company shareholders).

36. *See Fair Shares, supra* note 32, at 323-24 (combined entity after merger may well be more valuable than sum of merging corporations).

37. *See* Note, *Going Private: An Analysis of Federal and State Remedies*, 44 FORDHAM L. REV. 796, 797 & n.9 (1976) (average corporation on American Stock Exchange can save between $75,000 and $200,000 in legal and auditing fees by going private).

38. *See* Chazen, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?* 36 BUS. LAW 1439, 1445 (1981) (market may apply higher price earnings multiple to company's earnings because company becomes part of larger enterprise).

39. *See infra* notes 52-57 and accompanying text (incentive of private ownership results in greater productivity following buyout transaction).

40. *See* Chazen, *supra* note 38, at 1445-46 (going private transactions protect corporation from being taken over by undesirable party).

41. *See* Tanzer v. Int'l Gen. Indus., 379 A.2d 1121 (Del. Ch. 1977) (virtually impossible to determine which financial benefits occur solely because of merger).

42. *See* Chazen, *supra* note 38, at 1445-46 (shareholder will insist in arm's length negotiation to share in post-merger benefits by receiving premium price for shares).

43. *Id.*

44. *See* Harriman v. E.I. DuPont de Nemours & Co., 411 F. Supp. 133, 154 n.117 (D. Del. 1975) (court acknowledges value of gain-sharing requirement in parent-subsidiary mergers where arms-length bargaining is impossible).

45. *See* Brudney, *supra* note 3, at 1095-98 (difficulty of measuring post-merger gains may

In response to the charge that management buyout transactions are unfair to public shareholders because management may appropriate gains at the expense of public shareholders, proponents of management buyouts contend that buyouts produce gains sufficiently large to benefit all participants in the management buyout process.[46] By eliminating public shareholders, newly gone private companies can reduce many expenses which are attributable to the separation of ownership from management in public companies.[47] The payment of dividends to public shareholders,[48] the compliance with state and federal securities laws,[49] and the policing of management perquisite expenditures represent significant costs for public companies which management owned companies are able to reduce or eliminate.[50] Companies also benefit from management buyout transactions because managers are able to pursue more innovative business strategies following buyout transactions without having to consider the stock market's reaction to corporate decisionmaking.[51]

The most frequently cited benefit of management buyouts, however, is the incentive that private ownership creates for managers to reduce costs and to increase overall productivity.[52] Proponents of management buyouts assert that managers become revitalized in obtaining equity positions in their companies.[53] Informed, self-interested managers replace passive public investors to pursue a compensation structure that more directly rewards corporate success.[54] In addition to the incentive that private ownership creates for corporate performance, the vulnerability of heavily leveraged companies to

---

allow inside shareholders to benefit at expense of minority shareholders); Longstreth, *supra* note 2, at 21, col. 2 (state and federal laws do not sufficiently protect shareholders in management buyout transactions).

46. *See* De Angelo & De Angelo, *supra* note 7, at D-2, col. 3 (private ownership creates gains in corporate productivity that are large enough to benefit all parties involved in buyout); Hill & Williams, *supra* note 5, at 6, col. 2 (buyouts produce efficiency gains for corporation); supra note 8 and accompanying text (minority shareholders benefit from buyout transactions by receiving premiums for corporate shares).

47. *See* Green v. Santa Fe Indus., 533 F.2d 1283, 1308 (2d Cir. 1976) (Moore, J., dissenting) (going private transactions can eliminate or reduce many costs attributable to public ownership of company), *rev'd on other grounds*, 430 U.S. 462 (1977).

48. *See id.* (removal of pressure to pay dividends at expense of capital improvements is one advantage of going private).

49. *See supra* note 37 (company can save substantial legal and auditing costs by returning to private ownership).

50. *See* Wolfson, *supra* note 26, at 978 (going private transactions eliminate costs of monitoring management's conduct in public companies).

51. *See* Wantuck, *supra* note 1, at 60 (buyout transactions allow management to implement changes previous owners would disallow); Chazen, *supra* note 38, at 1445 (management buyout transactions provide managers greater ability to formulate business policy).

52. *See* Ross, *supra* note 6, at 78 (management buyouts promote economic efficiency by providing managers stake in company); Hill & Williams, *supra* note 5, at 6, col. 2 (management's enhanced stake in company following buyout transaction can result in heightened corporate productivity).

53. *See* Wantuck, *supra* note 1, at 60 (investment banker states that buyout transaction can make executive officer into mature entrepreneur).

54. *See* DeAngelo & DeAngelo, *supra* note 7, at D-2, col. 3-4 (management buyouts enable compensation structures that could not be achieved in publicly held companies).

downturns in the economy further induces management to maximize corporate cash flows for the purpose of retiring the corporation's leveraged borrowings.[55] Moreover, management's efforts to reduce corporate borrowings following buyout transactions often result in producing leaner, more tightly run companies with more efficient capital deployments.[56] Proponents of management buyouts therefore contend that buyouts add value to the economy by enabling companies to operate on less capital, thus freeing capital for other uses.[57]

To the extent that buyout transactions produce gains for the corporation and the corporation's shareholders by redeploying capital and enhancing productivity, proponents of management buyouts contend that gains from buyout transactions increase the value of corporate shares.[58] Public investors, therefore, presumably value a corporation's shares more highly in expectation of postmerger gains allowing both minority and majority shareholders to benefit from enhanced market values.[59] Although some buyout proponents concede that freezeout mergers may prevent minority shareholders from directly participating in the synergistic gains of buyout transactions,[60] buyout proponents assert nonetheless that minority shareholders indirectly benefit from buyout transactions because newly merged companies must pay to minority shareholders a value at least as great as the company's previous trading prices which reflect the possibility that post merger synergistic gains might one day accrue to the company in question.[61] Additionally, freezeout mergers facilitate buyout transactions because purchases of public companies might not be profitable to public investors if the law required investors to share directly with minority shareholders the synergistic gains which buyouts create.[62]

---

55. *See* Ross, *supra* note 6, at 78 (cyclical downturns can imperil company that has heavily leveraged assets because cash flows are essential to paying off interest charges); *Getting Hot, supra* note 1, at 86 (high leverage of management buyouts imposes stricter discipline on managers enabling company to run on less capital).

56. *See* Hill & Williams, *supra* note 5, at 6, col. 2-3 (management capable of reducing company's accounts receivable and inventory levels following management buyout); Longstreth, *supra* note 2, at 15, col. 2 (managers employ corporate assets more efficiently following buyout transaction).

57. *See* Ross, *supra* note 6, at 78 (buyouts help to redeploy capital making excess capital available for other users); *Getting Hot, supra* note 1, at 86 (buyouts add to economy by enabling companies to operate with less capital).

58. *See* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 705 (1982). In examining the societal utility of corporate control transactions, Fischel and Easterbrook maintain that voluntary exchanges of corporate control move assets to more valued uses because buyers would not pay a premium for corporate control unless buyers thought corporate assets could be more efficiently employed. *Id.* Easterbrook and Fischel therefore argue that the premium which buyers are willing to pay for corporate control reflects the buyer's anticipated increase in the value of corporate assets once the buyout transaction takes place. *Id.*

59. *See id.* (presumption that anticipated gains from buyout transactions raises market prices for corporate shares).

60. *See id.* (Easterbrook and Fischel do not refute fact that freezeout mergers prevent minority shareholders from receiving premium in buyout transaction).

61. *See supra* note 58 and accompanying text (expectation of benefits from buyout transactions raises market's value for corporate shares).

62. *See* Easterbrook & Fischel, *supra* note 58, at 705-06. Easterbrook and Fischel contend that in freezing out minority shareholders following a buyout transaction, purchasers of cor-

Another argument supportive of buyout transactions holds that since market prices are determinant of the value of corporate shares, buyout transactions are necessarily fair to minority shareholders so long as shareholders receive a price at least as great as the market price for the company's shares prior to public announcement of the buyout transactions.[63] To maintain that the market price is in some sense unfair or oppressive to minority shareholders, as critics of buyout transactions contend, is to challenge the market system of pricing which underlies a capitalist economy.[64] Proponents of buyout transactions conclude by asserting that the law provides avenues of relief for minority shareholders should the market occasionally err in valuing corporate shares.[65]

The law does indeed provide protection for minority shareholders during mergers and other fundamental changes in corporate structure.[66] The principal state protection for shareholders in merger transactions is the remedy of appraisal.[67] Appraisal statutes typically provide dissenting shareholders the right to obtain a judicial determination of the fair value of the shareholders' shares and the opportunity to sell back to the corporation the shareholders' shares at the judicially determined fair value.[68] State legislatures designed the

---

porate control are merely eliminating free-riding shareholders who neither sold to the purchaser nor contributed to the profitable transfer of control. *Id.* To the extent that the expectation of gains from freezeout transactions induces investors to more highly value corporate shares, all shareholders benefit from the occurrence of freezeout transactions. *Id.*

63. *See* Hetherington, *supra* note 11, at 234-35. In responding to the criticism that repurchase tender offers are unfair to public shareholders, Hetherington asserts that the market price is by definition the current value of a company's shares. *Id.* Hetherington, moreover, maintains that corporate repurchases of shares after full disclosure cannot be unfair to public shareholders unless the market price itself is in some sense unfair or oppressive. *Id.* at 235.

64. *Id.* at 235-37 (minority shares only have value as an investment and the law should ignore idiosyncratic attachments).

65. *See infra* notes 67-121 and accompanying text (discussion of state protections for minority shareholders), 122-59 and accompanying text (federal protections for shareholders in buyout transactions).

66. *See* 6 Z. CAVITCH, *supra* note 23, § 112.02[1], at 112-13 to -25 (state laws generally provide shareholders right of appraisal following mergers, consolidations, and sales of substantially all corporate assets).

67. *See* Vorenberg, *Exclusiveness Of The Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1191 (1964) (availability of appraisal remedy may foreclose shareholders from other forms of relief); Note, *Corporations—Exclusiveness Of The Appraisal Remedy—Legislature Intended That All Actions Be Barred Except For An Appraisal After Consummation Of A Merger*, 84 DICK. L. REV. 543, 547-48 (1980) [hereinafter cited as *Exclusive Remedy*] (appraisal is exclusive remedy for dissenting shareholders in Pennsylvania); *see, e.g.*, DEL. CODE ANN. tit. 8, § 262 (1983) (procedure for effecting Delaware's appraisal remedy); MASS. GEN. LAWS ANN. ch. 156B, §§ 86-90 (West 1973) (Massachusetts appraisal remedy); TEX. BUS. CORP. ACT ANN. art. 5.11-5.13 (Vernon 1983) (Texas appraisal procedure).

68. *See* 6 CAVITCH, *supra* note 23, § 112.01, at 112-4 to 5 (appraisal statutes afford shareholders right to withdraw from corporation at fair value); Comment, Bell v. Kirby Lumber Corp: *Ascertaining "Fair Value" Under The Delaware Appraisal Statute*, 81 COLUM. L. REV. 426, 426 (1981) (appraisal statutes afford shareholder right to receive compensation in place of shares). In order to enforce the statutory right of appraisal, a dissenting shareholder must follow the statutory appraisal procedure of the jurisdiction in question. *See* 6 CAVITCH, *supra* note 23, § 112.03[2], at 112-54 to -56. Most state appraisal procedures involve a six step process which

appraisal remedy to replace the veto power over all changes in corporate structure that each shareholder had possessed under the common law.[69] While unanimous shareholder consent for changes in corporate structure proved too restrictive for the needs of modern business, state appraisal proceedings provide management too much flexibility in altering shareholder rights.[70]

Although legislatures intended for appraisal to serve as a check on management's ability to freeze out minority shareholders at prices which management unilaterally sets in the merger agreement, shareholders may utilize the appraisal remedy only after fundamental changes in corporate structure occur.[71] The appraisal remedy, therefore, allows shareholders to challenge the price at which a freezeout merger has divested minority shares without providing shareholders a means of challenging the merger itself.[72] Moreover, appraisal allows management groups to consummate a freezeout transaction despite objections to the price that the corporation will pay for minority shares since state legislatures have designed the appraisal remedy to resolve all questions concerning the fair value of minority shares.[73] To the extent that appraisal proceedings can accurately value minority shares, appraisals do protect minority shareholders from exploitation in freezeout transactions.[74] Whether appraisal proceedings are in fact successful in valuing corporate shares, however, is an issue of considerable controversy.[75]

---

first requires a dissenting shareholder to file a written objection to the pending transaction at the time of or prior to the shareholder meeting at which the board of directors will act on the pending transaction. *Id.* The dissenting shareholder, however, must either vote against the proposed transaction or abstain from voting entirely. *Id.* The dissenting shareholder must next make a formal demand for payment and file a written notice of the dissenting election within a stated period after the corporation has informed the dissenting shareholder that a majority of shareholders have authorized the proposed transaction. *Id.* The dissenting shareholder must finally submit his share certificates after electing to dissent and initiate legal proceedings if the amount which the corporation offers is unacceptable and the corporation has not initiated legal proceedings upon the dissenting shareholders' refusal to accept the corporation's offer. *Id.*

69. *See* 13 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5906.1 (rev. perm. ed. 1980) (states enacted appraisal statutes to afford relief to dissenters following changes in corporate structure); Comment, *Valuation of Dissenters' Stock Under Appraisal Statutes*, 79 HARV. L. REV. 1453, 1453 (1966) (states enacted appraisal statutes to replace common-law right of shareholders to veto changes in corporate structure).

70. *See Exclusive Remedy, supra* note 67, at 546-47 (unanimous consent requirement was unsatisfactory to both corporation and dissenting shareholders); *infra* notes 71-82 and accompanying text (appraisal remedy favors management in management buyouts transactions).

71. *See* 6 Z. CAVITCH, *supra* note 23, § 112.02[1], at 112-16 (dissenting shareholders' right to be bought out is contingent on consummation of corporate transactions); 13 W. FLETCHER, *supra* note 69, at § 5906.7 (procedure to obtain appraisal generally requires shareholders to give notice to corporation within stated period of time following resolution authorizing merger).

72. *See supra* note 68 (appraisal provides means for shareholder to equitably depart from corporate ownership).

73. *See* Vorenberg, *supra* note 67, at 1191 (availability of appraisal remedy may foreclose shareholders from other forms of judicial relief); *Exclusive Remedy, supra* note 67, at 547-48 (appraisal is exclusive remedy for dissenting shareholders in Pennsylvania).

74. *See In re* Jones & Laughlin Steel Corp., 263 Pa. Super. Ct. 378, 389, 398 A.2d 186, 192 (1979) (appraisal remedy protects interests of both shareholders and corporations).

75. *See* Pellman v. Cinerama, Inc., 503 F. Supp. 107, 110 (S.D.N.Y. 1980) (procedural

In determining the value of dissenting shareholders' shares, appraisal proceedings often rely heavily on the price at which the corporation's shares were trading prior to public announcement of the merger transaction.[76] Because the value of control of a public company commands a premium over the price at which a company's shares normally trade,[77] court reliance on pre-tender offer market prices precludes shareholders electing the appraisal remedy from receiving any portion of the premium that typically accompanies tender offers.[78] Shareholders whose companies are conducting a freezeout of minority shares may confront the alternatives of accepting management's tender offer at a price that does not reflect the company's value or electing the appraisal remedy to produce a still lower judicial valuation.[79] Either way, management is able to purchase the corporation at a price which management perceives to be favorable, particularly when the market is depressed at the time of the buyout.[80]

---

defects in state appraisal proceedings prevent victims from receiving adequate relief in freezeout mergers); Weinberger v UOP, Inc., 457 A.2d 701, 713 (Del. 1983) (court terms Delaware's valuation procedure as structured, mechanistic, and outmoded); Vorenberg, *supra* note 67, at 1201 (resort to appraisal under best state statutory procedures provides shareholders with less than fair value); *Fair Shares, supra* note 32, at 306 (judicial procedure of appraisal proceedings is likely to underestimate future earnings of old enterprise).

76. *See* Harriman v. E.I. duPont Nemours & Co., 411 F. Supp. 135, 154 (D. Del. 1975) (Delaware law requires only that corporation pay to displaced shareholders premerger value of exchanged shares); Tanzer v. International Gen. Indus., 402 A.2d 382, 391 (Del. Ch. 1979) (control group's offer of premium over market price constitutes prima facie evidence of fairness); Poole v. N.V. Deli Maatschappij, 243 A.2d 67, 72 (Del. 1968) (fair market value is best measure of fair value of corporate shares in most circumstances); Deutschman, 281 App. Div. 14, 22-23, 116 N.Y.S.2d 578, 585, (1st Dept. 1952) (court holds that current market value is certainly fair indication of value of minority's interest).

77. *See* Lipton, *Takeover Bids In The Target's Boardroom*, 35 Bus. Law. 101, 132-33 (1979) (list of previous tender offer bids all involving large premiums); Weiss, *supra* note 27, at 679 (transactions prove that value of corporate shares is greater than normal trading prices when person is bidding for control).

78. *See* Chazen, *supra* note 38, at 1443-44. Courts have generally upheld acquisitions by controlling shareholders as fair so long as the displaced public shareholders received cash or securities of an equivalent value to the stock the public shareholders surrendered. *Id.*; *see* Mills v. Electric Auto-Lite Co., 552 F.2d 1239, 1246-47 (7th Cir.) (court uses average market prices for six months preceding buyout transaction to determine fair value of minority shares), *cert. denied*, 434 U.S. 922 (1977); Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, ____, 93 A.2d 107, 114 (Del. Sup. Ct. 1952) (court places reliance on market value of minority shares prior to merger transaction to value minority shares subsequent to merger); *supra* note 76 (courts traditionally rely on past market prices to value minority shares). Some commentators, however, argue that gains arising from the expectation of a merger should be shared with minority shareholders. *See Note On Going Private, supra* note 19, at 1037 (minority shareholders are entitled to portion of gains which corporation realizes through forced elimination of public shareholders); *Fair Shares, supra* note 32, at 311 n.37 (market prices are uniformly inadequate to measure contributions of parties to merger); Vorenberg, *supra* note 67, at 1202-03 (market price may reflect past distortions in economy or industry).

79. *See* Longstreth, *supra* note 2, at 15, col. 1-2 (appraisal remedy unlikely to yield higher price than management's tender offer); Sommer, *supra* note 14, at D-3 (shareholders confront empty choice of tendering shares or becoming liquidated in cashout merger).

80. *See* Berkowitz v. Power Mate Corp., 135 N.J. Super. 36, 43, 342 A.2d 566, 570 (1975) (depressed market prices induce corporate insiders to repurchase public's shares at fraction of original cost).

Management, moreover, is in a position to artificially deflate the market value of the corporation's shares, a practice which may ensure favorably low prices preceding a buyout and against which the SEC has few safeguards.[81] Appraisal proceeding reliance on market prices for valuing minority shares, therefore, favors management's interests because management has access to information concerning their company's true value as a going concern and will be likely to engage in buyout transactions when the market undervalues the company's shares.[82]

State courts, however, have recognized the limitations of the appraisal remedy in protecting minority shareholders and have responded by expanding the valuation procedures available in appraisal proceedings.[83] In the recent case of *Weinberger v. UOP, Inc.*[84] a plaintiff attempted to present evidence of corporate value using the discounted cash flow valuation technique.[85] The lower court rejected the plaintiff's discounted cash flow method of valuing the corporation's shares and held that evidence of valuation must be consistent with practice under prior Delaware appraisal proceeding case law.[86]

---

81. *See* Longstreth, *supra* note 2, at 20, col. 4. In deflating a corporation's trading prices prior to a buyout transaction, managers have broad discretion in reporting corporate financial information. *Id.* Management can affect earnings adversely by altering inventory, depreciation, or loss reserves accounting techniques. *Id.* The nonpayment of dividends, the sale of assets, and the deflation of earnings all provide management opportunities to deflate the corporation's market prices. *Id.* The SEC, moreover, has designed reporting conventions to guard against unduly optimistic financial reporting and has had little experience guarding against fraud in pessimistic reporting. *Id.* Although intentionally deflating a corporation's trading prices in preparation for a management buyout constitutes fraud under federal securities laws, courts afford a great deal of discretion to corporate fiduciaries in making business judgments. *Id.*; *see* 15 U.S.C. §§ 78j, 78j(b) (1934) (Section 10(b) of the Securities & Exchange Act of 1934 prohibits use of fraudulent devices in securities transactions). Moreover, management may engage in conduct which has the effect of depressing stock market prices for the legitimate purpose of strengthening the corporation's balance sheet. *See* Longstreth, *supra* note 2, at 21, col. 1 (legitimate business practices may have interim effect of depressing stock market prices); *infra* notes 191-92 and accompanying text (court will not interfere with management's business judgment so long as court can find rational business purpose to management's conduct).

82. *See* Brudney, *supra* note 3, at 1095. Brudney's contention is that the market cannot correctly value a corporation's shares because the market does not possess inside information concerning the firm's future prospects. *Id.* Brudney asserts further that market imperfections such as under-valuation of share prices enhances the temptation of corporate insiders who do possess inside information to pursue personal gain by taking companies private. *Id.* at 1096; *see supra* note 1 (allure of economic interests induces management to take companies private).

83. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983) (court terms Delaware's appraisal remedy valuation procedure as "outmoded").

84. 457 A.2d 701 (Del. 1983).

85. *Id.* at 712 (Chancellor rejected use of discounted cash flow method of valuation as not corresponding with either logic or existing law); *see* V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 3-59 (1981) (discussion of techniques for valuing going concerns). In arriving at the value a purchaser would currently pay for a company's future earnings, the discounted cash flow technique accounts for the time value of money. *Id.* at 36. Because banks and institutions are willing to pay interest for the use of an individual's cash, a dollar paid in the future is worth less than a dollar payable today. *Id.* The discounted cash flow technique discounts or reduces the value of expected future earnings to reflect the fact that earnings available in the future are worth less than earnings available in the present. *Id.*

86. 457 A.2d at 712.

Although Delaware's appraisal statute does not specify the techniques by which courts are to conduct valuation of public companies,[87] Delaware courts have fashioned a rigid procedure of valuation known as the Delaware Block Approach.[88] Under the Delaware block approach to valuation, the court first determines a corporation's market value, earnings value, and asset value.[89] The court next assigns a percentage weight to each value and sums the weighted values to produce an appraised value for the corporation.[90] The *Weinberger* court, however, determined that the Delaware block procedure was outmoded, structured, and mechanistic, and held that appraisal proceedings must in the future allow proof of value by any of the techniques of valuation acceptable in the financial community.[91] The financial community in fact uses a series of valuation techniques to ascertain the value of public companies including the discounted cash flow procedure,[92] the capitalization of prospective earnings,[93] and the comparison of purchase prices to recent sales of similar companies in open market transactions.[94]

---

87. *See* DEL. CODE ANN. tit. 8, § 262 (1953) (procedure for valuing public companies does not appear in Delaware's appraisal statute).

88. *See* Sporberg v. City Specialty Stores, 35 Del. Ch. 560, ___, 123 A.2d 121, 124-27 (Del. Ch. 1956) (Delaware courts utilize Delaware block approach to value public companies during appraisal proceedings).

89. *See id.* (court discerns value of corporation's assets, future earnings, and outstanding shares). In determining the value of a corporation's assets, the court looks to the fair market value of the corporation's assets at the time of the merger. *See* Poole v. N.V. Deli Maatschappij, 243 A.2d 67, 70-72 (Del. 1968). The earnings value reflects the corporation's averaged earnings, capitalized at an industry derived capitalization rate. *See* Universal City Studios v. Francis I. DuPont & Co., 334 A.2d 216, 218-22 (Del. 1975) (court considers industry outlooks in determining appropriate multiplier); *In re* Olivetti Underwood Corp., 246 A.2d 800, 804 (Del. Ch. 1968) (court included past sales as one factor in determining appropriate earnings multiple). Finally, the court looks to the trading price of the corporation's shares on the last day before announcement of the merger to assign a value to the corporation's shares. *See* Levin v. Midland-Ross Corp., 41 Del. Ch. 276, ___, 194 A.2d 50, 53-54 (Del. Ch. 1963).

90. *See* Poole v. N.V. Deli Maatschappij, 243 A.2d 67, 72-73 (Del. 1968) (court adds weighted values to determine true value of corporate shares); Sporberg v. City Specialty Stores, 35 Del. Ch. 560, ___, 123 A.2d 121, 124-27 (Del. Ch. 1956) (weighted values of earnings, assets, and market price comprise the value of corporate shares).

91. 457 A.2d at 713.

92. *See supra* note 85 (discounted cash flow technique accounts for time value of money with respect to future cash flows).

93. *See* V. BRUDNEY & M. CHIRELSTEIN, *supra* note 85, at 3-59 (1981) (discussion of techniques for valuing going concerns). In valuing a stream of payments which will continue in perpetuity, an investor will frequently multiply the payment which the investor expects to receive each year by the reciprocal of an appropriate discount rate. *Id.* at 36. The investor can derive an appropriate discount rate for a stream of future payments by adding to the rate of interest an investor would receive on a hypothetical riskless investment a premium to account for the risk intrinsic to the investment in question. *See* J. BONBRIGHT, THE VALUATION OF PROPERTY 219 (1965) (factors of pure interest and risk premium comprise discount rate). Once the investor determines the time value of money or discount rate which another would pay for the use of funds for a particular investment, the investor multiplies the payment which the investor expects to receive in each year by the reciprocal of the discount rate. *See* V. BRUDNEY & M. CHIRLESTEIN, *supra* note 85, at 36. This process of multiplying a payment which an investor expects to receive each year in perpetuity by the reciprocal of a discount rate is known as capitalizing a future income stream. *Id.*

94. *See* Chazen, *supra* note 38, at 1478 (possible to determine fairness of controlling

The *Weinberger* court's broadening of admissible appraisal proceeding valuation evidence represents a significant advancement in Delaware case law.[95] Delaware courts have been very reluctant to deviate from precedents using the block approach despite convincing evidence that the block approach is too restrictive a procedure to arrive at accurate valuations in certain circumstances.[96] By permitting the use of modern valuation techniques in Delaware appraisal proceedings, the *Weinberger* court has increased the probability that appraisal proceedings will produce accurate valuations of corporate shares.[97] Moreover, minority shareholders will now be able to present in appraisal proceedings the modern techniques of valuation which management has likely utilized in planning the buyout transaction.[98] Some commentators have suggested additionally that *Weinberger*'s expanded appraisal remedy will result in higher appraised values of public companies, benefitting electing shareholders.[99] Since Delaware is a leading state in the area of corporate and securities laws, other states may similarly permit the use of modern valuation techniques in statutory appraisal proceedings.[100]

In addition to the protection which the appraisal remedy provides to minority shareholders, a majority of states protect minority shareholders by enjoining on equitable grounds transactions for which the appraisal remedy would not provide adequate relief.[101] Particularly in cases involving fraud, misrepresentation, self-dealing, or waste of corporate assets, state courts fre-

---

shareholder's offer by comparisons to negotiated acquisitions of public shares in similar companies).

95. *See supra* notes 91-94 and accompanying text (Weinberger court's valuations procedure represents significant change from previous Delaware valuation procedure).

96. *See* Levin v. Midland Ross Corp., 41 Del. Ch. 276, ____, 194 A.2d 50, 58 (Del. Ch. 1963) (despite court's recognition that appraiser's high weighting of asset value was appropriate, court lowered asset value weight to conform with Delaware precedents); Weiss, *supra* note 27, at 655 (failure of Delaware block approach to include post merger value of company results in less than fair valuations of shareholder interests); Comment, Tannetics Inc. v. A.J. Indust., 5 DEL. J. CORP. L. 337, 346-48 (1980) (court insisted on averaging earnings over five year period in conformance with precedents despite convincing evidence that three year earnings period was more appropriate).

97. *See* Berger & Allingham, *A New Light on Cash-Out Mergers:* Weinberger *Eclipses* Singer, 39 BUS. LAW. 1, 22 (1983) (new appraisal approach should yield shareholders greater fair values).

98. *See supra* notes 92-94 and accompanying text (finance professionals use series of modern valuation techniques to discern value of ongoing companies).

99. *See* Berger & Allingham, *supra* note 97, at 22 (appraisals utilizing modern valuation techniques will likely provide minority shareholders greater value for minority shares than appraisals utilizing Delaware block approach).

100. *See* Kaplan, *Fiduciary Responsibility In The Management Of The Corporation*, 31 BUS. LAW. 883, 889 (1976) (large proportion of all corporate litigation occurs in State of Delaware because of disproportionate number of corporations with Delaware charters).

101. *See, e.g.*, Bryan v. Brock & Blevins Co., 490 F.2d 563, 570 (5th Cir.) (court enjoined merger under Georgia law for serving no legitimate business purposes), *cert. denied*, 419 U.S. 844 (1974); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) (court will interfere with corporation's decision to pay dividend despite corporation's compliance with dividend statute when plaintiff can prove corporation paid dividend for improper purposes); Berkowitz v. Power/Mate Corp., 135 N.J. Super. 36, 49-50, 342 A.2d 566, 570-74 (1975) (court enjoined merger to secure interests of minority shareholders despite compliance with state merger statute).

quently provide equitable relief for the protection of minority shareholders.[102] A minority of states, however, have gone even further in protecting shareholder rights by recognizing an equity right of shareholders to continued participation in the corporation which extends beyond the right of shareholders to receive fair value for displaced shares.[103]

For example, in the California case of *Jutkowitz v. Bourns, Inc.*,[104] the plaintiff shareholder brought an action to obtain injunctive relief preventing Bourns, Inc. (Bourns) from engaging in a merger transaction for the purpose of eliminating Bourns' publicly held shares.[105] Bourns argued to the court that injunctive relief was inappropriate because California's appraisal remedy was capable of adequately protecting minority shareholder interests.[106] The *Jutkowitz* court, however, held that shareholder values other than the right to receive fair value subsequent to the merger transaction were at stake in going private transactions.[107] Specifically, the *Jutkowitz* court stated that shareholders may have differing tax problems, investment goals, or personal attachments to specific companies for which the appraisal remedy could not provide adequate relief after a buyout transaction had occurred.[108] The *Jutkowitz* court, therefore, enjoined Bourns from engaging in any transaction that would compel the retirement of Bourn's publicly held shares.[109]

In establishing that a shareholder has personal interests in a share of stock which the appraisal remedy is incapable of protecting, the *Jutkowtiz* court opened the way for minority shareholders to challenge directly buyout transactions despite the availability of the appraisal remedy.[110] To the extent that the appraised value of minority shares does not satisfy the differing investment interests of shareholders, appraisal should not preclude shareholder ac-

---

102. *See, e.g.*, Goldberg v. Meridor, 567 F.2d 209, 219 (2d Cir. 1977) (courts of New York show no hesitancy in granting injunctive relief where appraisal remedy is not available to protect shareholders), *cert. denied*, 434 U.S. 1069 (1978); Zimmerman v. Tide Water Associated Oil Co., 61 Cal. App. 2d 585, ___, 143 P.2d 409, 411-12 (1943) (court provided equitable relief to shareholder following inequitable dissolution transaction); Weinberger v. UOP, Inc., 457 A.2d 701, 714 (Del. 1983) (Chancellor may provide any form of equitable relief when appraisal remedy is not sufficient to protect minority shareholders).

103. *See infra* notes 103-21 and accompanying text (minority of states recognize shareholders equitable right to continued participation in corporation).

104. CA 000268, slip op. (Cal. Super. Ct. Nov. 19, 1975).

105. *See* Jutkowitz v. Bourns, Inc., 118 Cal. App. 3d 102, 105, 173 Cal. Rptr. 248, 249 (1981) (Bourns family intended to take company private through freezeout merger transaction).

106. *See* Jutkowitz v. Bourns, Inc., CA 000268, slip op. (Cal. Super. Ct. Nov. 19, 1975), *as reported in* Singer v. Magnavox Co., 380 A.2d 969, 977 n.8 (Del. 1977) (defendant argued that appraisal was sufficient to protect plaintiff shareholder because appraisal would provide fair value of plaintiff's shares).

107. *See id.* (money will not satisfy all shareholder interests).

108. *See id.* (although some or most minority shareholders will be satisfied to receive money payments, other shareholders will have different judgments as to desirability of selling out).

109. *See* Jutkowitz v. Bourns, Inc., 118 Cal. App. 3d 102, 105, 173 Cal. Rptr. 248, 249 (1981) (Jutkowitz obtained preliminary injunction preventing freezeout attempts).

110. *See* Berger & Allingham, *supra* note 97, at 7 (court's acknowledgement of shareholder's nonpecuniary right in corporate shares which appraisal remedy cannot protect allows shareholders to directly challenge merger transactions).

tions to enjoin pending freezeout transactions.[111] In *Singer v. Magnavox*,[112] the Delaware Supreme Court relied in part on the *Jutkowitz* decision in holding that a shareholder possesses an equity right to continued participation in the corporation which extends beyond a right to receive fair value in subsequent appraisal proceedings.[113] In *Singer*, former minority shareholders of the Magnavox Corporation brought an action in the Delaware Court of Chancery to nullify a merger that Magnavox's parent company had arranged for the purpose of freezing out Magnavox's minority shareholders.[114] The Supreme Court of Delaware stated on appeal that a parent company, as the controlling shareholder of its subsidiary companies, owes the subsidiary's public shareholders a fiduciary duty of fairness which the parent company violates by engaging in mergers for the sole purpose of freezing out minority shareholders.[115] The *Singer* court held that a parent company must possess a proper business purpose for carrying out a merger which eliminates minority shares to avoid breaching the parent company's fiduciary duty to shareholders of the subsidiary companies.[116] Although the *Singer* court stated that shareholders possess legally protected rights in owning a corporation's shares which extend beyond the right to receive fair value in post-merger appraisal proceedings,[117] the *Singer* court was not specific in describing a shareholder's legally protected rights.[118] Moreover, the Delaware Supreme Court has subsequently broadened the definition of a proper business purpose to such a degree as to permit freezeout mergers in most instances[119] and has recently determined

111. *See id.* at 7-8 (shareholder's equity right in shares provided minority shareholders grounds to challenge consummation of freezeout mergers).

112. 380 A.2d 969 (Del. 1977).

113. *Id.* at 980 (shareholders abuse corporate process by engaging in freezeout mergers for sole purpose of divesting minority shareholders).

114. *Id.* at 971-73 (acquiring corporation had obtained 84.1% of Magnavox's outstanding shares prior to conducting freezeout of Magnavox's remaining shareholders).

115. *Id.* at 978.

116. *See id.* at 980 & n.11. In holding that a party abuses the corporate process by conducting a freezeout merger for the sole purpose of divesting minority shareholders, the *Singer* court indicated that a freezeout merger is valid if the merger serves proper business purposes. *Id.* The *Singer* court, however, specifically declined to elaborate on whether a merger must serve the business purposes of the subsidiary corporation or the business purposes of the parent corporation in order to be valid. *Id.*

117. *See id.* at 977 (*Singer* court states that shareholder's right is not exclusively in value of equity investment).

118. *See id.* Although the *Singer* court strongly denied that a dissenting shareholder has no legally protected rights beyond the right to receive fair value from the majority shareholders, the *Singer* court did not elaborate on what a dissenting shareholder's other legally protected rights were. *Id.* The *Singer* court, however, did cite *Jutkowitz v. Bourns* for the proposition that shareholders have differing interests in corporate shares which may lead to differing judgments as to the desirability of selling out. *Id.* at 977 n.8; *see* Jutkowitz v. Bourns, CA 000268, slip op. (Cal. Super. Ct. Nov. 19, 1975) (shareholders have differing investment goals, tax problems, and sentimental attachments).

119. *See* Tanzer v. Int'l Gen. Indus., 379 A.2d 1121, 1124-25 (Del. 1977) (discussing *Singer*'s proper business purpose requirement for parent-subsidiary mergers). In Tanzer v. Int'l Indus., International General Industries (IGI) sought to merge IGI's 81% owned subsidiary into IGI for the purpose of facilitating IGI's long term debt financing. *Id.* at 1124. The Delaware Supreme

that *Singer's* business purpose requirement does not serve any function at all.[120] Nevertheless, courts in a growing minority of states have cited *Singer v. Magnavox* for the proposition that a parent company must possess a valid business purpose for freezing out minority shareholders and have awarded equitable relief to minority shareholders whose companies have attempted to complete mergers for the sole purpose of eliminating minority shares.[121]

In addition to state protections for minority shareholders, federal law also provides protection against shareholder exploitation in management buyout transactions.[122] The jurisdiction of federal courts to regulate management buyouts, however, has been an issue of considerable controversy.[123] In 1977, the SEC proposed rules that would have required buyout transactions to be fair to minority shareholders.[124] Commentators on the proposed rule, however, quickly responded that Congress had not granted the SEC authority to regulate buyout transactions because buyout transactions were an area of state concern[125]

Court held on appeal that a merger which conveys economic benefit to a parent corporation is a legitimate merger under *Singer's* proper business purpose requirement. *Id.* at 1124-25. The Delaware Supreme Court, moreover, held that freezeout mergers between parent and subsidiary corporations which solely benefit the parent company do not violate *Singer's* business purpose requirement so long as the parent company's real interest in causing the merger is not the elimination of minority shareholders. *Id.*

120. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 715 (Del. 1983) (discussing utility of *Singer's* business purpose requirement for parent-subsidiary mergers). In reviewing the protections available to Delaware shareholders during parent-subsidiary mergers, the *Weinberger* court questioned whether *Singer's* business purpose requirement provided additional meaningful protection to shareholders. *Id.* The *Weinberger* court suggested that Delaware's expanded appraisal remedy in particular was sufficient to adequately protect minority shareholders. *Id.*; *see supra* notes 91-100 and accompanying text (*Weinberger* court greatly expands valuation criteria for Delaware's appraisal proceedings).

121. *See* Albright v. Bergendahl, 391 F. Supp. 754, 756-57 (D. Utah 1974) (court set aside merger on grounds that merger served no business purpose other than termination of minority shareholder interests and therefore breached controlling shareholder's fiduciary duty to minority shareholders under Utah law); Perl v. IU Int'l Corp., 607 P.2d 1036, 1046 (Hawaii 1980) (merger for sole purpose of divesting minority shareholders is a violation of fiduciary principles under Hawaii law and appraisal is not exclusive remedy for minority shareholders in such cases); Gabhart v. Gabhart, 267 Ind. 370, ____, 370 N.E.2d 345, 357-58 (1977) (merger which serves no valid corporate purpose other than elimination of minority shares is a de facto dissolution which shareholders may enjoin); Clark v. Pattern Analysis, 87 Misc. 2d 385, 388-90, 384 N.Y.2d 660, ____ (1976) (freezing out of minority shareholders violates controlling shareholders' fiduciary obligation to minority shareholders absent valid corporate purpose).

122. *See* Longstreth, *supra* note 2, at 19, col. 1-2 (discussion of federal protections for minority shareholders in freezeout transactions); *infra* text accompanying notes 135-59 (inadequacy of federal protections for minority shareholders in buyout transactions).

123. *See* Note, *Regulating Going Private Transactions: SEC Rule 13e-3*, 80 COLUM. L. REV. 782, 786 (1980) (Congress has not authorized SEC to regulate fairness of buyout transactions which are subject to state concern).

124. *See id.* at 786 & n.40 (rule would have made illegal going private transactions unless going private transaction was fair to "unaffiliated security-holders").

125. *See* SEC Release No. 34-16075, 44 FED. REG. 46, 736 (1979) (criticism of proposed SEC rule that would have required that going private transactions be fair to minority shareholders in accordance with SEC determinations); Brudney, *supra* note 3, at 1098 (organized security bar

in light of the Supreme Court's decision in *Santa Fe Indus. v. Green.*[126] In *Santa Fe,* former minority shareholders of the Kirby Lumber Corporation (Kirby) brought an action to set aside a merger between Kirby and Santa Fe Industries (Santa Fe) on the grounds that the merger violated section 10(b) of the '34 Act which prohibits the use of any fraudulent or manipulative devices in the sale of securities.[127] Specifically, the plaintiffs alleged that Sante Fe had breached the prohibitions of the '34 Act[128] and Santa Fe's fiduciary duty to Kirby's minority shareholders by obtaining a fraudulent appraisal of Kirby's value for the purpose of freezing out Kirby's public shareholders at a wholly inadequate price.[129] Moreover, Santa Fe owned 95 percent of Kirby's outstanding shares prior to the merger transactions and was therefore able to set the price that Kirby shareholders were to receive for Kirby's shares pursuant to Delaware's one-step merger statute.[130] The United States District Court for the Southern District of New York, however, found that Santa Fe had fully disclosed to Kirby's minority shareholders the information with which Santa Fe had valued Kirby's minority shares without omission, misstatement, or fraudulent conduct that would have impeded a shareholder's choice between accepting Santa Fe's offering price or electing appraisal.[131] On appeal, the Supreme Court held that Santa Fe had not violated section 10(b) of the '34 Act prohibiting manipulation and deception because Santa Fe had made full and fair disclosures to Kirby minority shareholders in compliance with the Securities and Exchange Act.[132] The Supreme Court further stated that section 10(b) of the '34 Act did not apply to a fiduciary's use of a freezeout merger to eliminate minority shares because state law generally governs alleged abuses in going private transactions as well as allegations of corporate fiduciary self-dealing.[133] The Supreme Court concluded by stating that absent clear in-

---

responded sharply that Congress had not authorized SEC to require that transactions be "fair" to shareholders).

126. 430 U.S. 462 (1977).

127. *Id.* at 467-68; *see* 15 U.S.C. § 78j(b) (1976) (§ 10(b) of '34 Act).

128. *See* 15 U.S.C. § 78j(b) (1976) (§ 10(b) of '34 Act); *id.* § 78m(e) (§ 13(e) of '34 Act authorizes SEC to design regulations for purpose of preventing "fraudulent," "deceptive," or "manipulative" practices in sale of securities).

129. *See* 430 U.S. at 467 (plaintiff alleged that Santa Fe had obtained an unrealistically low appraisal of Santa Fe's stock so that Santa Fe's shareholders would believe that Santa Fe's offer was generous).

130. *Id.* at 465; *see* DEL. CODE ANN. tit. 8, § 253(a) (1979) (parent company may effect short-form merger of subsidiary company if parent company owns at least 90% of subsidiary's outstanding shares); *supra* notes 22-33 and accompanying text (freezeout procedures for effecting going private transactions).

131. *See* 430 U.S. at 474 (Santa Fe had furnished to minority shareholders all relevant information concerning Santa Fe's offer to purchase minority shares).

132. *See id.* at 474-80 (complaint failed to allege material misrepresentation or failures to disclose and thus involved no manipulation or deception under '34 Act); *supra* note 128 (Congress authorized SEC to design regulations prohibiting fraudulent, deceptive, or manipulative practices in sale of securities).

133. *See* 430 U.S. at 479-80 (state law defines duties and obligations of corporate fiduciaries).

dications of congressional intent, the Court would continue to be reluctant to federalize state fiduciary standards for internal corporate affairs.[134]

The effect of the *Santa Fe* decision is to deny federal jurisdiction to claims contesting the fairness of going private transactions unless an omission, misstatement, or fraudulent act is present to bring the buyout transaction within the ambit of the '34 Act.[135] The SEC, therefore, retracted the 1977 proposed rules that would have required that buyout transactions be fair to minority shareholders and instead issued SEC rule 13e-3 in 1979 to respond to the problem of management buyout transactions.[136] SEC rule 13e-3 requires that companies contemplating a going private transaction make a series of disclosures, the most significant of which are whether the nonmanagement directors have approved the transaction,[137] whether the transaction requires the ratification of shareholders not affiliated with the purchasing group,[138] whether management reasonably believes the transaction is fair to public shareholders,[139] and whether the company has obtained a fairness opinion.[140] Critics of management buyouts, however, contend that rule 13e-3's disclosure requirements are ineffectual in securing fairness for displaced shareholders during management buyout transactions.[141] The approval of nonmanagement directors to the terms of a buyout agreement is not likely to assure fairness for minority shareholders because nonmanagement directors are likely to have business or personal ties to management and the management directors who frequently select the nonmanagement directors.[142] Similarly, the vote of shareholders who are not affiliated with the purchasing group is of questionable value in assuring fairness

---

134. *Id.*

135. *See id.* at 478-80 (Court may not derive corporate fiduciary standards mergers from '34 Act); Longstreth, *supra* note 2, at 19, col. 1-2 (*Santa Fe* decision denies shareholders right to contest fairness in any federal forum).

136. *See* 17 C.F.R. §§ 140.13e-3, 240.13e-100 (1979) (SEC Rule 13e-3); Securities Exchange Act Release No. 16075, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,166 at 82,123-31 (Aug. 2, 1979) (discussion of disclosure requirements for going private transactions); *see also* Radol v. Thomas, 534 F. Supp. 1302, 1310-11 (S.D. Ohio 1982) (SEC enacted rule 13e-3 in response to problem of overreaching in going private transactions).

137. *See* 17 C.F.R. § 240.13e-100 (1979) (item 8(d) of rule 13e-3 requires disclosure of whether majority of directors not employees of issuer have approved transactions).

138. *See id.* (item 8(c) of rule 13e-3 requires disclosure of whether transaction requires approval of unaffiliated shareholders).

139. *See id.* (item 8(a) of rule 13e-3 requires disclosure of whether transaction requires approval of unaffiliated shareholders).

139. *See id.* (item 8(a) of rule 13e-3 requires disclosure of whether issuer reasonably believes transaction is fair or unfair to unaffiliated shareholders).

140. *See id.* (item 9(a) & (b) of rule 13e-3 requires disclosure of whether issuer has obtained an appraisal from an outside party).

141. *See* Longstreth, *supra* note 2, at 19, col. 2 (SEC commissioner Longstreth questions effectiveness of Rule 13e-3 disclosures in assuring fairness for minority shareholders); Thomas, *A Free Ride for Management Insiders*, N.Y. Times, Jan. 22, 1984, at D-2, col. 4 (criticizing present lack of disclosure in management buyout process).

142. *See* Longstreth, *supra* note 2, at 20, col. 1 (Longstreth discounts effectiveness of outside director approval in securing fairness for minority shareholders because sentiments of directors are normally with management rather than shareholders).

for minority shareholders when unaffiliated shareholders are not in a position to evaluate the terms of the buyout transaction and perceive no alternatives to accepting management's offer. Finally, management's personal interest in a management buyout transaction leads one to question the value of management's opinion as to whether the transaction is fair to minority shareholders in assuring fairness for minority shareholders.[143] Although SEC rule 13e-3 does not actually require that a company contemplating a buyout transaction implement the practices which the rule requires to be disclosed, a former SEC commissioner has suggested that a company's use of rule 13e-3's disclosed practices may give the appearance that the SEC has sanctioned the fairness of the buyout transaction.[144] To the extent that rule 13e-3's disclosure requirements fail to assure fairness for minority shareholders and create the misleading impression that the SEC has reviewed the fairness of the buyout transaction, rule 13-e may be more of a boon to management contemplating a buyout transaction than a protection for minority shareholders.[145]

SEC rule 13e-3's most significant disclosure requirement, however, is whether the corporation has obtained a fairness opinion from an independent financial institution.[146] Investment banking firms normally issue fairness opinions which state that the financial terms of a transaction are fair to public shareholders.[147] While SEC rule 13e-3 does not actually require controlling shareholders to obtain a fairness opinion, an investment banker's opinion on fairness may favorably influence a court or shareholder in reviewing the fairness of a buyout transaction.[148] A favorable opinion on fairness, however, does not mean that management's offering price to minority shareholders is similar

---

143. *See* Schreiber v. Bryan, 396 A.2d 512, 519 (Del. Ch. 1978) (court does not give legal effect to minority shareholder vote in part because majority shareholders have influence over subsidiary corporations); Mayer v. Adams, 37 Del. Ch. 298, 301, 141 A.2d 458, 460 (Del. 1958) (court acknowledges fact that shareholders will seldom oppose management in shareholder meetings); Weiss, *supra* note 27, at 676 (shareholders frequently behave like sheep when voting on transactions and normally support management's recommendation).

144. *See* Longstreth, *supra* note 2, at 20, col. 2 (SEC Rule 13e-3's disclosure requirements may encourage buyout transactions because disclosures provide management groups with SEC approved procedure for conducting transaction).

145. *See id.* at 21, col. 2 (Longstreth questions adequacy of state and federal protections in buyout transactions). In criticizing the effectiveness of SEC Rule 13e-3's disclosure requirements for the protection of minority shareholders, Commissioner Longstreth stated that Rule 13e-3's disclosures protect management from shareholder attacks but fail to assure fairness for shareholder. *Id.* Longstreth moreover terms Rule 13e-3's disclosure requirements as "boilerplated passkeys" to advantageous buyouts. *Id.*

146. *See* 17 C.F.R. § 240.13e-100 (1979) (items 9(a) & (b) of SEC Rule 13e-3 require disclosure of whether an outside party has considered fairness of management's offer to minority shareholders and content of outside party's findings with respect to company's value).

147. *See* Chazen, *supra* note 38, at 1442 (boards of directors normally obtain fairness opinions prior to corporate acquisitions).

148. *See* Tanzer v. International Gen. Indus., Inc., 379 A.2d 1121, 1124-25 (Del. Ch. 1977) (entire fairness of buyout transaction is determinative of whether management has fulfilled fiduciary obligation to shareholders); Longstreth, *supra* note 2, at 19, col. 3 (fairness opinion provides powerful support for board's judgment in buyout transactions).

to the value a third party might pay for the same minority interests.[149] On the contrary, a determination of financial fairness accommodates a large range of managerial discretion and represents only that a given offer is not unreasonably low in relation to a company's other sale opportunities.[150]

The latitude inherent in fairness opinions derives from the standard which courts apply to test a corporate fiduciary's conduct in differing contexts.[151] The standard which most states apply to test a corporate fiduciary's conduct is the business judgment standard.[152] The business judgment standard presumes that corporate fiduciaries act in good faith and exercise sound business judgment which courts will not disturb in the absence of bad faith, fraud, or palpable overreaching.[153] Because courts test a corporate fiduciary's conduct under the business judgment standard, a corporate fiduciary does not require a financial opinion which states that an offer is the highest or best available to minority shareholders in a corporate control transaction.[154] A fairness opinion reflecting the business judgment standard's presumption of good faith is sufficient to justify both the fairness of the sale transaction and the fiduciary's conduct in making the purchase.[155] Moreover, a corporate fiduciary does not require a financial opinion which states that the price minority shareholders receive in a freezeout transaction is equivalent to that which minority shareholders would likely receive in an arms-length negotiation.[156] A fairness opinion reflecting the business judgment standard's presumption of good faith serves the fiduciary's purpose of justifying the fairness of the merger transaction and the fiduciary's conduct in executing the merger.[157] Although a

149. *See* Chazen, *supra* note 38, at 1454 (fairness opinions cover a large range of fair prices and do not assure shareholders that management's offering price is best available in market).

150. *See id.* (fairness opinion does not certify that management's offer is best or highest available); *infra* notes 151-58 and accompanying text (favorable opinion on fairness obligates neither investment banker issuing opinion or management group making offer that management's offer to minority shareholders is best available in market).

151. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719-22 (Del. 1971) (business judgment rule generally governs parent company's fiduciary duty to subsidiary company shareholders); *infra* notes 191-92 and accompanying text (business judgment rule permits management great deal of discretion).

152. *See* Massaro v. Vernitron Corp., 559 F. Supp. 1068, 1080 (D. Mass. 1983) (Delaware corporate law evaluates claims involving corporate fiduciary conduct under business judgment standard); Chazen, *supra* note 38, at 1453 (business judgment rule generally governs corporate fiduciary's response to acquisition proposals).

153. *See* Massaro v. Vernitron, 559 F. Supp. 1068, 1080 (D. Mass. 1983) (court will not disturb corporate fiduciary's business judgment so long as fiduciary's corporate decisions may have rational business purposes).

154. *See* Chazen, *supra* note 38, at 1453-54 (investment banker would probably not even issue opinion that specific offer is highest or best available).

155. *See* Longstreth, *supra* note 2, at 19, col. 3 (fairness opinion provides powerful legal support for judgment of corporate fiduciaries).

156. *See* Chazen, *supra* note 38, at 1453-54 (board of directors does not require opinion on financial fairness that utilizes standard stricter than business judgment standard); *infra* text accompanying note 157 (court will judge corporate fiduciary's conduct by business judgment rule which presumes that fiduciary acts in good faith).

157. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719-22 (Del. 1971) (court will not inter-

favorable opinion on fairness provides some protection for minority shareholders by assuring that a given offer is not unreasonably low in relation to a company's other sale opportunities, shareholders may incorrectly perceive an investment banker's opinion on fairness to mean that management's offering price for minority shares is equivalent to that which a third party would offer in an arms-length negotiation.[158] SEC rule 13e-3's disclosure of whether the company has obtained a fairness opinion, therefore, may be of greater benefit to management in establishing the fairness of a buyout transaction than to shareholders in assuring that minority shareholders receive fair value during buyout transactions.[159]

A recently attempted buyout transaction illustrates the utility of fairness opinions in assuring that minority shareholders receive a value equivalent to market values in management buyout transactions.[160] In June of 1983, Stokley-Van Camp, Inc. (Stokely) sought shareholder approval for a management buyout of all of Stokely's publicly held shares.[161] Stokely had previously obtained a fairness opinion from an investment banking firm which stated that management's 55 dollar offer to Stokely's shareholders was fair from a financial point of view.[162] Moreover, Stokely's nonmanagement directors recommended the transaction to the entire board of directors who in turn concluded that the buyout transaction was fair and attractive to Stokely's shareholders.[163] Four weeks after Stokely's 55 dollar offer, however, Pillsbury Company offered 62 dollar per share for Stokely's outstanding shares.[164] Still three weeks after Pillsbury's offer, Quaker Oats Co. tendered at 77 dollar per share for all outstanding shares and was successful in acquiring Stokely.[165] Here, Stokely's shareholders were lucky.[166] The Stokely management group only controlled

---

fere with fiduciary's business conduct under business judgment rule absent showing of gross and palpable overreaching).

158. *See* SEC v. Parklane Hosiery Co., 442 F. Supp. 477, 486 (S.D.N.Y. 1976) (shareholder placing weight on fairness opinion risks danger of believing that management's offer is actually fair while fairness opinion is in fact of little value in assessing fairness of management's offer); Longstreth, *supra* note 2, at 20, col. 2 (fairness opinion will heavily influence shareholders into believing transaction is fair without assuring that management's offer is actually fair).

159. *See* Longstreth, *supra* note 2, at 20, col. 2 (SEC Rule 13e-3 disclosures are more effective in protecting management than in assuring fairness for minority shareholders).

160. *See id.* at 19, col. 3 (range of fairness is too great for fairness opinions to be of value in determining fair price for minority shares); *infra* text accompanying notes 162-69 (market exceeded management's offer by over 40% despite fact that investment banker had determined that management's offer was fair to minority shareholders).

161. *See* Longstreth, *supra* note 2, at 15, col. 1 (Stokely's management intended to finance cash buyout transaction by borrowing against Stokely's assets).

162. *See id.; supra* notes 148 & 158 and accompanying text (fairness opinion may give powerful support to fairness of management's offer).

163. *See* Longstreth, *supra* note 2, at 15, col. 1 (special committee of nonmanagement directors investigated fairness of management's offer); Hill & Williams, *supra* note 5, at 6, col. 3 (Stokely's Chairman still maintains that Stokely's offer to public shareholders was fair).

164. *See* Longstreth, *supra* note 2, at 15, col. 1 (Pillsbury's offer was a cash tender offer for all of Stokely's outstanding shares).

165. *Id.*

166. *See infra* text accompanying notes 167-69 (Stokely's shareholders were able to profit

22 percent of Stokely's shares and thus had to conduct a tender offer for corporate control as the first stage of a two-step merger transaction.[167] Had the Stokely management group controlled a larger percentage of Stokely's outstanding shares prior to the attempted buyout transaction, the management group could have directly conducted a one-step merger transaction to freezeout Stokely's minority shareholders.[168] If the Stokely management group had been able to conduct a one-step merger, however, Stokely's public shareholders would never have benefitted from Pillsbury's and Quaker Oats' subsequent offer.[169]

In responding to the danger of management groups freezing out minority shareholders at prices substantially below those which the market would pay for minority shareholder interests, some commentators have advocated a ban on management buyout transactions.[170] Such a position is clearly an overreaction.[171] Evidence indicates that buyouts produce gains that can benefit all participants in a buyout transaction.[172] Particularly in the case of solid, slow growing companies with little debt and dedicated management teams, going private may result in increased productivity and more efficient capital utilization.[173] Moreover, a recent study of 72 buyout transactions that occurred between 1973 and 1980 indicates that shareholders involved in freezeout transactions received a premium above market prices that was on average equivalent to the premiums which shareholders received in armslength tender offers during the same period.[174] The fear of management groups exploiting

from subsequent bids because Stokely's management did not own a controlling interest prior to buyout transaction).

167. *See* Longstreth, *supra* note 2, at 15, col. 1 (management's 22% holding was not sufficient to block third party bidders); *supra* notes 25-29 and accompanying text (management groups may conduct two-step merger procedure when management does not possess controlling block of corporate shares prior to buyout transaction).

168. *See* Longstreth, *supra* note 2, at 15, col. 1 (Stokely's shareholders profited from fact that Stokely's management did not own enough of Stokely's shares to prevent third parties from bidding for Stokely's publicly held shares).

169. *See id.* (Longstreth questions meaning of fairness when marketplace exceeds management's fair offer by over 40%).

170. *See* Brudney, *supra* note 3, at 1098 (categorical prohibition of going private transactions is most effective way of ensuring public shareholders receive fair value); Longstreth, *supra* note 2, at 21, col. 2 (some have argued for prohibiting management buyouts).

171. *See supra* notes 46-57 and accompanying text (buyout transactions produce real gains which can benefit all parties to transaction).

172. *See supra* notes 58-62 and accompanying text (synergistic gains of buyout transaction accrue to all interested parties).

173. *See* Ross, *supra* note 6, at 74, col. 2 (companies with little debt, predictable cash flows, and capable management teams make excellent buyout candidates); Wantuck, *supra* note 1, at 60 (companies with dedicated management, small inventories, and little debt are safer buyout candidates); Hill & Williams, *supra* note 5, at 6, col. 2 (companies become leaner following buyout transactions resulting in more efficient capital allocation); De Angelo & De Angelo, *supra* note 7, at D-2, col. 3 (improved incentives for managers under private ownership creates significant productivity gains).

174. *See* De Angelo & De Angelo, *supra* note 7, at D-2, col. 2 (study examined 72 leveraged buyout proposals on American and New York Stock Exchanges).

minority shareholders in buyout transactions appears to have been unwarranted.[175]

Commentators nonetheless have proposed procedures for enlarging the protections available to minority shareholders in management buyout transactions.[176] The most frequently proposed procedure for protecting minority shareholders during management buyouts is the court imposition of a third-party sale standard to govern the fairness of buyout transactions.[177] Under a third-party sale value standard, an acquisition of corporate shares is unfair unless the value shareholders receive for the acquired company's shares is within the range of prices that the acquired company's shareholders might have received had an unaffiliated buyer purchased the entire company in an arms-length negotiation.[178] The difficulty of imposing a third-party sale value standard, however, is discerning the value that an unaffiliated shareholder might pay for the purchase of the entire company in question.[179] One commentator, for instance, has suggested that courts could implement a third-party sale value standard by prohibiting management groups owning a controlling block of corporate shares prior to a buyout transaction from freezing out minority shareholders unless the management group allows third parties to bid for the minority's shares.[180] The management group would then have to match the highest third-party bid for the minority's shares or sell-out to the highest bidder before management could execute a buyout transaction.[181] Such a third-party sale standard, however, misunderstands the value of corporate shares to differing purchasers in acquisition transactions.[182] Because control of a public

175. *See supra* notes 172-74 and accompanying text (evidence indicates that buyouts produce gains for public shareholders without presenting great risk of exploiting minority shareholders); *infra* notes 206-09 and accompanying text (public exposure will deter companies from engaging in exploitive buyouts).

176. *See* Longstreth, *supra* note 2, at 21, col. 2 (law should require managers to permit outside parties to bid for corporate shares before conducting buyout transaction); Chazen, *supra* note 38, at 1446-61 (Chazen advocates formation of committee to negotiate for minority shareholders during management buyout transactions); text accompanying notes 177-79 (discussion of third-party sale standard for protection of minority shareholders).

177. *See* Chazen, *supra* note 38, at 1439 (acquisition is unfair unless price shareholders receive for shares is within range of prices shareholders would have received had an unaffiliated buyer purchased entire company); Longstreth, *supra* note 2, at 21, col. 2 (law should require management to allow all potential buyers to bid for company before conducting buyout transactions).

178. *See supra* note 177 (critics contend that minority shareholders should receive in management buyouts value that unaffiliated purchaser would pay for corporate shares).

179. *See* Umbriac v. Kaiser, 467 F. Supp. 548, 554, 554 n.5 (D. Nev. 1979) (lack of firm offers renders theoretical evidence of value speculative and impractical); Berman v. Gerber Prod. Co., 454 F. Supp. 1310, 1317-18 (W.D. Mich. 1978) (overtures for possible purchases are distinct from definite offers); Scott v. Multi-Amp Corp., 386 F. Supp. 44, 55 (D.N.J. 1974) (court considers identity of corporate acquirers significant in assessing fairness of control transaction).

180. *See* Longstreth, *supra* note 2, at 21, col. 2-3 (management must provide potential bidders time to investigate company and opportunity to make competing bids).

181. *See id.* at 19, col. 4 to 20, col. 1 (management buyout proceeds from management's initial decision that selling company is in interest of shareholders).

182. *See infra* notes 183-87 and accompanying text (controlling shareholders value minority shares very differently from purchaser buying entire company).

corporation commands a premium over market prices,[183] a public company's minority shares are not as valuable to investors as the company's shares which constitute a controlling block.[184] A standard of fairness which requires a controlling shareholder to match the highest value that minority shareholders would receive were a third party purchasing the entire company does not account for the fact that the controlling shareholder already owns the more valuable controlling shares.[185] A third party purchaser would therefore be willing to pay more for the minority's shares in purchasing the entire company than would a controlling shareholder in purchasing just the minority's shares because the third party would be purchasing a mixture of control and noncontrol shares while the controlling shareholder would be purchasing only noncontrol shares.[186] It would thus be unfair for courts to require controlling shareholders in purchasing minority shares to match the offer that a third party would pay for the minority's shares in purchasing the entirey company.[187]

State courts, however, are in a position to better assure fairness for minority shareholders in management buyout transactions by employing a stricter standard to test the fairness of buyout transactions.[188] The business judgment standard,[189] which generally governs corporate fiduciary conduct, is too permissive a standard with which to test the fairness of buyout transactions.[190] Under the business judgment standard, a court presumes that corporate fiduciaries act in good faith in displacing minority shareholders during management buyout transactions.[191] Moreover, the business judgment standard places

183. *See* Essex Universal Corp. v. Yates, 305 F.2d 572, 575 (2d Cir. 1962) (control block of corporate shares commands premium price); Zetlin v. Hanson Holdings Inc., 48 N.Y.2d 684, 685, 397 N.E.2d 387, 388, 421 N.Y.S.2d 877, 878 (1979) (control shares command premium price which reflects privilege of directly influencing corporate affairs).

184. *See* Chazen, *supra* note 38, at 1468 (controlling shares of corporate stock are more valuable than noncontrol shares).

185. *See id.* (discussing value of corporate shares to different buyers). In determining the value that a controlling shareholder would pay for the company's publicly held shares, Chazen asserts that a controlling shareholder would pay less share than an outside purchaser would pay per share in buying the entire company because the controlling shareholder is buying less valuable noncontrol shares while the outside purchaser is buying a mixture of control and noncontrol shares. *Id.*

186. *See id.* (outside purchaser must pay premium to purchase corporation that has controlling shareholder).

187. *See id.* (controlling shareholders will pay less per share for company's minority shares than outside purchaser would pay per share for all of company's shares).

188. *See* Harriman v. E.I. DuPont de Nemours & Co., 411 F. Supp. 133, 153 (D. Del. 1975) (court must determine which standard to employ for purpose of testing propriety of mergers).

189. *See* Massaro v. Vernitron Corp., 559 F. Supp. 1068, 1080 (D. Mass. 1983) (business judgment standard presumes that corporate fiduciaries exercise good faith in making business decisions with which courts will not interfere in absence of fraud, bad faith, or gross overreaching).

190. *See id.* (Delaware courts test corporate fiduciary conduct under business judgment standard); *infra* text accompanying note 203 (management buyout transactions warrant stricter standard of judicial scrutiny because of inherent potential for self-dealing).

191. *See* Massaro v. Vernitron Corp., 559 F. Supp. 1068, 1080 (D. Mass. 1983) (court will not disturb corporate fiduciary's judgments if court can attribute any rational business purpose to fiduciary's decisions).

the burden of persuasion on a plaintiff shareholder challenging a buyout transaction to establish a showing of bad faith, fraud, or palpable overreaching before a court will interfere with the transaction.[192] Plaintiff shareholders, however, may lack the financial or informational resources necessary to overcome the difficult burden of the business judgment rule by establishing a showing of bad faith, fraud, or palpable overreaching on the part of corporate fiduciaries.[193] Courts, therefore, should test the fairness of management buyout transactions under a standard stricter than that of the business judgment rule.[194] The standard of intrinsic fairness, for instance, would provide for greater protection for minority shareholders in management buyouts by shifting the burden of persuasion to the proponents of a buyout transaction to establish the fairness of the transaction in question and by requiring courts to scrutinize carefully fiduciary conduct to assure fairness for minority shareholders.[195]

State courts, however, have been reluctant to apply the intrinsic fairness standard to test the fairness of corporate transactions.[196] The State of Delaware, moreover, requires a showing of domination and control and a showing of self-dealing to invoke the intrinsic fairness test.[197] Although the factor of domination and control requires only a showing of a parent-subsidiary relationship and thus applies to one and two-step mergers,[198] Delaware courts will only find that self-dealing has occurred when the dominant party in a transaction receives value to the detriment of minority shareholders.[199] Delaware courts may therefore engage in lengthy financial analysis to determine whether the dominant party in a transaction receives value to the exclusion of or detriment to minority shareholders.[200] This judicial process of financial examina-

192. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719-22 (Del. 1971) (burden of proof remains with plaintiff under business judgment standard).

193. *See* Puma v. Marriot, 283 A.2d 693, 695-96 (Del. Ch. 1971) (court requires that plaintiff present evidence of fraud to overcome burden of business judgment rule).

194. *See* Massaro v. Vernitron Cop., 559 F. Supp. 1068, 1080 (D. Mass. 1983) (plaintiff must show fraud, bad faith, gross overreaching, or abuse of discretion on part of corporate fiduciary to overcome burden of business judgment rule); *infra* text accompanying notes 203-05 (temptation toward self-dealing in management buyout transactions warrants judicial imposition of standard stricter than business judgment standard).

195. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719-22 (Del. 1971) (intrinsic fairness standard requires high degree of fairness and shift in burden of proof).

196. *See* Kaplan v. Centex Corp., 284 A.2d 119, 122-23 (Del. Ch. 1971) (court refuses to invoke standard of intrinsic fairness in absence of plaintiff 's showing of control and domination on part of corporate fiduciary); *infra* text accompanying notes 197-200 (Delaware courts require plaintiffs to prove elements of domination and control before invoking standard of intrinsic fairness).

197. *See* Kaplan v. Centex Corp., 289 A.2d 119, 122-23 (Del. Ch. 1971) (domination and control imply direction of corporate conduct to serve purposes of corporation or person in control).

198. *See* David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 430-31 (Del. Ch. 1968) (intrinsic fairness standard is appropriate to test fiduciary conduct in parent-subsidiary mergers); *supra* notes 22-33 and accompanying text (one and two-step merger techniques involve parent-subsidiary relationships).

199. *See* Harriman v. E.I. DuPont de Nemours & Co., 411 F. Supp. 133, 147-51 (D. Del. 1975) (dominant party must receive something to exclusion of minority shareholders in order to establish self-dealing).

200. *See* David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427, 431 (Del. Ch. 1968)

tion and valuation, however, does not necessarily produce accurate appraisals[201] and can serve as an impediment to the invocation of the intrinsic fairness standard in Delaware actions.[202] Since buyout transactions present a clear potential for self dealing, state courts should be willing to invoke the intrinsic fairness standard without financial proof of self-dealing to the detriment of minority shareholders.[203] The invocation of the intrinsic fairness standard could then serve as a deterrent to management groups contemplating exploitive buyout transactions for fear that the management insiders would be unable to sustain the burden of proving the fairness of the buyout transaction under careful judicial scrutiny.[204] The business judgment standard, by comparison, provides management groups contemplating a buyout transaction far greater latitude in determining the value that minority shareholders will receive for displaced shares in buyout transactions.[205]

The single greatest deterrent to unfair treatment of minority shareholders in buyout transactions, however, is likely to be public exposure.[206] The literature that documents alleged buyout abuses does much to mitigate the danger of shareholder injustice in buyout transactions.[207] These articles presumably deter managers from contemplating inequitable buyouts for fear of personal and

---

(court insists on examining extensive financial information to determine fairness of merger transaction).

201. *See supra* notes 76-82 and accompanying text (criticism of court's ability to conduct accurate valuations in appraisal proceedings).

202. *See* Kaplan v. Centex Corp., 284 A.2d 119, 122-23 (Del. Ch. 1971) (plaintiff unable to prove that financial transactions between corporate fiduciaries constituted self-dealing to detriment of corporate shareholders); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 719-22 (Del. 1971) (court refused to invoke intrinsic fairness standard because plaintiff shareholders could not prove that dividend payments which parent company extracted from subsidiary company were unfair or otherwise fraudulent).

203. *See* Longstreth, *supra* note 2, at 15, col. 3 (management acts on both sides of buyout transaction in pursuit of management's own self-interest); *supra* notes 18-20 and accompanying text (management's participation on both sides of sale and repurchase transaction presents clear case of fiduciary self-dealing).

204. *See* Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del. 1952) (court will carefully scrutinize fiduciary's attempt to establish entire fairness of merger transaction under intrinsic fairness standard).

205. *See* Massaro v. Vernitron Corp., 559 F. Supp. 1068, 1080 (D. Mass. 1983) (court will not disturb judgment of corporate fiduciary under business judgment standard so long as court can attribute some rational business purpose to fiduciary's decisions).

206. *See, e.g.*, Sommer, *supra* note 14, at D-4 (unfair buyout transactions will erode investor confidence in markets and dampen interest in future public financing); Thomas, *supra* note 141, at D-2, col.4 (criticizing management's informational advantage in buyout transaction); *Getting Hot*, *supra* note 1, at 86 (some see buyout as classic insider technique for acquiring companies at favorable prices); *infra* text accompanying notes 207-10 (companies will fear judicial attention following exploitive buyout transactions).

207. *See* Lynch v. Vickers Energy Corp., 429 A.2d 497, 501 (Del. 1981) (potential for corporate and personal liability does not end after inequitable transaction is completed), *rev'd on other grounds*, 457 A.2d 703 (Del. 1983); Longstreth, *supra* note 2, at 21, col. 1-3 (stating that SEC will more closely scrutinize buyout transactions in future); *supra* text accompanying notes 160-69 (public documentation of potentially exploitive buyout).

corporate liability.[208] Where shareholders have already sustained losses during completed buyout transactions, the awarding of rescissory damages in lieu of actual recission would nonetheless deter other management groups contemplating similar schemes of enrichment.[209] Furthermore, state courts should show no reluctance in holding corporate officers and boards of directors personally liable for taking part in exploitive buyouts.[210] Corporate fiduciaries must not perceive the separation of ownership from management in public companies as an opportunity to expropriate assets and earnings which in fact belong to the shareholders.[211] Perhaps in response to the potential for personal and corporate liability, however, management buyouts have not yet proven to be a serious danger to the interests of public shareholders.[212] To the extent that present and future legal safeguards are sufficient to protect public shareholders in buyout transactions, investors, managers, and the capital markets may continue to benefit from management buyout transactions.[213]

STUART ROBIN KAPLAN

---

208. *See* Ross, *supra* note 6, at 78 (real risk to persons involved in buyout transactions is credibility of buyout procedure).

209. *See* Lynch v. Vickers Energy Corp., 429 A.2d 497, 501 (Del. 1981) (court awards recissory damages in place of unraveling unfair merger), *rev'd on other grounds*, 457 A.2d 703 (Del. 1983).

210. *See supra* notes 101-02 and accompanying text (most states will provide equitable and monetary relief to shareholders when appraisal remedy is insufficient to protect shareholder interests).

211. *See* A. BERL & G. MEANS, *supra* note 16, at 196-98 (managers are mere agents of corporation which in fact belongs to shareholders).

212. *See supra* note 174 and accompanying text (premiums shareholders received in freezeout transactions were equivalent to premiums that shareholders received in public tender offers during same period of time).

213. *See supra* notes 46-57 and accompanying text (management buyout transactions can produce gains sufficiently large to benefit all participants in buyout process).