THE MANAGEMENT BUYOUT: AN IDEA WHOSE TIME MAY HAVE PASSED*

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I. Introduction

The leveraged buyout[1] phenomenon, so conspicuous a part of the American corporate scene during the decade of the 1980s, has served to expose a profound structural tension in the governance of the modern publicly-owned corporation.[2] The hallmark of many such transactions has been the participation of the key managers employed by the enterprise which is the subject of the buyout. Such persons have often either initiated the buyout or have been invited to join with the outside investment group who initiated it. The acquisition by the former insiders of an equity stake in the new enterprise organized to continue the old business is a distinguishing feature of that species commonly called the "management buyout."[3]

* The author wishes to dedicate this article to two individuals who significantly influenced his thinking on issues of corporate stewardship: Louis Stein, Esq., who founded the Stein Institute of Law and Ethics at Fordham University School of Law and who, as a lawyer and chief executive officer, taught the author much about the fiduciary responsibilities of business persons; and the late Mendes Hershman, Esq., whose distinguished 60-year legal career included service as an advisor to the American Law Institute's Corporate Governance Project, and who encouraged the author in the preparation of this article.

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1 *See infra* note 4 and accompanying text.

2 See A.L.I., Principles of Corporate Governance: Analysis and Recommendations § 1.24 (Final Draft May, 1992)[hereinafter Final Draft]. The Corporate Governance Project is presently embodied in a document entitled Principles of Corporate Governance: Analysis and Recommendations (Proposed Final Draft 1992). The American Law Institute is herein sometimes referred to as the "A.L.I." The Proposed Final Draft was approved at the May, 1992 Annual Meeting of the A.L.I.

3 A management buyout is a transaction in which a group of incumbent management participates and continues to operate the business or particular acquired assets to the exclusion of the public shareholders. *See* Edelman v. Fruehauf Corporation, 798 F.2d 882 (6th Cir. 1986)(this case considered the extent to which state corporation law permits target directors to "tilt the playing field" in favor of one

As discussed here, the term management buyout[4] is used in a broad sense to encompass a range of transactions, all of which have as their common thread the acquisition, by insiders to the exclusion of the public shareholders, either particular corporate assets or the entire business. Such transactions include: (1) the typical "going private" transaction in which an existing dominant shareholder, whether or not owning a majority interest, acquires the shares held by the public, through a combination of a tender offer followed by a cash-out merger[5] into an entity owned solely by him and his associates; (2) the joinder by key managers, who typically own few shares, with outside investors to accomplish a similar transaction; or (3) the acquisition from the public corporation by an insider group, with or without the participation of outside investors, of assets comprising a particular segment or division of the public company, through an asset or subsidiary stock purchase. These kinds of transactions are all part of a process which some see as a desirable transformation of the business corporation from an enterprise marked by the separation of ownership from management, in which the shareholders are relegated to a distinctly passive role, to one in which key managers acquire a meaningful minority interest in conjunction with a dominant investor group. The result is that the enterprise's owners are no longer constrained by the impotence which characterizes public company shareholders.[6]

This fundamental metamorphosis has been brought about

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bidder, i.e., management, and the extent to which it requires open bidding on an equal basis by all parties).

4 *See* Deborah A. DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L.J. 517, 519-34 (1988)[hereinafter Demott, *Directors' Duties*]. A management buyout (MBO) is a species within the corporate genus of leveraged buyout (LBO). The typical LBO involves four distinct [but conjunctive] transactions: (1) the formation of a new company to acquire all the assets or shares of an existing operating company or to acquire the assets of an operating division of a multi-division company; (2) the cash purchase of those assets or shares and a distribution to public shareholders of cash or a combination of cash and senior securities; (3) loans to the new company from banks and other institutional lenders to furnish the cash; (4) [acquisition of] the new company's equity [by] members of its management [usually in conjunction with certain of] its. . .lenders. *Id.*

5 *See, e.g.*, Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985)(for discussion of two-step merger process).

6 This dilemma is explored in the classic work, ADOLF A. BERLE AND GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932) [hereinafter BERLE AND MEANS, MODERN CORPORATION].

by a process which, in apparent contradiction to long-accepted principles of corporate stewardship, encourages the corporation's insiders to advance their own interests without primary regard to, and even to the detriment of, the public shareholders. And, it is those very same shareholders to whom the insiders[7] have traditionally been seen to owe twin duties of loyalty,[8] sometimes called "fair dealing" and "care."[9] Management buyouts would not, after all, exist but for the insiders' perception, right or wrong, that the enterprise's future is brighter than its present, and that the buyout group is better able to exploit the corporation's assets and business for their own benefit, relieved of responsibility to the public shareholders.

Management buyouts are typically marked by the preferential treatment accorded the existing enterprise's key managers, who often acquire their equity stake[10] in the new venture upon highly favorable terms. These managers thus stand to gain should the business prosper in the future—provided, of course, they have not overpaid. In contrast, depending on the type of transaction, the public shareholders may be compelled to surrender a valuable part of the business or be excluded entirely. The effect is to deprive them of the opportunity to benefit from what may be a very bright future, often one brighter than they are able to perceive.

Seen thus, the management buyout poses significant risks to shareholder interests, and ultimately to the very integrity of the public corporation. These risks are endemic to any relationship which allows a party serving one set of interests to place those interests in competition with his own, as is done by insiders engaging in buyout activity. These are inescapable consequences of permitting the insider to become a bidder for, and ultimately a buyer of, the corporation's assets or business. For once the barrier to such conduct is removed, the insider is motivated and encouraged, no matter how subconsciously, to discharge his corporate responsibilities in a fashion at least partly calculated to

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7 *See* 15 U.S.C. § 78 *et seq.*; 17 C.F.R. §§ 200, 230, 240, 249, 249(b)(1991).

8 *See* FINAL DRAFT, *supra* note 2, § 5.01; Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).

9 *See* FINAL DRAFT, supra note 2, § 4.01 and A.B.A., REVISED MODEL BUSINESS CORPORATION ACT § 8.30(a)(1984)(for explanation of duty of care).

10 *See* 15 U.S.C. § 78c(a)(11)(1983).

advance his own prospects. In crudest form, this will entail the acquisition of corporate assets at a price which is not only less than what the insider believes their fair value[11] to be, but also below the maximum which the insider is prepared to pay. Lowball bids are an almost certain consequence of the division of loyalty induced by the prospect of a management buyout. In the management-initiated takeover of RJR Nabisco,[12] discussed below, the insider group's first offer was some $8 billion, or 40% below that same group's final bid, which, although unsuccessful, approximated the winning bid.

The insider's opportunity to manipulate the corporation for his personal advantage is not limited to the pricing negotiation. The ability to manage the flow of corporate disclosure,[13] whether during actual negotiations with rival bidders or simply as part of an on-going policy designed to deflect potential outside interest, is but one of many contexts affording insiders the temptation to bend the corporate decision-making process to personal advantage.

Historically, the law of corporations forbade the insider to transact business with the corporation because of his fiduciary relationship with the shareholders.[14] And, as a separate restraint, the consent of all shareholders was required for any transaction which would effectively exclude them from continued participation in the corporate enterprise.[15] Over a period of years, however, the governing statutes[16] have been universally modified to

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[11] *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989). *See also infra* note 12 and accompanying text.

[12] For an interesting retelling of the very dramatic RJR Nabisco takeover, *see* BRYAN BURROUGH AND JOHN HEYLAR, BARBARIANS AT THE GATE (1990). *See also* In Re RJR Nabisco, Inc., Shareholders Litigation, Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. 1989).

[13] *See* Dale Arthur Oesterle and Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 217-18 (1988)[hereinafter Oesterle and Norberg, *Shareholder Wealth*], where the opportunity for management buyouts is described as encouraging managers of publicly-held firms to shirk their responsibilities in managing the enterprise, allowing them "strategically to increase their personal profits from successful buyouts." *Id.* at 228.

[14] 1 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 913, at 4185 (perm. ed. rev. vol. 1986)[hereinafter FLETCHER].

[15] *See* Goodwin v. Agassiz, 186 N.E. 659 (Mass. 1933).

[16] *See, e.g.*, DEL. CODE ANN., tit. 8, § 121-22 (Michie 1983); N.Y. BUS. CORP. LAW § 202 (West 1983); N.J. REV. STAT. § 14A:3-1 (West 1969); CAL. CORP. LAW § 300 (West 1990).

permit insiders to engage in transactions with the corporation where there is sufficient disclosure and approval by disinterested directors or by shareholders. In addition, the veto which once protected each shareholder from being unwillingly forced out has been eliminated.[17]

This lifting of the constraints on the relationship permitted between insiders and the corporation has only recently become a truly significant factor because of the substantial increase in the frequency and scale of management buyouts. The risks flowing from the statutory relaxation of the earlier behavioral norms have become apparent. Insiders have frequently benefitted, often substantially, from the quick resale[18] of some or all of the assets acquired in a buyout. There have been numerous instances where, soon after a corporation went private, the enterprise once again sold shares to the public at a price reflecting a substantially increased valuation.[19] Such events can only raise questions about whether the public shareholders received fair value for their interests and, conversely, whether advantage was taken by the insiders. The insiders may answer that improvements in corporate performance, unattainable under the old ownership, were responsible for such favorable outcomes. The shareholders may, in turn, respond by asking why these results could not have been achieved while they owned the company. As one commentator has put the question, "if the value of the employee-managed firm can differ so dramatically from the highly leveraged, owner-managed firm, the fundamental question of absentee ownership of American corporations is again ripe for rethinking."[20]

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17 R. Franklin Ballotti and Jesse A. Finkelstein, Delaware Law of Corporations and Business Organizations § 4.9 (2d ed. 1991).

18 In 1984, John Kluge took Metromedia private and within several years realized five times the purchase price through partial liquidation, giving him a personal profit of close to three billion dollars. *See* Gary Hector, *Are Shareholders Cheated By LBOs?*, Fortune, Jan. 19, 1987, at 98. *See also* Oesterle and Norberg, *Shareholder Wealth*, *supra* note 13.

19 *See* Thomas Moore, *KKR Is Rolling With the Punches*, U.S. News & World Report, May 7, 1990, at 49.

20 *See* Oesterle and Norberg, *Shareholder Wealth*, *supra* note 13, at 227 n.88. The authors, who defend management buyouts, acknowledge the charge "that managers who follow buyouts with dramatic business improvements must have been acting irresponsibly when they did not undertake the same measures on behalf of public shareholders that they subsequently have taken to bring success to their private corporation." *Id.* at 219. It may not be amiss to note the relationship between

Beyond any particular instance of overreaching looms the broader philosophical question of the effect upon the corporation's functioning caused by permitting insiders actively to pursue their own interests when these interests are in competition with those of the corporation or shareholders.

A recent leading Delaware Supreme Court decision recognizes the uniqueness of the information which sophisticated insiders are assumed to, and do in fact, possess.[21] In that case, the insiders' knowledge was employed not to support their own bid but instead to justify rejection of an unwanted third-party bid made at a huge premium to the market.[22] The significance of the opinion to the present discussion is found in the extraordinary deference accorded the target company's board in its desire to implement a long-term strategic plan for enhancement of shareholder values. The board's opinion of the company's future prospects, obviously not accepted by the market-place, was held to outweigh the market's substantially lower valuation of the company.[23] Such "inside" information is equally available to be misused to aid the insider's self-interest in advancing his own acquisition proposal. The fact that, in any particular instance, the market may prove more correct than the insider does not obviate this danger or disprove the need for concern.

The management buyout points up a contradiction in our corporate jurisprudence, reflected in the dichotomy between the permissive enabling statutes[24] and the rule forbidding utilization of corporate office for personal gain. Insiders are called upon to demonstrate utmost good faith[25] and the most scrupulous fair-

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the theme of this article, and the current furor over the process, and the underlying criteria, employed to establish senior-level executive compensation. Perceived abuses in this area of corporate functioning, long thought to be insulated from shareholder and regulatory oversight and solely a matter of board concern, have led to calls to change the applicable rules. Attention has been focused upon the heretofore unchallenged assumption that any attempt to place limitations upon permissible compensation will invariably lead to the departure of key employees. *See also infra* note 287.

21 *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

22 *Id.* at 1146.

23 *Id.*

24 *See* FINAL DRAFT, *supra* note 2, § 5.02 note, collecting statutes permitting insiders to transact business with the corporation which they serve.

25 *See* Dirks v. SEC, 463 U.S. 646 (1982); Mendell on Behalf of Viacom, Inc. v.

ness in all transactions in which they possess a personal interest that does not impact upon all shareholders equally.[26] Complete candor[27] in their dealings with the corporation is demanded of the insiders who are said to be forbidden to use positions of trust and confidence to further their private interests.[28] How are these propositions to be reconciled with the management buyout?

The American Law Institute's monumental Corporate Governance Project,[29] undertaken at the dawn of the buyout wave of the 1980s, has just recently been completed. This Project, however, does not satisfactorily address the dilemma for the governance of the corporation and the danger to shareholder interests implicit in the relaxation of the rules that once forbade management buyouts.[30] On the one hand, the Institute proclaims the principle which would forbid the insider, negotiating a buyout, to bargain with the corporation as he would with a stranger to whom he owed no duty, and it imposes an obligation of adequate disclosure.[31] Moreover, the Institute concedes that bids competing with management-sponsored offers are typically infrequent and that competing bidders suffer from significant informational and negotiating disadvantages.[32] Yet, at the same time the Pro-

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Gollust, 909 F.2d 724 (2d Cir. 1990); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

26 *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989); Weinberger v. UOP Inc., 457 A.2d 701, 710 (Del. 1983); Gottlieb v. Heyden Chemical Corp., 91 A.2d 57, 58 (Del. 1952).

27 *Id.*

28 *See* Lynn v. Vickers Energy Corp., 383 A.2d 278 (Del. 1977); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985); In Re Anderson, Clayton Shareholders Litigation, 519 A.2d 694, 697 (Del. Ch. 1986).

29 *See supra* note 2.

30 The author does not wish his comments to be seen to denigrate the significant contribution represented by the American Law Institute's Corporate Governance Project. The Project, which has been aptly characterized as both "rooted in well-established law" and as an effort to "harmonize widely varying articulations of the law and to state emerging principles," necessarily operates within the limitations delineated by such descriptions; and existing statutory law clearly does not prohibit management buyouts. *See* Roswell B. Perkins, *The ALI Corporate Governance Project in Midstream*, 41 BUS. LAW. 1195, 1198 (1986). It is, however, the author's belief that the permissive statutory formulations are at odds with important *general principles* repeatedly enunciated in relevant judicial pronouncements on various aspects of corporate governance, and that the Project could make an important contribution by addressing this disparity.

31 *See* FINAL DRAFT, *supra* note 2, § 5.02(a)(1) cmt., at 285.

32 *Id.* § 5.15 cmt., at 488.

ject not only continues to allow insiders to undertake buyouts, but also suggests that an insider may properly withhold from the corporation much information that is undeniably material. Examples of such material information include: the insider's anticipated profit, the insider's opinion as to true value, and the maximum price which the insider is prepared to pay.[33]

To address the conflict issue as it manifests itself in a buyout, the Corporate Governance Project emphasizes reliance upon the only existing structural mechanism in place: the presumed oversight of directors not involved in the buyout. These directors must pass upon the proposal's fairness and, where appropriate, seek competing bids. Such directors are encouraged to organize themselves into a special committee, and to retain their own attorneys and investment bankers to counsel them. This proposed solution suffers, however, from being out of touch with the realities of corporate and business life, which reflect the inherently unequal positions of the insiders and the independent directors relative to one another. Even the most conscientious and disinterested directors, operating within the strictly compressed time constraints characteristic of buyout transactions, will face a herculean task trying to counteract the tactical and strategic advantages enjoyed by the insider. Such advantages come from the combination of an intimate knowledge of the corporation's assets, business plans and long-term prospects, familiarity with his peers on the board with whom he will negotiate, and dominance over subordinate corporate personnel who may play an important role in the due diligence phase of a buyout. As discussed below, the independent directors have too often acted as rubberstamps for the insider group; their failures have been attributable, at least in part, to deficient advice from their professional outside advisors who have, in the event, proved susceptible to manipulation by management.

Questions thus remain whether the tension in corporate governance engendered by potential management participation in buyouts represents a fundamental flaw in the scheme of corporate governance and, thus, from the perspective of the corporation and its shareholders, whether the buyout has truly improved

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33 *Id.* § 1.14 cmt., at 19.

upon the much-criticized present reality in which ownership and management are separated.

II. The Present-Day Rationale for Management Buyouts

Sometimes, the relaxation of behavioral norms is so gradual and so evolutionary that the value judgments underlying a particular rule of conduct are forgotten as that rule slides first into disuse and then into eventual abandonment. Then, in an environment drastically altered, concerns originally felt and consequences originally feared, but put out of mind, reassert themselves with vastly renewed force. This, in turn, compels a reconsideration of the practical and philosophical concerns which animated the discarded rule in light of the real-life consequences of its abandonment.

The so-called "management buyout,"[34] once forbidden entirely by our corporate jurisprudence, is the progeny of what may be described as the metastization of the permissive legal environment replacing the earlier prohibition. During the last decade, corporate buyouts initiated or participated in by key managers became a frequent phenomenon on the American business scene. As the battle over RJR Nabisco[35] proved, not even the largest and strongest of America's publicly-owned corporations[36] remains immune from being taken over. Such transactions typically involve the acquisition by the corporation's senior executives in conjunction with investor partners[37] of the corporation's business and assets, and the concomitant exclusion of the non-insider shareholders from continued participation in the enterprise.

Such transactions have been widely heralded, not only for rewarding existing public shareholders by the purchase of their shares at substantial premiums over current market prices, but also for ushering in a new era of reinvigorated corporate functioning, characterized by a much needed restoration of a management role to the corporation's owners.

[34] *See supra* note 3.

[35] *See supra* note 12. *See also* Richard D. Hylton, *Metropolitan Life Settles Its Bond Dispute With RJR*, N.Y. TIMES, Jan. 25, 1991, at D1.

[36] *Id.*

[37] *See supra* note 3.

A significant equity ownership stake[38] for the corporation's key managers is a distinguishing characteristic of the management buyout. This ownership stake is found irrespective of whether the managers are newly brought in from the outside by the acquiring investor group, or are the same persons who previously managed the business.[39] In some instances, the magnitude of the stake promised existing managers has caused particular consternation.[40] The management buyout, however, has been generally praised for providing the means of redressing the deficiencies of accountability deriving from the separation of ownership from management, a key and troublesome characteristic of the modern publicly-owned corporation.[41] The management buyout[42] has been upheld as a principal antidote to the abuses which derive from leaving control of the corporation in the hands of senior executives who have become largely immune from shareholder discipline and effectively accountable to none but themselves. This scenario is brought about through traditional shareholder ownership and voting patterns, such as the general tendency of unhappy institutional investors to "vote with their feet" and sell their shareholdings rather than seek to replace an inadequate management and the bias towards incumbent managements reflected in existing procedures for nominating directors and for proxy solicitation.[43] This infirmity in the

[38] *See generally* Oesterle and Norberg, *Shareholder Wealth*, *supra* note 13; Richard A. Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U.L. REV. 630 (1985)[hereinafter Booth, *Limits of Fiduciary Duty*].

[39] It is not unusual for the allocation of equity in an MBO to be structured so that management participants receive the actual shares themselves. *See* DeMott, *Directors' Duties*, *supra* note 4, at 519-34.

[40] *See infra* note 188. It has been estimated that management's unsuccessful bid to acquire RJR Nabisco would have given management an interest immediately worth as much as $220 million, for an investment of only $20 million, and that this investment would have been repaid by the purchasing entity. The Macy's department store chain was taken private in 1986, in a management buyout costing for $3.7 billion, nearly all borrowed. In 1989, *Forbes Magazine* estimated that the company was worth $7.5 billion, or $3 billion after deducting long-term debt. FORBES, May 1, 1989, at 42. Edward Finkelstein, the chief executive officer who led the buyout, was estimated by *Forbes* to have an investment then worth $140 million for which he had only three years before paid $4,375,000. Another publication estimated Finkelstein's investment to be worth $122,500,000. *See* Michael M. Lewis, *Leveraged Rip-off*, THE NEW REPUBLIC, Nov. 14, 1988, at 25-27.

[41] *See* BERLE AND MEANS, MODERN CORPORATION, *supra* note 6.

[42] *See supra* note 3.

[43] *See* 15 U.S.C. § 78n (1983).

shareholder participation process has permitted managers to reward themselves, and to perpetuate their tenures, often with little regard for the objective quality of their performance or the success of the enterprises they lead. Management buyouts are perceived as a means of eliminating this abuse.

The apparent remedy, however, has come at a price. Where an existing management group participates in the buyout, an inescapable characteristic of the transaction is the appropriation of corporate assets, by knowledgeable insiders occupying a privileged position within the corporation. These corporate assets encompass proprietary or confidential information concerning existing and potential business strategies, opportunities and prospects. In seeking to effect such a transaction, the insiders are permitted to superimpose the morals of the marketplace upon the relationship between the shareholders and themselves which is said to be governed only by the highest standards of duty[44] and fair-dealing.[45] By allowing market forces to dominate the dynamics of the buyout process, the insiders are permitted, not only to use confidential and proprietary information to personal advantage, but also to bargain with the objective of paying as little as possible for the corporation's assets.[46] The insiders typically intend to finance the purchase through high loan-to-value non-recourse[47] loans,[48] with the smallest possible equity investment. This heightens their impetus to disregard all vestige of loyalty to their shareholders in favor of acquiring the corporate assets as cheaply as possible. Indeed, the ability throughout most of the past decade to finance such transactions substantially, and in some cases almost entirely, through borrowed funds is indicative

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44 *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Klinicki v. Lundgren, 695 P.2d 906 (Or. 1985); Lincoln Stores v. Grant, 34 N.E.2d 704 (Mass. 1941).

45 *See, e.g.*, Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949).

46 *See* Patrick S. Dunleavy, Note, *Leveraged Buyout, Management Buyout, and Going Private Corporate Control Transactions: Insider Trading or Efficient Market Economics?*, 14 FORDHAM URB. L.J. 685 (1986). *See also* Fredric D. Woocher, Comment, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977)(for a discussion of the Efficient Capital Market Hypothesis).

47 *See, e.g.*, Doe v. U.S. By and Through Dep't of Treasury, 777 F. Supp. 228 (E.D. Tenn. 1991).

48 *See, e.g.*, Harrison v. Orleans, 755 F. Supp. 592 (S.D.N.Y. 1991). This species of loans carries with it no personal liability.

of the bargaining advantage achieved by the insiders.[49] The personal advantages conferred upon the insiders by such a *laissez-faire* attitude are obvious. They can focus upon maximizing their own potential profits from the transaction and upon obtaining the necessary financing with the least possible investment risk or cost to themselves. In short, the management buyout encourages the insider to treat his corporation at arm's-length, as he would a stranger, by allowing him to bid for and to purchase its business and assets for a price which is less than what he may know them to be worth and may be prepared and able to pay.

The benefits to be so realized by corporate insiders are achieved in a process which, at the core, entails the forced exclusion of existing shareholder interests and their replacement by a new set of owners, encompassing, among others, the corporate insiders.[50] These insiders act out of a self-interest[51] that has been nurtured by a unique understanding of the enterprise's business and assets, which is acquired by the insider in his role as compensated fiduciary for the shareholders and includes its corporate strategies and short and long term prospects.

During the heyday of the takeover era, transactions involving leveraged management buyouts frequently evolved into opportunities for corporate insiders, shortly following the transaction, to realize substantial quick profits through the resale or refinancing of purchased assets,[52] the recapitalization of the corporation,[53] or

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49 *See* DeMott, *Directors' Duties*, *supra* note 4. The bulk of MBO financing comes from banks, in the form of revolving credit or term loans that amortize over a ten to twelve year period. Additional subordinated or "mezzanine" debt may be sold to institutional investors and may take the form of preferred stock rather than debt securities. *See also* Peter C. Canellos, *The Over-Leveraged Acquisition*, 39 TAX LAW. 91, 96 (1985). Lenders may bargain for and receive combinations or "strips" of senior and subordinated debt, preferred stock and common stock, warrants or rights to purchase common stock.

50 *See, e.g.*, Rosenstein v. CMC Real Estate Corp., 522 N.E.2d 221 (Ill. App. 1988)

51 *See generally* Harold Marsh, Jr., *Are Directors Trustees? Conflicts of Interest and Corporate Morality*, 22 BUS. LAW 35 (1966).

52 To cite but one example, in the R.H. Macy buyout mentioned above, shopping malls valued at $250,000,000 in the buyout were sold for $555,000,000 only three months thereafter. *See* Michael M. Lewis, *Leveraged Rip-off*, THE NEW REPUBLIC, Nov. 14, 1988, 25-27.

53 *See, e.g.*, Colon v. Mesa Petroleum Co., 951 F.2d 1512 (9th Cir. 1991), *cert. denied*, 112 S.Ct. 1943 (1992).

taking the purchased business, or a part, public again.[54] Such profits have often represented a significant multiple of the insiders' original investment. In the most successful of the highly leveraged buyout transactions, the returns on equity over as little as one or two years were truly staggering.[55] Viewed retrospectively, such transactions must inevitably raise questions about the accuracy and completeness of information provided to directors or shareholders of the enterprise which was the object of the buyout or "going private"[56] transaction. This discussion assumes that insiders engaging in such transactions owe, at a minimum, a very high level of disclosure. Yet, when one looks at the aftermath of the transactions that have occurred, it is difficult to believe that adequate disclosure could have been made in every instance.

For the moment, the frenzied pace of mergers and acquisitions of the past decade has abated.[57] The quick profits generated by many insider buyouts were often available only in a marketplace of great optimism and limitless expectations. In the cold light of hindsight, legal issues and repercussions remain to be examined and rethought, at a time when pause for deliberation is possible. The corporate governance structure that has allowed the management buyout to flourish remains unchanged. Insiders are still permitted to employ their special position and unique knowledge to acquire corporate assets or control upon advantageous terms. In a more favorable economic and financial climate we may expect to see a resurgence of the adversarial relationship between insiders and shareholders which lies below the

54 *See* George Anders, *Many Firms Go Public Within a Few Years of Leveraged Buyout*, WALL ST. J., Jan. 2, 1987, at A1.

55 *See, e.g.*, George Anders, *Leaner and Meaner, Leveraged Buyouts Make Some Companies Tougher Competitors*, WALL ST. J., Sept. 15, 1988, at A1. In one example, the investor group in Denny's Inc. reportedly quadrupled a $45 million investment made only two years earlier, and in a second case, involving Signode Corp., an investor group realized a ten-fold return in four years. *See* Laurie P. Cohen, *Merrill Lynch Leads Wall Street's Buy-Out Business*, WALL ST. J., Aug. 5, 1987, at A6.

56 *See, e.g.*, Blanchette v. Providence & Worcester, 428 F. Supp. 347, 354 (D.Del. 1977). *See generally* Patrick S. Dunleavy, Note, *Leveraged Buyouts, Management Buyouts, Going Private Corporate Control Transactions: Insider Trading or Efficient Market Economics?*, 14 FORDHAM URB. L. J. 685 (1987).

57 *See* Paul D. Freeman, *Is the M&A Bubble Bursting?* CALIFORNIA LAWYER, at 45 (March 1990). Since mid-1989 certain types of M&A activity have declined significantly.

surface, in a dormant state, whenever the possibility of the management buyout exists.

III. Management Buyouts: Flaws in the Rationale

It is open to serious question whether the fiduciary duties of corporate insiders[58] are fundamentally compatible with their participation in management buyouts. Buyouts include the so-called "going private" transactions, in which the corporation or an entity affiliated with the insiders buys in the shares owned by the public. It remains uncertain whether management buyouts have succeeded in their much touted role of resolving the ambiguities in the governance of the modern business corporation stemming from the separation of ownership from management. Rather, one structural tension in the relationship between insiders and shareholders appears to have been replaced by another. It is questionable whether the appointment of a special committee of theoretically disinterested directors, advised by competent legal and financial advisers ostensibly not beholden to management, and having full authority to act for the corporation in such transactions, can eliminate this structural tension

Under this view, management buyouts do not merely fail to resolve the traditional tensions between owners and managers, but actually exacerbate these tensions. They sacrifice, or seriously compromise, the objective that the publicly-owned business corporation be run, for the benefit of all of its shareholders, by directors and senior executives bound by fiduciary obligations. They ignore the degree to which the objectives and processes of the buyout are fundamentally incompatible with the insider's fiduciary duties and the shareholders' interests. The principle of public ownership of corporate shares is placed at issue by the claim that corporate assets can be exploited and managed to better advantage when owned by a privately-owned entity not subject to the constraints of reporting requirements, and of public investor expectations and demands.

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58 *See* Foremost-McKesson Inc. v. Provident Securities Co., 423 U.S. 232, 243-44 (1975)(insiders defined as directors, officers, and beneficial owners presumed to have access to inside information). *See also* Chiarella v. U.S., 445 U.S. 222 (1979); SEC v. Singer, 786 F. Supp. 1158 (S.D.N.Y. 1992)(tippee charged with derivative liability upon obtaining information improperly disclosed by insider where tippee knows or should have known insider committed a breach).

Takeovers are not the subject of discussion, although the excesses of the takeover era illustrate the dangers of any wholesale abandonment of principle.[59] The revolutionary view of corporate balance sheets, which perceived corporate performance as unaffected by the substitution of debt for equity and even asserted that the discipline imposed by the need to pay off debt would guarantee improved operating results, fueled takeovers. In less than a decade, a traditional and deeply-ingrained commitment to equity capital,[60] and a concomitant aversion to excessive debt, was abandoned with inconceivable recklessness as leveraged buyouts multiplied in size and scale. Only now has the traditional corporate objective of avoiding excessive borrowing regained respectability, as the debt-burdened corporate progeny of the takeover binge have begun crashing with the ink barely dry on the loan instruments.

So, too, there ought to be a similar reexamination of the legal environment which has allowed buyouts to flourish, and, necessarily, of the wisdom of abandoning once-accepted rules of managerial conduct which would have stood in the way of the excesses of recent years. The discarded rules,[61] precluding acquisitions of corporate assets by insiders,[62] as well as transactions forcing out shareholders without their consent,[63] would effectively have barred management buyouts. These rules were considered incompatible with modern corporate realities. In jettisoning them, the legal stage was set for the leveraged management buyout. In a transaction either initiated or participated in by key management personnel, existing shareholders are forced out, their economic interests involuntarily converted without necessity for their individual consents, into cash typically provided from proceeds of loans secured by the acquired corporate assets. The result is to deny such shareholders the chance to par-

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59 *See, e.g.*, Margaret Cronin Fisk, *KKR Buys American Reinsurance*, 14 N.J.L.J. 12 (1992); Kenneth L. Bachman, Jr., et al., *New Wave of Acquisitions Raises Regulatory and Structural Issues*, 12 N.J.L.J. 28 (1990).

60 *Id.*

61 *See* FLETCHER, *supra* note 14.

62 *See* Pepper v. Litton, 308 U.S. 295 (1939)(transactions where fiduciaries have conflicts of interest will be upheld only if they are determined to be fair); Galfand v. Chestnut, 363 F. Supp. 291 (E.D.Pa. 1973); Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378 (N.Y. App. 1918).

63 *See infra* notes 94 - 97 and accompanying text.

ticipate in the realization of the full fruits of the enterprise that had been owned by them and operated for their account.

Much has been written generally about the so-called "leveraged" buyout, in which assets are purchased from a public corporation with funds substantially provided by loans based upon the collateral value of those assets and of the cash flows of the enterprise as a going concern. It is the intent here to discuss only those aspects of such transactions which are peculiar to buyouts in which corporate insiders participate. It is this class of transaction which allows insiders, for their own advantage, to place themselves at odds with the interests of the corporation's shareholders. This is an inherent and inescapable dimension of the management buyout. The legal propriety of various defensive actions and strategies employed by corporate managements to resist unwelcome takeovers has been extensively analyzed, as has been the proper role of the so-called independent directors once a company has been put "into play."[64] But, somewhat curiously, there has been little discussion of the bedrock issue: the propriety of allowing corporate insiders, under any circumstances, to participate in corporate takeovers. It is a measure of how far we have moved from first principles that it has come to be assumed that there is not — and ought not to be — any fundamental legal or philosophical objection to such activity.

Although beyond the focus of this discussion, the management buyout also threatens non-shareholder interests, an issue which for the first time is becoming an increasing concern for the board. These interests are those of the various groups, persons or entities now protected under the recently enacted so-called "other constituency" statutes,[65] which allow, and in one instance mandate, directors to take into account the effects of proposed actions upon employees, customers, suppliers and creditors, and upon communities in which the enterprise operates.[66] Decisions

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64 *See, e.g.*, Martin Lipton & Andrew Brownstein, *Takeover Responses and Directors' Responsibilities — An Update*, 40 BUS. LAW. 1403 (1985); Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Frank H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

65 *See infra*, Part IX.

66 *See generally* Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355 (1991); Jannette M. Webster, Comment, *Achieving a Proper Economic Balance: Non-Shareholder Constituency Statutes*, 19 STETSON L. REV. 581 (1990).

concerning buyouts, whether or not involving management participation, will have a profound impact, not necessarily positive, upon many persons other than shareholders.[67] Depending upon one's view of the corporate common law, these statutes have served either to establish, or to codify, the legal basis for directors, consistent with the discharge of their fiduciary obligations, to consider the effects of a proposed buyout upon non-shareholders. At a minimum, such statutes must be seen to impose additional disclosure obligations on the part of those management directors cognizant of the effects of a buyout upon protected constituencies. When they participate in the buyout, the disclosure obligation is heightened. The facts revealed may impose additional duties upon all of the directors called upon by such statutes to weigh and balance the various constituency interests as they evaluate an insider bid, or compare it to a third-party offer.[68]

IV. The Independent Directors: A Theoretical Cure for the Problem

In a recent and thoughtful discussion of management buyouts, Chancellor William T. Allen of the Delaware Court of Chancery addressed legal issues relating to management buyouts in a context other than that in which such questions typically arise. These questions usually arise as an inquiry into whether particular transactions are governed by the "business judgement" rule or some broader standard of "fairness" or "entire fairness."[69]

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67 *See* Oesterle and Norberg, *Shareholder Wealth*, *supra* note 13, at 237. The authors explained, "The notion that a management buyout better protects the interests of non-shareholder constituencies such as labor, creditors, and local citizenry simply does not comport with the evidence."

68 *See* discussion *infra* pp. 178 - 182.

69 *See* William T. Allen, *Independent Directors in MBO Transactions: Are They Fact or Fantasy*, 45 Bus. Law. 2055 (1990)[hereinafter Allen, *Independent Directors*]. The Chancellor acknowledged that:

> [W]e have just now concluded a decade in which unpredicted merger and acquisition activity raised issues of corporation law that had lain dormant for fifty years. For whose benefit are public corporations to be managed? To whom and how are corporate managers to be accountable? Who properly should decide whether or not the corporation should be sold? Basic questions of this sort have been debated during the 80's, not just by lawyers, but in the press and in legislative halls.

Yet, having raised the issue of the management buyout, Chancellor Allen confines himself to a consideration of whether, as a practical matter, effective mechanisms can be found to monitor and control the conflicts of interest which inhere in such self-dealing transactions.[70] The principal mechanism with which he concerns himself is the role of the outside directors. He inquires whether they can effectively intervene and take on the very managers who are responsible for their being on the board in the first place.[71] He is frank to acknowledge the reasons which account for skepticism in this regard.[72] His conclusion is that

[a]ll these considerations suggest that an outside director,

> The struggle to fashion answers for our age to these elementary questions placed enormous strain on conventional legal doctrine. . .the phenomenon of corporate managers taking their firms private in transactions financed largely by the corporation's own credit, raised questions of the scope of the fiduciary duty of loyalty and what methods or devices are available to monitor and enforce the duty.

Id. at 2055.

70 *Id.*

71 *Id.* The Chancellor concedes that:

> [o]n this fundamental question, there is a disturbing dichotomy of views. A prominent view is the view that outside directors serve a largely ornamental role in the month-to-month direction of the enterprise. Peter Drucker, a leading scholar of business management, asserts that boards of directors are 'an important ceremonial and legal fiction that do not function.' Another scholar quotes a CEO as saying, 'the board rubber-stamps the action of management and the board members are there to mollify the outside stockholders.' Outside directors are widely seen as so bound up with management in a variety of ways that it is delusion or pretense to expect them to represent shareholder views when a conflict transaction arises.

Id. at 2056.

72 The Chancellor stressed that:

> The firm's CEO will have invited many of the outside directors onto the board. Perquisites — annual pay, insurance, retirement benefits — are originated by the CEO and may be generous. Feelings of cordiality and friendliness will have developed over the years of service. Outside directors will have limited exposure to information and a limited time commitment to the month-to-month functioning of the firm. The resulting deference to management will, at least in the large public corporation, very often be reinforced by the fact that the outside directors are typically CEO's of their own firms. These businessmen or women will view their roles as directors in the same way that they probably wish outside directors on the board of their own companies to view their role — as a source of expert advice and judgment, on call to the CEO but not to be officiously interjected.

Id. at 2057.

even when functioning in good faith, is unlikely to view himself as properly opposing the firm's CEO on an important matter, even one of corporate structure or control, at least if the course proposed by the CEO seems plausible or defensible. These considerations have persuaded some observers that outside or independent directors offer little hope as a source of expert, disinterested judgment when management is interested.[73]

Yet in the face of these considerations, and despite numerous instances where the directors, aided by prestigious advisers, have failed in the event,[74] Chancellor Allen concludes that a special committee of outside or independent directors can be employed effectively to protect corporate and shareholder interests in the context of a transaction between insiders and the corporation.[75] His conviction is that most failures occur when outside directors do not fully understand what is expected of them, and that improved functioning by their advisers, especially their lawyers, can protect against this pitfall.[76]

Chancellor Allen's willingness to trust in the outside advisers to lead, cajole or coerce independent directors into playing a role to which he concedes they are so temperamentally and structurally ill-suited seems naive, and his confidence in an efficacious outcome is arguably misplaced. This is particularly so when one considers the

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73 *Id. See also* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477 (1984)[hereinafter Manning, *Time for Reality*]. Bayless Manning's basic thesis is that traditional formulations of directorial responsibility and traditional performance models are no longer meaningful. He is primarily concerned with what he perceives to be the inadequacies, in terms of the reality of directorial functioning, of the usual expressions of the business judgment rule. He cites, among other reasons, many of the factors cited by Chancellor Allen. As a result of such factors, and others, a "chief executive officer who generally enjoys the confidence of his board will usually be able to carry any proposal he makes if he does his homework, prepares his supporting arguments, is backed up by his other officers, and — of key importance — personally throws his full weight behind the proposal. Courts and the public must understand that quite commonly a director will go along with a business proposal that he does not really like." *Id.* at 1490. Manning concludes that in general the "doctrinal model of the fiduciary. . .that had traditionally operated under the watchful eye of the equity courts" is an inappropriate measure of the director's conduct, although a director "can be conceived of as some special species of fiduciary insofar as his own dealings with the corporation are concerned." *Id.* at 1493.

74 *See infra* pp. 181 - 194.

75 *See* Allen, *Independent Directors*, *supra* note 69, at 2062.

76 *Id.*

degree to which existing corporate law has insulated directors from personal accountability for their failure to perform. One need only consider the outcry raised by the Delaware Supreme Court's decision in *Smith v. Van Gorkom*,[77] virtually the only case in which directors untainted by personal interest in a transaction were held financially responsible for the consequence of their failure to adequately perform their duties. This decision directly precipitated the frenzied adoption, in state after state,[78] including Delaware, of statutes allowing directors to be insulated from liability for even gross negligence.[79] The enactment of such statutes must place in question any easy assumption that the current legal status of directorial accountability can be relied upon to insure that independent directors will perform their proper oversight function when passing upon proposed management buyouts.

V. The Erstwhile Legal Obstacles to the Management Buyout

At one time, two distinct lines of legal precedent would have meshed to provide a substantive obstacle to management buyouts, in contrast to the present-day practice which sanctions such transactions while leaving the decision making function to the judgment of the disinterested directors.[80] Trustees were historically forbidden to purchase assets from trusts which they served.[81] There was a "well established rule" that, absent a contrary provision in the trust instrument, a trustee was

> not permitted to purchase trust property. Under the rule, it [was] completely immaterial that the trustee acted in good faith or paid a fair consideration for the property because it is a rule of public policy which applies in all cases, whether there be fraud or not.[82]

Corporate directors and senior executives, although not trustees in a technical sense, have long been considered to stand in a

77 488 A.2d 858 (Del. 1985).

78 *See, e.g.*, VA. CODE ANN. § 13.1-690 (Michie 1992); OHIO REV. CODE ANN. §§ 1701.59(B), (C) & (D) (Baldwin 1991).

79 *See, e.g.*, DEL. CODE ANN., tit 8, § 102(b)(7)(Michie 1983).

80 *See, e.g.*, Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982), *cert. den.*, *sub. nom.*, Citytrust v. Joy, 460 U.S. 1051 (1983); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Sinclair Oil Co. v. Levien, 280 A.2d 717, 720 (Del. 1971).

81 *See* 3 BOGERT ON TRUSTS AND TRUSTEES § 484 (1935).

82 Appeal of Burke, 108 A.2d 58 (Pa. 1954). *See also* RESTATEMENT OF TRUSTS § 170 cmt. b (1948); In Re Hubell's Hill, 97 N.E.2d 888 (N.Y. App. 1951).

fiduciary relationship to the corporation and its shareholders.[83] The Delaware Supreme Court has repeatedly reiterated the proposition that in discharging their duties of managing the business and affairs of the corporation, directors "owe fiduciary duties of care and loyalty to the corporation and its shareholders."[84] This principle is not limited to the role of the director, but extends to corporate officers generally.[85]

Notwithstanding the proscription against the purchase by fiduciaries of trust property and the repeated articulation of the fiduciary relationship of directors and officers to the corporation, such persons are no longer forbidden to purchase assets from the corporation, or to acquire the corporation itself.[86] The statement is often made that a corporate officer cannot contract with himself or represent the corporation in any transaction in which the officer, as an individual, has a conflicting interest, but what the cases really stand for is that a transaction wherein a corporate officer represents the corporation on one side and himself, either individually or as an of-

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83 *See, e.g.*, Guth v. Loft. 5 A.2d 503, 510 (Del. 1939); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Aronson v. Lewis, 473 A.2d 805 (Del. 1984). For a criticism of such formulations of the duties of a director, *see* Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1494 (1984).

84 *Mills Acquisition Co.*, 559 A.2d at 1280.

85 *Id.* The fiduciary nature of a corporate office is immutable. . .Corporate officers and directors are not permitted to use their positions of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its shareholders. . . . This rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation. Not only do these principles demand that corporate fiduciaries absolutely refrain from any act which breaches the trust reposed in them, but also to affirmatively protect and defend those interests entrusted to them. . . . Thus directors are required to demonstrate both their utmost good faith and the most scrupulous inherent fairness of transactions in which they possess a financial, business or other personal interest which does not devolve upon the corporation or all shareholders generally. . . . *Id.* (citations omitted).

86 *See* Scott v. Multi-Amp Corp., 386 F. Supp. 44, 67-68 (D.N.J. 1974); Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66, 74 (Cal. App. 1952); Marciano v. Nakash, 535 A.2d 400, 405 (Del. 1987); Fliegler v. Lawrence, 361 A.2d 218 (Del. 1976).

ficer of the corporation, the transaction is voidable, not void.[87]

> In less than half a century, the rule has moved from holding the transaction *ipso facto* void or voidable at corporate option; through holding it voidable if the interested director voted or was necessary for quorum; to its present status which permits the corporation to void the transaction only on the ground of unfairness.[88]

Indeed, even unfairness can be put aside as a disqualifying test under certain circumstances.[89]

This has come about through the adoption by many states of so-called "safe-harbor" statutes[90] which govern situations where one or more directors or senior executives are personally interested in transactions with the corporation. These statutes were enacted to ameliorate the common law rule which made such transactions voidable whether or not they were fair or approved by disinterested directors.[91] Without further explanation, it is said that this "liberalizing trend has been viewed as more in keeping with the needs and practices of modern business life."[92] The great weight of authority today permits a director or senior executive to enter into transactions with his corporation so long as he has acted fairly in his dealings with the corporation.[93]

Thus, the outright common law prohibition no longer exists. Statutes permit such transactions so long as there is approval or rat-

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87 *See* FLETCHER, *supra* note 14.

88 *Id.*

89 Where there has been disinterested shareholder approval, courts have limited judicial scrutiny of the fairness of the transaction by requiring a showing of waste, illegality, ultra vires or fraud. *See, e.g.*, Kerbs v. California Eastern Airway, 90 A.2d 652 (Del. 1952). Where there has been waste, unanimous shareholder ratification is necessary to forestall judicial review. *See* Screiber v. Bryan, 396 A.2d 512, 518 (Del. Ch. 1978).

90 *See, e.g.*, N.J. REV. STAT. § 14A:6-8(1) (West 1969); DEL. CODE ANN., tit. 8, § 114(a) (Michie 1983); N.Y. BUS. CORP. LAW § 713(a) (West 1986); CAL. CORP. CODE § 310(a) (West 1990).

91 *See* FRANKLIN R. BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS (Law & Business 1985 with 1988 Supplement) § 4.9. For a discussion of the evolution of judicial decisions, from the view that such transactions are voidable without regard to fairness to the current view, *see* Harold Marsh, Jr., *Are Directors Trustees? Conflicts of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

92 *See* FINAL DRAFT, *supra* note 2, at 312.

93 *See* FLETCHER, *supra* note 14 (collecting cases); HARRY G. HENN & JOHN R. ALEXANDER, LAW OF CORPORATIONS § 238 *et seq.* (3rd ed. 1983).

ification by a majority of the corporation's directors not personally interested in the transaction, or by the corporation's shareholders.[94]

The second erstwhile legal precedent that would have operated to prohibit the management buyout, or, at a minimum, sharply to inhibit its use, was the rule that required unanimous shareholder consent for actions that would terminate the corporate enterprise or eliminate the continuing participation of shareholders.[95] At common law, unanimous shareholder approval was required to effectuate a merger or sale of all assets of a corporation.[96] The rationale for this doctrine was based upon the view that

> there was an implied contract among the shareholders to pursue the business for which the corporation was created for the specified period of its existence and that barring business disaster, there should be no voluntary dissolution, sale or discontinuance of the business except by unanimous consent.[97]

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94 *See* FINAL DRAFT, *supra* note 2, § 5.02 note, at 312-20. This contains an analysis of the variations in the statutory approaches to the subject. The Reporter's Note to Section 5.02 of the Final Draft indicated that 45 states have adopted "safe harbor" statutes codifying, in varying ways, the view adopted by most courts that a transaction between a director and his corporation is not voidable simply because of the existence of a fiduciary relationship between the parties. The statutes of 14 states provide that contracts in which directors are interested are not voidable because of the relationship or interest, or because of the presence of the director at the meeting which authorizes, approves or ratifies the contract or transaction, or because such director's vote is counted, so long as any one of three alternative conditions is satisfied: (a) the fact of the relationship or interest is disclosed to the board of directors or committee which authorized the contract or transaction by vote sufficient for that purpose without counting the vote of the interested director; (b) the fact of relationship or interest is disclosed to and approved by the shareholders; or (c) the contract or transaction is fair to the corporation. This is the approach of old Section 41 of the Model Corporation Act. Twenty-one other states, including New York and Delaware, are said generally to follow the approach of old Model Act Section 41 but also to require disclosure of the *material facts* concerning the transaction. A.B.A., MODEL BUSINESS CORPORATIONS ACT § 41 (1950).

95 *See, e.g.*, Voeller v. Neilston, 311 U.S. 531 (1941)

96 *See* William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. BAR FOUND. RES. J. 69, 77-97; Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 226-30 (1962), for two discussions of the rule, both at common law and in the early state corporate codes. *See also* Fontaine v. Brown County Motors Co., 29 N.W. 744, 746-47 (Wis. 1947); Katz v. Bregman, 431 A.2d 1274 (Del. Ch. 1981), *appeal ref'd sub. nom.* Plant Indus., Inc. v. Katz, 435 A.2d 1044 (Del. 1981).

97 FLETCHER, *supra* note 14, § 2949.1. *See also* Hariton v. Arco Electronics, Inc., 186 A.2d 22, 25 (Del. Ch. 1962); Reynolds Metals Co. v. Colonial Realty Corp., 190 A.2d 752, 755; (Del. Ch. 1963); Jesse A. Finkelstein and Gregory V. Varallo, *Action by Written Consent*, 42 BUS. LAW. 1075, 1084 (1987); Leo Herzel, Scott J. Davis and

The requirement for unanimous consent has been described as being consistent with both the common law of corporations and Delaware policy.[98] Under this rule, shareholders could not involuntarily be eliminated from their continued participation in the corporate enterprise through mergers, consolidations, or sales of all or substantially all of a corporation's assets followed by liquidation.

Changes in statutory law have eliminated the requirement of unanimity, allowing, in most jurisdictions, simple majorities of shareholders to authorize transactions which terminate the corporation's legal existence.[99] In the process, the public shareholders are forced out, their equity interests in the corporation converted, often over individual objection, into cash, or sometimes even into debt of the purchaser.[100] The old shareholders are thus denied the right to participate in the future growth and anticipated prosperity of the corporation. This is brought about as the consequence of a transaction initiated, or participated in, by corporate insiders retaining their existing ownership or first acquiring a significant equity stake in the entity intended to continue the business and to realize the ultimately expected gains.

Clearly, management buyouts would never have flourished as a commonplace of the corporate scene had the legal principles described retained continued vitality in our corporate jurisprudence. Principally through statutory enactment, these legal principles have been cast aside. Yet, when the realities of management buyouts are laid side by side with judicial pronouncements on the duties of corporate insiders, one is forced to inquire whether the two are really compatible, notwithstanding the enabling statutes. Are the conflicts which inhere in management buyouts too pervasive and too deep? Are the methodologies of corporate governance too ineffective and unavailing? Are the contradictions between such transactions and the basic rationale for public investment in equity securities too wide to permit continued acquiescence in the abandonment of these

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Daniel Harris, *Consents to Trouble*, 42 BUS. LAW. 135, 143 (1986)[hereinafter Herzel, et. al, *Consents to Trouble*]; FINAL DRAFT, *supra* note 2, § 6.01 note, at 539.

98 *See* Herzel, et. al, *Consents to Trouble*, *supra* note 97, at 143.

99 *See, e.g.*, N.J. REV. STAT. § 14A:12-4 (West 1969); N.Y. BUS. CORP. LAW § 1103(c) (West 1992); DEL. CODE ANN., tit. 8, § 275(b) (Michie 1983).

100 *See, e.g.*, Murry v. Empire Ins. Co., 572 N.Y.S.2d 909 (A.D. 1st Dep't 1991); Gulbreath v. H.K. Scott, 433 So. 2d 454 (Ala. 1983)(when majority stockholders personally assume multiple roles of owners, directors, and officers, they can deprive and siphon off income from their interest in the business).

earlier rules? And, as a related matter, has the American Law Institute's recently completed Corporate Governance Project bypassed an essential opportunity, or even obligation, to confront these concerns?[101]

VI. The Danger to the Corporation and its Shareholders

To sustain the legitimacy of management buyouts is necessarily to undermine the single-minded fidelity to the corporation and its shareholders which is supposed to characterize the behavior of corporate fiduciaries. Once the wall is breached which would have barred the insider from advancing his interests in competition with the shareholders, the seeds for the subversion of shareholder interests are planted. The corrosive potential of this division of loyalty is not confined to any single point in the relationship between insider and enterprise, such as negotiation of the price of the buyout. Rather, it may compromise the corporate decision-making process at any one of a number of points between the moment of initial conception of the buyout and its ultimate consummation.

The insider engages in conduct inconsistent with the duty owed by him to the corporation in certain situations: (1) when,

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101 The various Drafts published as part of the work of the ALI on this project entirely bypass any question as to the fundamental propriety of management buyouts, and the issue is also ignored in Roswell B. Perkins, *The ALI Corporate Governance Project in Midstream*, 41 Bus. Law. 1195 (1986). The closest the Project comes to recognizing the inherent conflict which exists between the interests of the insiders and the shareholders is to be found in Final Draft, *supra* note 2, § 5.15 cmt., which deals with so-called transfers in corporate control, where it is said that "[u]nder current circumstances, there is substantial reason to doubt that bids competing with the management - sponsored bid will be forthcoming with sufficient frequency. Although announcement of the terms of a proposed management buyout often has given rise to a competing bid, a party that might contemplate bidding against a management-sponsored group suffers under significant information and timing disadvantages. Most important, the management-sponsored group, and its financing sources, have access to substantial, often non-public, information concerning the corporation at essentially no cost. Additionally, even if the potential competing bidder has the means to develop independent sources of information, the opportunity for the management-sponsored group to choose the moment when it makes its offer, and to act first, puts any potential competitor at a disadvantage." Final Draft, *supra* note 2, at 488. The Comment argues that § 5.15 effectively "sets out governance rules that will allow the market for corporate control to operate as a realistic protection against non-arm's-length division of gains from a transaction in control of the corporation to which its directors or principal senior executives are parties." *Id.*

recognizing that the assets of the corporation can be deployed to better advantage than their existing manner of use, he elects not to advance that objective for the betterment of the corporation, but instead for his own advantage; (2) when upon commencement of a plan to acquire such assets, he then fails to explain sufficiently either the particulars of their intended utilization or his reasons for believing that these assets can be put to better advantage than the corporation is doing; (3) when anticipating the opportunity to realize substantial profits from the acquisition of such assets through an asset disposition program, from operating efficiencies, or from the fulfillment of still formative business plans or strategies, the insider fails to disclose adequately such expectations;[102] and (4) when he then acquires such assets for anything less than either their "fair value"[103] or the maximum amount to which he would have raised his bid.

The transformation of the insider from corporate steward into bidder and buyer, competing with the interests of his shareholders, is grounded in the insider's unique access to, and understanding of, confidential and proprietary information concerning asset values and corporate prospects not known to those outside of management.[104] In participating in a management buyout, the insider uses his extraordinary information base for personal advantage, to facilitate his purchase and subsequent exploitation of corporate property for private advantage rather than for the benefit of the corporation, its shareholders, and some or all of its "other constituencies." And, by being permitted to bargain for corporate assets as with a stranger, the insider seeks and is afforded the opportunity to take advantage of the corporation by acquiring its properties for less than the optimal price. In contravention of the oft-repeated proscription laid down in *Guth v. Loft*, the insider is thus clearly permitted to use his "position of trust and confidence to further [his] private interests."[105]

Once corporate insiders have been permitted to cross the forbidden threshold of divided loyalty, the way is opened for

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[102] *See* Talbot v. James, 190 S.E.2d 759, 764 (S.C. 1972).

[103] *See* Lewis v. S.L. & E., Inc., 629 F.2d 764, 772 (2d Cir. 1980).

[104] *See* Evangelista v. Queens Structure, 212 N.Y.S.2d 781, 782 (Sup. Ct. 1961); Massey v. Disc Manufacturing Inc., 601 So. 2d 449, 455-56 (Ala. 1992); Oesterle and Norberg, *Shareholder Wealth*, *supra* note 13, at 217-18.

[105] Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

them to bend to personal advantage, at various points and in different ways the corporate decision-making process.[106] Information is a critical component of the corporate takeover process. In the hands of those with an appetite to buy, it can whet their interest, encourage offers and drive up prices. Denied, it can drive away potential competitors and facilitate a bargain purchase.

Insiders possess the means to manage, and thus to retard, the timetable for the realization of business plans and objectives. Once a buyout has been conceived, insiders may be moved to suppress or delay corporate developments which might attract attention to the corporation, increase the likelihood of competing offers or the ultimate cost of acquisition, enhance shareholder values, or create impediments to a successful management buyout. The corporation may be pushed into actions which could not be undertaken once a buyout had become a known possibility, such as the issuance of bonds which could not be sold absent higher yields to compensate for such a risk.

The ability to manipulate the timing and scope of financial or other disclosure represents a powerful tool in the hands of a self-interested management.[107]

Many corporations are notorious for the paucity of information presented in their annual and periodic reports, as well as for their refusal to meet with shareholders or analysts.[108] The failure to break out financial data about particular divisions or lines of business can depress share values as well as deflect attention from particular undervalued assets or business segments.[109] Ab-

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106 *See, e.g.*, In Re MCA Inc., 598 A.2d 687, 693 (Del. Ch. 1991); Balkan v. Amsted Industries, Inc., 567 A.2d 1279, 1286 (Del. 1990).

107 As one commentator has noted, "[D]irectors lack *independent* information and analysis regarding a company's performance. Virtually all information comes to the board from management. Its content and use is a potent weapon with which the CEO can influence events." Clifton F. Wharton, Jr., *Just Vote No, in Advice and Dissent: Rating the Corporate Governance Project*, HARV. BUS. REV., Nov. - Dec. 1991, at 138 (emphasis in original).

108 *See, e.g.*, Gaffin v. Teledyn, Inc., 1992 Del. LEXIS 324; Fisher Provision Co. v. Lopatin, 237 N.W.2d 562 (Mich. App. 1975).

109 *See* Oesterle and Norberg, *Shareholder Wealth*, *supra* note 13, at 218-19, where the authors noted:

> While the buyout group is subject to the disclosure provisions of the federal securities laws in making its offer, the importance of new patents, investment opportunities, or changing competitive circumstances may not be disclosed or may be lost in the boilerplate language and intentional obfuscation that so often characterizes such disclosures.

sent narrative discussion in a shareholder report, off-balance sheet assets are frequently incapable of detection.[110] The reasons for a corporate policy which minimizes financial and other disclosures to shareholders and the investment community generally are varied. Management's motives can range from the benign to the aggressively selfish. They may reflect a genuinely cautious desire to avoid excessive "hype" about corporate prospects and a charge of "puffing"[111] the stock, and a correlative interest in minimizing possible personal liability. Perhaps, the motive may be somewhat more self-protective, such as avoiding an unwanted takeover and loss of corporate jobs or independence. Alternatively, a more aggressive self-interest may be at work, which perceives personal advantage to be derived from depressed share values or poorly understood assets or business strategies, whether that advantage takes the form of cheap stock option grants, stock repurchases from public shareholders, or a management buyout. In each of these instances, insiders will benefit from the combination of low share prices and limited outside interest in the company. Management information will rarely take the form of dissemination of outright misinformation. The more likely course is the suppression of positive news, a practice both harder to pinpoint and less fraught with the legal problems that would follow the release of deliberately misleading data.

The dangers from the withholding of information are particularly acute where the managers are seeking to acquire a corporate subsidiary or division for which separate data is not publicly available, and when the potential or actual profitability of which is largely unknown. The engagement of an investment banking firm to market the subsidiary or division to prospective buyers, particularly where this is to be accomplished within an abbreviated time period, may not prove a viable alternative to negotiat-

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Id.

110 *See, e.g.*, Wessel v. Guantanmo, 134 N.J.Eq. 271 (Ch. 1944)(off-balance sheet assets may include depreciation); Gallagher v. New York Dock Co., 19 N.Y.S.2d 789, 799 (Sup. Ct. 1940)(failing to set up necessary reserves and to write off sufficient depreciation).

111 *See, e.g.*, Mekrut v. Gould, 188 N.Y.S.2d 6 (Sup. Ct. 1959)(defined "puffing" as an opinion and not actionable in fraud).

ing a sale to a management group that has come forward with a bid.

In the many-step process of a corporate divestiture, insiders have considerable opportunity to "chill" the effort to induce a third-party suitor to come forward, and to impede the due diligence required for the negotiation of an acquisition contract or the submission of a bid. Buyout transactions are often negotiated under severe time pressure, and the ability to withhold from prospective third-party bidders valuable information already familiar to the insiders, to delay the release of such data, or to provide such information in a format which fails to present an accurate and complete picture represents a powerful tool in the hands of a self-interested insider. A prospective buyer may be furnished unduly conservative projections of earnings or cash flow,[112] while the competing insider will know all of the material information, including how these projections were prepared, and what relevant data may have been omitted, obscured or unnecessarily qualified. A normal degree of circumspection by any seller making such disclosure is appropriate, but where the insider's motives are suspect, so may be the completeness of the information provided.

The ability to discourage prospective buyers through a stone-walling process which utilizes uncommunicative or negative responses will be particularly effective in those situations where an unwelcome buyer is not prepared to proceed by means of a hostile tender[113] which relies entirely upon public information, but instead insists upon conducting the due diligence[114] appropriate to a negotiated sale. In one instance, a company chairman was described as having relied on the "red carnation approach" in displaying the company. Whenever a potential buyer showed up to tour the factory floor, the chairman "wore a red carnation to signal to his employees to talk the place down."[115]

While such a stone-walling response is unlikely to deflect the interest of a truly determined bidder, particularly where the ob-

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[112] *See, e.g.*, Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183-84 (Del. 1986).

[113] *Id.* at 198-84.

[114] *See, e.g.*, Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261 (Del. 1989).

[115] Michael M. Lewis, *Leveraged Rip-Off*, THE NEW REPUBLIC, Nov. 14, 1988, at 26.

ject of attention is a large public enterprise,[116] it should not be assumed that such behavior will not occur, nor will it not be effective in less visible contexts, such as the sale of a non-public division or subsidiary to an insider group. Whenever a corporation's board of directors voluntarily determines to place the company on the block and seek a buyer, there is a risk that key managers, concerned for their own jobs, will act to sabotage completion of a transaction or will seek to skew it in their favor. This potential for abuse is magnified when the managers are themselves permitted to become prospective buyers of the business, and the stakes are raised from the mere retention of corporate jobs to the prospect of large profits from a bargain purchase.

Moreover, the insiders typically possess another considerable advantage in their ability to advance their own agenda, whether that agenda consists of resisting a third-party offer or promoting management's own buyout proposal. The outside directors, entirely apart from the question of their willingness to take on senior management,[117] are often singularly ill-equipped to contend with a determined insider group intent on pursuing their self-interest. Independent directors cannot match the insiders' detailed and sophisticated knowledge of the internal dynamics of the corporate enterprise, of its business plans and prospects, and of its individual assets and their values.[118] An outside director has a myriad of other involvements and activities and typically spends little time on the affairs of any particular corporation in which he serves as an independent board member.[119]

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116 *See, e.g.*, *Mills Acquisition Co.*, 559 A.2d 1261 (1989) (which involved an extensive and ultimately unsuccessful effort to deny information to the unwanted suitor) *See infra* pp. 187 - 194.

117 *See* Allen, *Independent Directors, supra* note 69 and accompanying text, and *see infra* pp. 181 - 194.

118 *See* Victor Brudney and Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1366-68 (1978), in which the authors voice the suspicion that insiders will elect to go private when they perceive a turning point in the company's affairs, before that perception has become generally available. *See also* Jeffrey A. Tannenbaum, *Crazy Eddie, Inc. Report Discloses an SEC Inquiry*, WALL ST. J., June 18, 1987, at A4, discussing a scheme where an insider proposed a buyout after selling a substantial shareholding and thereby precipitating a market decline in the stock price because of his perceived withdrawal from the business. The fact that insider groups have sometimes overpaid for assets or businesses, as evidenced by work-outs or even bankruptcies following quickly on the heels of the buyout, simply proves that not all insiders make wise buyers.

119 *See* Manning, *Time for Reality, supra* note 73. Among the factors Manning men-

The intensive and proactive functioning of the outside directors in the RJR Nabisco buyout[120] is likely to prove the exception, rather than the rule. Moreover, in that situation the directors were virtually goaded into action by the egregious and highly publicized behavior of the insider group.[121]

Present corporate practice places great emphasis not only on the role of the outside directors in protecting against the risks of insider self-interest in the context of a management buyout, but also on the assistance to be provided by their outside legal and financial advisers.[122] Key executives, however, retain the ability to manipulate the process by which these professional advisers are selected, so as to call into question the independence of those retained.[123] It is also an unavoidable fact that outside financial advisers to the independent directors, charged, in a very limited time period, to produce valuations,[124] or "fairness" opinions,[125] or to identify and recruit potential buyers, will remain considerably dependent upon the good will and cooperation of management in discharging such functions and in developing or providing necessary data.

Insiders may use various techniques to fend off unwanted offers or to promote their own bids. Insiders have often supported grants of significant negotiating advantages to favored bidders,

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tions are the part-time nature of the typical outside director's involvement (averaging 1.5 days per month), the complexity of the modern corporate enterprise, the limited time to consider particular issues, the diversity of the directors' backgrounds and the fact that many are not businessmen.

120 *See supra* note 12.

121 *See infra* pp. 181 - 183.

122 *See* Oesterle and Norberg, *Shareholder Wealth, supra* note 13, at 249-50, where the authors concede that the

> weak link in the protections afforded shareholders is the misuse of fairness opinions from investment advisors. The buyout group has an obvious interest in legitimizing low bids as fair bids and will shop for formal letters of support from accommodating investment advisors. . . .As a consequence, the fairness letters do not protect shareholders from overreaching by their managers; indeed, the fairness letters may be part of the fraud.

Id. See also Allen, *Independent Directors, supra* note 69.

123 *See* Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989) and *see* text, *infra* pp. 181 - 194.

124 For a discussion of different valuation techniques, *see generally* ROBERT W. HAMILTON, CORPORATION FINANCE 1-54 (West 2d ed. 1989).

125 *Id.*

such as "lock-up" options[126] at favorable prices on so-called "crown-jewel" assets.[127] The financial adviser to the management group which made the unsuccessful effort to buy RJR Nabisco actually undertook to discourage other buyers — an action hardly compatible with the fiduciary duties of the management group.[128]

The submission of the offer to the corporation by the insider group brings the adversarial relationship between the two to the boiling point. The insider's bid may be for less than "fair value,"[129] or for less than what the insider subjectively believes to be "fair value." It may be in an amount below that which the assets would reasonably be expected to bring on a truly open market, i.e., one affording a reasonable time to solicit prospective purchasers and providing to would-be buyers maximum disclosure and opportunity for investigation, and below what the insider is himself prepared to pay. Insiders often will make a low-ball bid, raising it only in response to third-party offers or a rejection by the board. The insider may not adequately reveal to the corporation information about his intentions and expectations concerning the business or assets he proposes to acquire, his reasons for confidence in the corporation's long-term business prospects, his plans to modify existing corporate strategies, or his anticipated realization of near-term profits through asset dispositions or from the implementation of operating efficiencies or improvements. Furthermore, he may not disclose, or adequately explain why the advantages which he anticipates realizing cannot be obtained by the corporation itself, for its existing shareholders. The insider may not be forthcoming concerning his true reasons or justifications for seeking such advantages for himself.

Full disclosure relating to such matters would permit the directors to make a more informed judgment as to the fundamental fairness and essential propriety of the insider's bid, not merely in

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126 *See, e.g.*, *Mills Acquisition Co.*, 559 A.2d at 1279-80. *See also infra* note 206 and accompanying text.

127 *See Mills Acquisition Co.*, 559 A.2d 1261 (Del. 1989); Hanson Trust PLC v. SCM Corp., 781 F.2d 264 (2d Cir. 1986).

128 *See* John Helyar, *KKR Seeking A Compromise on RJR Offer*, WALL ST. J., Oct. 25, 1988, at A3.

129 Supporters of management buyouts argue that there is no such thing as a "fair price" to which insiders must be held. *See* Booth, *Limits of Fiduciary Duty*, *supra* note 38, at 633.

terms of price offered, but also in the broader context of whether the submission of such an offer may not actually reflect the failure of the insider to have met his responsibilities to the corporation.[130] This would permit an appropriate analysis of whether such a failure should not in fact disable the insider from making an offer, or even warrant his dismissal or demotion.

VII. The Incompatibility of the Buyout with the Insider's Duties

The insider's duties have repeatedly been defined in language facially broad and clear enough to bar him entirely from purchasing assets from the corporation, as well as from making any bid for corporate assets under circumstances involving inadequate pricing[131] or insufficient disclosure.[132] Thus, corporate officers and directors are "not permitted to use their position of trust and confidence to further their private interests."[133] They are required "to refrain from doing anything that would. . .deprive [the corporation] of profit or advantage which it might earn in the reasonable and lawful exercise of its powers."[134] This rule is intended to "extinguish all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation" of insiders to the corporation.[135]

The principles governing the behavior of corporate fiduciaries

> demand that corporate fiduciaries absolutely refrain from any act which breaches the trust reposed in them. . .[and] . . .affirmatively protect and defend those interests entrusted to them. Officers and directors must exert all reasonable and lawful efforts to ensure that the corporation is not deprived of any advantage to which it is entitled.[136]

Directors are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of transactions in which they possess a financial, business or other personal interest which

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130 *See, e.g., Mills Acquisition Co.*, 559 A.2d at 1280.

131 *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 183 (Del. 1986).

132 *See, e.g., Mills Acquisition Co.*, 559 A.2d at 1280.

133 Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

134 *Id.*

135 *Id.*

136 Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

does not devolve upon the corporation or all stockholders generally.[137]

Application of these general observations to the particular issue of disclosure in the context of a management buyout would seem to preclude insiders from submitting low-ball bids. It would also require the clearest accounting by the insiders of all facts and circumstances which, from the corporation's perspective, would either justify or militate against the buyout. This discussion transcends issues of valuation and pricing alone. The "duty of candor is one of the elementary principles of fair dealing."[138]

Such a formulation of an insider's responsibilities certainly mandates, in the context of a buyout, disclosure of much that an unrelated acquiror would not, because of his independent arm's-length relationship, be called upon to reveal. This requirement upon insiders is completely consistent with the specific duty owed by a corporate fiduciary to shareholders when the fiduciary is required or elects to seek shareholder approval. In such transactions, the Delaware courts have imposed the duty of "complete candor"[139] and the obligation to disclose fully and fairly pertinent information which is within the fiduciary's control and is germane to the transaction at issue.[140] Germane information is information in which "there is a material likelihood that a reasonable shareholder would consider important in deciding how to vote."[141]

In situations invoking the so-called "going private" rules, federal law imposes specific and detailed disclosure requirements. Rule 13e-3 of the Securities and Exchange Commission[142] governs transactions in which the issuer or an affiliate of the issuer proposes

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137 Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

138 *Mills Acquisition Co.*, 559 A.2d at 1283. The Delaware Supreme Court has said that the law

> imposes this unremitting obligation not only on officers and directors, but also upon those who are privy to material information obtained in the course of representing corporate interests. . . .At a minimum this rule dictates that fiduciaries, corporate or otherwise, may not use superior information or knowledge to mislead others in the performance of their own fiduciary obligations.

Id.

139 *Id.* at 1280.

140 *See* Lacos Land Co. v. Arden Group. Inc., 517 A.2d 271, 278-79 (Del. 1986); Lynch v. Vickers Energy Corp., 351 A.2d 570 (Del. 1976).

141 *Lacos Land Co.*, 517 A.2d at 279.

142 17 C.F.R. § 240-13e-3 (1988).

to acquire, either through open-market, privately-negotiated purchases, or formal tender offer, such number of the issuer's equity securities as would cause any unacquired shares to be delisted or no longer subject to the reporting requirements of the Securities and Exchange Act of 1934. The Rule requires a filing, on Schedule 13E-3, of information disclosing, among other things, the following: (1) any plans or proposals of the issuer or its affiliate which would result in any extraordinary corporate transaction, such as a merger, reorganization or liquidation of the issuer or a subsidiary;[143] (2) the sale or transfer of material assets of the issuer or a subsidiary, including, where the schedule is filed by an affiliate, information as to prior contacts, negotiations or transactions concerning such matters;[144] (3) the purpose(s) of the transaction, any alternative means considered to accomplish such purpose(s) and the reasons for rejection of such alternative;[145] (4) the reason for the structure of the transaction and for undertaking the transaction at the time;[146] (5) whether the issuer or affiliate reasonably believes the transaction to be fair to the unaffiliated shareholders;[147] and (6) any additional information necessary to make any disclosures not materially misleading.[148] The disclosures must include a reasonably detailed discussion of the benefits and detriments of the transaction to the issuer or affiliate and to the shareholders, including a quantification of the benefits and detriments.[149] Any reports, opinions or appraisals from outside parties materially related to the transaction, or its fairness, must be disclosed.[150]

A filing under Rule 13e-3 is not required where the transaction is made by an entity, other than the issuer, in which existing management does not hold such an interest that would classify the prospective acquiror an affiliate of the issuer, i.e., where the issuer or the acquiror does not control the other and where they are not under common control.[151] Nor, does the Rule apply to the acquisition of only selected assets, or of a subsidiary, division or segment

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143 *Id.* § 240.13e-3(a)(3)(i)(C) (1988).
144 *Id.* § 240.13e-100(3)(a)(2) (1992).
145 *Id.* § 240.13e-100(7)(b) (1992).
146 *Id.* § 240.13e-100(7)(c) (1992).
147 17 C.F.R. § 240.13e-100(8)(a) (1992).
148 *Id.* § 240.13e-100(16) (1992).
149 *Id.* § 240.13e-100(7)(d)(2) (1992).
150 *Id.* § 240.13e-100(9)(a) (1992).
151 *Id.* § 240.13e-3 (1988).

of the business.[152] However, there seems to be no reason why insiders, consistent with their duties to the corporation and its shareholders, should not, irrespective of the existence of any particular statutory or regulatory requirement, be compelled to provide disclosures similar to those required by Rule 13e-3, as a condition to their transacting business with the corporation.

Even if current law does not bar management buyouts entirely, and even without a return to the earlier outright prohibition, the principles laid down in the cases would seem to require certain standards of conduct which are not, in fact, being met. In particular, application of such principles in the buyout context would seem to demand a full and candid explanation from the insiders. Such matters include: (1) why they should be allowed to undertake any acquisition from the corporation; (2) what they expect to earn; (3) why the business opportunities implicit in the proposed acquisition cannot be availed of by the corporation; (4) how and why they are able to obtain financing for the transaction; and (5) why the corporation could not, or should not, obtain similar financing. The same principles would also seem to support the proposition that a bid submitted for corporate assets by an insider should be taken to represent the highest and best bid that such person expects, intends and is able to make. Shareholders who dispose of their shares, once an insider has submitted a bid, should be permitted to sue and recover damages for fraudulent misrepresentation.[153] This would arise in a situation where the insider subsequently increases his offer, assuming that the board is even willing to consider such an increased bid and not reject it as constituting a breach of the insider's fiduciary obligations to the corporation sufficient to disqualify him as a prospective buyer.

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152 17 C.F.R. § 240.13e-3 (1988).

153 *See* List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965). The Court explained that:

> It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilizing his position to take unfair advantage of the uninformed minority stockholders.

Id. at 461 (quoting Speed v. Transamerica Corp., 99 F. Supp. 808, 828-29 (D. Del. 1951).

VIII. The ALI's Acceptance of Present Practice

The American Law Institute's recently completed Corporate Governance Project[154] fails to challenge, and would not disturb, existing law's permissive acceptance of the management buyout. The Project takes, as its general rule, that a director or senior executive "may not use corporate property, material non-public corporate information, or his corporate position to secure a pecuniary benefit."[155] Among the permissible exceptions to this prohibition are transactions with the corporation in which value is given for such use and certain other standards are met.[156] This also applies to transactions involving the use of non-public but non-proprietary corporate information in a manner which does not harm the corporation.[157] A condition of any transaction between a director or senior executive and the corporation is the disclosure of both the material facts of the transaction and the interest of the director or senior executive.[158] A director or senior executive may not deal with the corporation as a stranger at arm's length.[159]

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154 *ALI Wraps Up Corporation Law Project*, 60 U.S.L.W. 2727 (May 26, 1992).

155 *See* FINAL DRAFT, *supra* note 2, § 5.04(a), at 338.

156 *Id.* § 5.04(a)(1), at 328. Section 5.04(a)(1) requires that the transaction either be fair to the corporation, be authorized or ratified by disinterested directors who could reasonably have concluded that the transaction was fair to the corporation or by disinterested shareholders and not constitute a waste of corporate assets.

157 *Id.* § 5.04(a)(3), at 338.

158 *Id.* § 5.02(a)(1), at 277. The formulation of § 5.02(a)(1) is described as following the approach of many jurisdictions. *See* FINAL DRAFT, *supra* note 2, § 5.02, at 320.

159 *Id.* § 5.02(a)(1) cmt., at 285. Even where the conflict of interest is made known, there is a relationship of "trust and confidence' with the corporation, so as to require disclosure of 'material matters," rather than the relationship of a stranger to the corporation with a much more limited duty of disclosure. *Cf.* RESTATEMENT (SECOND) OF TORTS § 551(2)(a) with RESTATEMENT (SECOND) OF TORTS § 551(2)(e). *See also* RESTATEMENT (SECOND) TORTS § 551 cmts. e, f, k. The duty of one who occupies a relationship of trust and confidence to disclose material facts is widely recognized. *See, e.g.*, RESTATEMENT OF CONTRACTS § 161 cmt. f; RESTATEMENT (SECOND) OF AGENCY § 390; RESTATEMENT OF RESTITUTION § 191 (comment on section (b)). A director or senior executive owes a duty to the corporation not only to avoid misleading it by misstatements or omissions, but affirmatively to disclose the material facts known to him. The interested director or senior executive also has an obligation to explain the implications of a transaction when he or she is in a position to realize those implications and the disinterested directors or superior is not. *See* Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378 (N.Y. App. 1918).

A director or senior executive who fails to make required disclosure is described as having failed to fulfill his duty of fair dealing

> even if the terms of the transaction are fair. A contract price might be fair in the sense that it corresponds to market price, and yet the corporation might have refused to make the contract if a given material fact had been disclosed. . . . Furthermore. . .fairness is often a range, rather than a point, and disclosure of a material fact might have induced the corporation to bargain *the price down lower in the range.*[160]

This statement is obviously directed to the factual context where the corporation is purchasing goods or services from the insider. Logically, it should also apply in the reverse, i.e., where the insider is buying from the corporation. In such circumstances, proper disclosure, particularly of the insider's intentions with respect to the assets or business being acquired and as to his expectations of profit, might have induced the corporation to bargain harder so as to exact a higher price.

Disclosure is required not only of the material facts[161] concerning the conflict, but also of the "material facts known to [the insider] concerning the transaction."[162] A fact is deemed "material" if "there is a substantial likelihood that a reasonable person would consider it important under the circumstances in determining his course of action."[163] An insider's belief that he is getting a bargain should be viewed as material, as should the insider's willingness or intention to raise his offer if it is rejected or if there is competition from a third party. Despite the Project's specific definition of "materiality" and its generally expansive description of an insider's duties towards the corporation, the Project's formulation of the scope of required disclosure by the insider appears to fall short. Disclosure is not mandated for much that would seem to be material to the shareholders, such as the insider's expected profit and the maximum price which he is prepared to pay. Instead, a more confined and ambiguous rule is set forth:

> Normally, interested parties [directors or senior executives]

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160 *See* FINAL DRAFT, *supra* note 2, § 5.02(a)(1) cmt., at 285-86 (emphasis added).
161 *Id.* at 285.
162 *Id.* § 1.14, at 18-19.
163 *Id.* § 1.25, at 35. *See also* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

are *not obliged to volunteer the maximum amount they are willing to pay or the minimum amount they are willing to charge the corporation, because the lowest price a seller will take or the highest price a buyer will pay are usually not facts in the normal sense of that term but rather present intentions that often change during bargaining.* An interested seller is also normally not required to disclose the profit the seller will make on the transaction because normally the corporation will have access to market information concerning prices paid or received in comparable transactions, and can make its own decision as to what it wishes to pay or receive *so long as there is an opportunity for arm's-length bargaining.*[164]

The Project recognizes that "special circumstances may change this normal rule" which justifies the concealment of anticipated profit or the maximum bid contemplated.[165]

The Corporate Governance Project ultimately reflects a confused view and inconsistent expectations of the insider's behavior.

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164 *See* FINAL DRAFT, *supra* note 2, § 1.14 cmt., at 19 (emphasis added). The ALI Project's proposed rule governing the burden of proof of fairness in so-called "Transactions in Control," involving transfers of control of the corporation to directors, "principal senior executives," or their associates, is similarly intended to insulate such persons from the imperatives of full disclosure; insiders and their associates competing with other bidders for control are specifically exempted from any obligation to "disclose to the competing bidder or to the public the price they are ultimately prepared to pay for the business" and only must reveal "the nature and amount of consideration they are initially prepared to offer for the business. Thereafter, however, they are under no obligation to advise competing bidders or the public as to the extent to which they may be prepared to improve their initial offer." *Id.* § 5.15 cmt., at 495. Section 5.15 provides that if, in connection with a "transfer of control" transaction, public disclosure is made, responsible persons "who express an interest are provided relevant information concerning the corporation and given a reasonable opportunity to submit a competing proposal," and the transaction is properly authorized or ratified by disinterested directors or shareholders, the party challenging the transaction must show that it constituted a waste of corporate assets. The Comment to § 5.15 interprets this to mean that competing participants must be provided by the insiders or their associates with "any nonpublic information concerning the corporation that [the insiders] make available to the investment bankers, financing entities, or any other third persons" associated with the insiders in the proposed transaction. *Id.*

165 *Id.* § 1.14, at 19-20. For example, if the interested party is making a substantial, quick profit on the transaction, particularly if no significant market risk is incurred, that fact should be disclosed to the corporate decisionmaker because it is relevant to the corporation's pricing calculations. Similarly, if the transaction involves an arrangement in which comparable market transactions will not necessarily serve as an accurate guide, the interested party will be under a greater obligation to disclose facts that demonstrate that he is not taking advantage of the corporation in the transaction.

The proscription against an insider dealing with the corporation "as a stranger at arm's length" is unqualified.[166] If, however, arm's-length bargaining is truly impermissible, then will the use of a special committee remove the taint of impropriety? The special committee process does not preclude the insider from aggressive bargaining. It merely insures that the insider will bargain from only one side of the table. Moreover, a further anomaly of the Project's position is that the interposition of a special committee will actually encourage the insider to deal with the corporation as with a stranger, by the removal of residual inhibitions against aggressive arm's-length bargaining.

It is, moreover, difficult to reconcile, either with the general proposition that a director or senior executive is not permitted to "deal with the corporation as a stranger at arm's length," or with the more particular rule of "complete candor" referred to in the cases noted above,[167] the Project's suggestion that disclosure of the insider's potential profit or the maximum that he is prepared to pay is not in all instances obligatory. The Final Draft of the ALI Project reflects a puzzling revision. The prior Draft explained, in support of the proposition that the insider need not volunteer the maximum amount he is prepared to pay, that "in the usual case, the corporation will have access to market information concerning prices. . .received in comparable transactions, and can make its own decision as to what it wishes to. . .receive so long as there is an opportunity for arm's-length bargaining."[168] In the final version of this Comment, the explanation is given that interested parties are not obliged to volunteer the maximum they are willing to pay, or the minimum they are willing to charge, because "the highest price a

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166 *Id.* § 5.02(a)(1) cmt., at 285.

167 See Oesterle and Norberg, *Shareholder Wealth, supra* note 13, at 258-59, where the authors also decline to condemn insiders for refusing to disclose, in advance, their ultimate price, arguing that the insider "walks the line between making offers that are 'fair' while not revealing what it ultimately is willing to pay." They argue that if shareholders are entitled to the management group's "reservation price," two undesirable effects will result: management groups will lose much of their incentive to discover and fund buyout opportunities if they can make only break-even bids for a firm, and they will have a heavy incentive to cheat. Both arguments not only disregard the conflicts with fiduciary duty which are implicit in insider bids, but are actually premised on expectations that insiders cannot be expected to act consistently with their fiduciary obligations.

168 *See* A.L.I., CORPORATE GOVERNANCE PROJECT § 109 cmt. (Tentative Draft No. 11 1991).

buyer will pay [is] not [a] fact in the normal sense of that term, but rather [a] present intention that often change[s] during bargaining."[169] The Final Draft retains the concept that anticipated profits need not be disclosed because in the usual case the corporation will have access to market information concerning prices paid or received in comparable transactions and can make its own decision "so long as there is an opportunity for arm's-length bargaining."[170] The revision and explanation remain unsatisfactory, for several reasons. First, the purported dichotomy between intentions and facts seems fundamentally irrelevant to the issue of defining the particular obligations which insiders, as distinct from strangers, bear towards the corporation. Second, the suggestion that *arm's-length bargaining* provides a sufficient monitoring mechanism to restrain the insider's ability to take advantage of the corporation is at odds with the rule adopted elsewhere in the Final Draft that the insider is *not entitled to bargain with the corporation as a stranger at arm's length.*[171] Finally, the ALI formulation also falls significantly short of the scope of disclosure required in "going-private" transactions which are subject to Rule 13e-3.[172]

IX. The Effect of "Other Constituency" Statutes

Buyouts substantially affect important interests beyond those of the shareholders. Depending upon the circumstances surrounding a buyout, non-shareholders having relationships with the enterprise such as employees, customers, suppliers and creditors, may be profoundly and negatively affected. So, therefore, communities may be served by the corporation in which it does business. Buyouts which involve leveraged financing are especially likely to produce such adverse consequences. The incurrence of substantial additional indebtedness jeopardizes repayment to existing bondholders or other creditors. The buyout may mandate reductions in corporate overhead through the relocation or closing of plants or offices, cutbacks in research and development programs, curtailment of purchases from vendors, and the implementation of other cost-cutting measures en-

169 *See* FINAL DRAFT, *supra* note 2, § 1.14 cmt., at 19.
170 *Id.*
171 *See* FINAL DRAFT, *supra* note 2, § 5.02(a)(1) cmt., at 285.
172 *See* 17 C.F.R. § 240.13e-3 (1988).

tailing employee layoffs.[173]

The so-called "other constituency" statutes[174] offer a means and measure of protection to non-shareholder groups and interests affected by buyouts. These statutes expressly authorize directors, in reaching decisions concerning actions to be taken, to consider the probable effects on groups and interests other than shareholders.[175] One statute actually mandates that the directors do so.[176] These statutes are intended to clarify ambiguities in the common law concerning the ability, or even the obligation, of directors to take into account such interests.[177]

The origin of these statutes has been described as follows:

> It is probable that they arose in the context of the hostile takeover movement as corporate counselors, engaged to craft defenses against hostile bids, realized that no case law existed in many states expressly permitting directors to consider the interests of constituencies other than shareholders when making decisions.[178]

These statutes in their application are not confined to hostile takeovers,[179] but extend to management buyouts as well. This is a somewhat paradoxical circumstance in that the management buyout has traditionally been viewed in the corporate boardroom as the very antithesis of the hostile takeover and, consequently, a favored alternative to the unwelcome embrace. In reality, the management buyout often operates as such a palliative only with respect to the concerns of senior management. The interests of others, such as

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173 *See* ROBERT W. HAMILTON, CORPORATION FINANCE 503-08 (2d ed. 1989), for examples of favorable and adverse consequences in leveraged buyouts.

174 *See* Hansen, *Other Constituency Statutes*, *supra* note 66, at 1355. According to the author, "The typical statute provides that in acting in the best interests of the corporation, the directors may take into account the interests of a variety of constituencies other than the shareholders, including employees, the communities in which facilities of the corporation are located, customers and suppliers." *Id.*

175 *See* Hansen, *Other Constituency Statutes*, *supra* note 66, at 1376 (Hansen collects such statutes in an appendix).

176 *See* CONN. GEN. STAT. ANN § 33-313(e) (West 1990), discussed in Hansen, *Other Constituency Statutes*, *supra* note 66, at 1372.

177 *See* Hansen, *Other Constituency Statutes*, *supra* note 66, at 1356-57.

178 *Id.* at 1356.

179 *See* Joseph V. Cuomo, Note, *State Regulation of Hostile Takeovers: The Constitutionality of Third Generation Business Combination Statutes and the Role of the Courts*, 64 ST. JOHN'S L. REV. 107 (1989). A "hostile takeover" occurs when one entity, the predator, acquires control of another, the target, through the acquisition of stock, despite resistance by the target's management. *Id.* at 107 n.4.

the great mass of employees, may be hurt more drastically by a leveraged management buyout, with its potential for stringent cost-cutting, than by a takeover by a financially strong third party, even where such a third party is a business competitor.[180]

The "other constituency" statutes, when applied to management buyouts, may operate to impose heightened obligations on the insider and non-management directors. Where directors are actively pursuing their own self-interest, it can be argued that the private benefit which they are seeking obligates, rather than merely permits, the management directors to consider the consequences of their proposed acquisition upon employees and others. If the foreseeable end result is too draconian, and likely to prove more injurious to one or more constituencies than would a competing bid, it may be inappropriate for the insiders to pursue their own proposal, especially where any incremental benefit to shareholders is relatively slight.

The unaffiliated directors who are not involved in the buyout are entitled to the clearest statement of the intentions and expectations of the participating insiders with respect to the probable effect upon other constituencies of the enterprise. Moreover, the independent directors may have a discrete obligation to ensure that they are fully informed on this subject, even where the law defining their right to consider the "other constituencies" is cast in purely permissive terms; for without an understanding of the consequences for the "other constituency" interests, the directors cannot adequately discharge their responsibilities under the "other constituency" statutes.

Irrespective of the extent of the obligation of the unaffiliated directors, in jurisdictions having enacted permissive "other constituency" statutes,[181] they are responsible for informing themselves of the likely consequences of a buyout upon non-shareholder interests. This is done for the limited purpose of determining *whether* they wish to take such interests into account. "Other constituency" statutes would seem to impose substantial additional disclosure obligations on the insiders, inasmuch as their knowledge of the

[180] *See* Oesterle and Norberg, *Shareholder Wealth*, *supra* note 13, at 237-38.

[181] For examples of other constituency statutes, *see* GA. CODE ANN. § 14-2-202(5) (West 1987); OHIO REV. CODE ANN. § 1701.59 (Anderson 1985); CONN. GEN. STAT. § 33-313 (West 1987); MO. REV. STAT. § 351.347 (West 1991); N.J. REV. STAT. §§ 14A:6-1, 6-14 (West 1990).

predictable effects of the buyout is directly relevant to the ability of the independent directors, when evaluating a buyout proposal, to weigh and take into account the impact upon non-shareholder interests.

X. *The Realities of Divided Loyalty in Practice*

There is ample evidence of the corrupting circumstances which permeate management buyouts. As the cases will show, the prospect is real, not merely theoretical, that self-interested managers will manipulate and bend to personal advantage the internal company processes set in motion by the submission of a buyout bid. In this regard, it is well to remember that the formulations of insider duty, which have been noted above, were not grounded in "ivory tower" abstractions but in a very hardheaded perspective of human nature. It has been well stated that the rule that demands of the insider scrupulous observance of his duties, including avoiding depriving the corporation of profit or advantage which it might realize, is based on "a public policy existing through the years and *derived from a profound knowledge of human characteristics and motives*."[182] This rule "does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but *upon a broader foundation of a wise public policy that, for the purposes of removing all temptation*, extinguished all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation."[183]

The management effort to acquire RJR Nabisco, although ultimately not successful, is amply revelatory of the corrupting nature of insider involvement in buyouts, and particularly of the prospect that insiders will endeavor to enrich themselves at the direct expense of the shareholders. This case presents a particularly clear picture of the reasons for concern. The RJR Nabisco buyout had its origin, somewhat ironically, in investor dissatisfaction with an earlier merger, between the R.J. Reynolds Company and Nabisco, which had been engineered by the combined entity's chief executive officer,[184] who then became the key influ-

182 Guth v. Loft, 5 A.2d 503, 510 (Del. 1939)(emphasis supplied).
183 *Id.* (emphasis supplied).
184 *See* Bill Saporito, *How Ross Johnson Blew the Buyout*, BUS. WK., Apr. 24, 1989, at 297-98.

ence behind the proposed management buyout. The very failure of that prior business combination to produce an "adequate" return to the public shareholders was advanced by the chief executive officer and his management group as the rationale justifying taking the company "private" through the management buyout.

The management group initially offered to purchase the company at a price of $75 per share; however, the stock was then trading at $55 per share.[185] Ultimately, in response to competition from a rival group organized by Kohlberg Kravis Roberts & Co. (KKR), management increased its bid to $112 per share which represented a 40% increase over what management had originally offered the shareholders.[186] The outside directors ultimately rejected management's bid and accepted an offer from the rival bidder that involved a slightly reduced cash price, but which, because it gave the public shareholders a small continuing equity stake in the acquiring entity, was found to overcome the cash disparity.[187] Not only did management's bid thus involve an attempt to deprive the shareholders of as much as $8 billion, (the difference between the value of management's initial bid and the final price) it was also calculated to enrich, to the extent of several hundred million dollars, the insider group. According to one report, the board's disenchantment with the management bid became stronger after the outside directors learned through a newspaper article that financial arrangements between the chief executive officer, his small group of executives, and the investor group, led by the investment banking firm of Shearson Lehman Hutton, would have made the RJR Nabisco executives enormously wealthy with profits that could easily have topped $100 million apiece.[188] The directors then became concerned about

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185 *See* Sandra L. Kirsch, *They Cleaned Our Clock*, FORTUNE, Jan. 2, 1989, at 53.

186 *See* Leah J. Nathans and David Ziggs, *RJR May Roll Junk Into the Recovery Room*, BUS. WK., July 2, 1990, at 75.

187 *See* Thomas Moore, *KKR is Rolling With the Punches*, U.S. NEWS & WORLD REPORT, May 7, 1990, at 49; Bill Saporito, *Biggest Bidders, Wildest Auction*, FORTUNE, Jan. 2, 1989, at 34.

188 *See* James Sterngold, *Nabisco Battle Redefines Directors' Role*, N.Y. TIMES, Dec. 5, 1988, A1 [hereinafter Sterngold, *Nabisco Battle*]. An earlier article in the same newspaper had described a letter from the grandson of the founder of R.J. Reynolds Company to the chairman of the RJR Nabisco board, sent while the bidding was in process. The letter noted that "the architects of such an unsuccessful business combination [the Reynolds-Nabisco merger] are usually not granted special financial rewards. But in this case, no matter how the buyout competition plays out, Mr.

the propriety of such profits for the insiders, but received an unsatisfactory response from Ross Johnson, the chief executive officer, who failed to "address the fundamental issue of why the management group should receive such enormous rewards when supposedly they were working for the shareholders."[189]

The management group, through its financial partner, Shearson Lehman Hutton, attempted to keep the rival from entering the bidding.[190] This tactic, had it succeeded, would have deprived the shareholders of $8 billion. RJR Nabisco was also sued by certain financial institutions which had made open market purchases of the company's bonds before management had publicly proposed the buyout, but at a time when the investors alleged that management was already contemplating such a transaction. Following announcement of the buyout proposal, the bonds declined precipitously in price because of the deterioration in the issuer's balance sheet and credit rating that would result from the additional indebtedness to be incurred as part of the transaction.[191] Although the company denied these allegations, the matter was ultimately settled on terms advantageous to the bondholders.[192]

Hanson Trust PLC v. ML SCM Acquisitions, Inc.[193] and *Mills Ac-*

Johnson and more than 100 other senior executives will collect a total of more than $125 million in 'golden parachutes' and 'tin parachutes'. . . . Mr. Johnson himself will walk away with a minimum of $25 million and perhaps more than $100 million. . . .Why the management would contemplate a buyout became clear recently with the disclosure of the financial deal that RJR Nabisco's management cut with it chief financial partner, Shearson Lehman Hutton, Inc. The group of about 10 executives would form a management company to run RJR Nabisco after it is taken private. . . .The management company would be given 8.5% of the private RJR Nabisco for $20 million. Since the buyout would be likely to have about $2.6 billion of equity initially, that stake would be worth $220 million. On top of that, the company would effectively repay the management group the $20 million it would put up for the 8.5% stake." *See* James Sterngold, *Managers' Huge Stake in a Private Nabisco*, N.Y. TIMES, Nov. 14, 1988, DI.

189 *See* Sterngold, *Nabisco Battle*, *supra* note 188, at D5.

190 *See* John Heylar, *KKR Seeking A Compromise on RJR Offer*, WALL ST. J., Oct. 25, 1988 at A3.

191 *See* Metropolitan Life Ins. Co. v. RJR Nabisco, 716 F. Supp. 1504 (S.D.N.Y. 1989). Plaintiffs alleged that defendants began to develop the buyout plan in September, 1987, but did not announce it until October 20, 1988. Plaintiff purchased bonds as late as July, 1988.

192 *See* Richard D. Hylton, *Metropolitan Life Settles Its Bond Dispute With RJR*, N.Y. TIMES, Jan. 25, 1991, at D1.

193 781 F.2d 264 (2d Cir. 1986).

quisition Corp. v. Macmillan, Inc.[194] both illustrate, in varying degree, the ability of a self-interested management to influence or co-opt the independent directors called upon to oversee the sale of the corporation. Such directors were induced to act passively, to rely largely on the advice of outside advisers selected, at least in part, by the insiders and to delegate negotiating and other responsibilities to the insiders notwithstanding their conflicts of interest. In each of these cases, the corporation received an unwanted takeover bid from a third party. In both cases, insiders responded by initiating or supporting a competing effort to acquire the company in a leveraged buyout in which they, together with outside investors, would participate.

In the *Hanson* case, following Hanson's unwanted bid, management immediately met with representatives of the investment banking firm of Goldman Sachs & Co. and the law firm of Wachtell Lipton Rosen & Katz to consider a response.[195] Among the alternatives discussed was the possibility of a leveraged buyout involving management participation. The court's opinion took note of the fact that even before the directors first met in response to the hostile bid, Goldman Sachs and Wachtell Lipton, "who were later to become the *Board's* advisers, were already discussing an LBO with management."[196] There was in fact some confusion as to how the attorneys came to represent the Board. One participant in the ensuing board meeting believed that they were actually there representing management.[197] When the Board did meet, the nine outside directors unanimously approved the retention of the investment bankers and lawyers to act on behalf of the Board, at the same time delegating to management the responsibility to investigate whether a "white knight" could be found to counter the unwanted Hanson bid, as well as the alternative of a leveraged buyout.[198] Eventually the Board, in a telephone meeting, was presented with a proposal for a leveraged buyout with Merrill Lynch, in which certain insiders would

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194 559 A.2d 1261 (Del. 1989).

195 *Hanson Trust PLC*, 781 F.2d at 268.

196 *Id.* at 277.

197 *Id.* at 268.

198 *Id.* For a discussion of "white knights," *see generally* KNIGHTS, RAIDERS & TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 17 (Coffee, Lowenstein & Rose-Ackerman ed. 1988).

acquire up to 15% of the new company.[199] The proposal also contemplated substantial engagement and break-up fees to be paid to Merrill Lynch.[200] The Board did not actually see the proposal until after the nine outside directors had approved it, and authorized SCM management and Merrill Lynch to negotiate a definitive merger agreement.[201] A definitive agreement was presented to the Board at a meeting held three days later.[202] At that meeting, Goldman Sachs explained that no "white knight" could be found, and that the leveraged buyout proposal was the only firm offer to counter the unwanted bid from Hanson.[203] A "fairness" opinion was also delivered supporting the proposal.[204] The agreement was unanimously approved.[205]

Immediately thereafter, Hanson announced a revised and increased offer, conditional upon SCM refraining from granting any "lock-up" options on assets.[206] The SCM management-Merrill Lynch group proceeded to negotiate a new and revised merger agreement.[207] They also requested increases in the engagement and break-up fees and, critically, "lock-up" options on two key divisions of SCM. These divisions were responsible for over 50% of the company's operating income.[208] The revised agreement was presented to the SCM board a week later.[209] In what the court described as a late-night meeting lasting three hours, the outside directors approved the proposal, including the "lock-up" options which the court was to find effectively precluded any further bidding and improperly foreclosed the auction process in the management group's favor.[210]

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199 Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 268 (2d Cir. 1986).

200 *Id.* at 268

201 *Id.*

202 *Id.*

203 *Id.*

204 *Id.*

205 Hanson Trust PLC v. ML SCM Acquisitions, Inc., 781 F.2d 264, 270 (2d Cir. 1986).

206 *Id.* For discussions of lock-up options, *see* Barbara A. Koza, Note, *"Lock-up" Enjoined Under Section 14(e) of Securities Exchange Act*, 12 SETON HALL L. REV. 881, 892 (1982); Note, *Lock-up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068, 1081 (1983).

207 *See Hanson Trust PLC*, 781 F.2d at 270.

208 *Id.*

209 *Id.*

210 *Id.*

In determining whether to enjoin the "lock-up" options, the court found that there was no discussion of the significance of SCM selling the two divisions subject to the "lock-up" options. No documentation or *pro forma* financial statements were provided, or requested, showing the effects of such a sale. Furthermore, none of the directors suggested postponing a decision on the "lock-up" options or contacting Hanson to see if it would increase its offer.[211] Goldman Sachs advised the Board that the management proposal was "fair" to the shareholders and that the "lock-up" options on the two divisions were at prices "within the range of fair value."[212] However, no director asked, and the Board was never told, what the "fair value" of these businesses was, nor what was the "range" of fair value.[213] In fact, Goldman Sachs had not calculated such values, nor had it informed the Board of this fact.[214] Wachtell Lipton Rosen & Katz, the law firm retained to counsel the directors, simply informed them that the decision to approve the transaction was within the Board's business judgment.[215] Management and the Board's advisers were described as presenting the various agreements to the outside directors "more or less as *faits accompli*, which the Board hastily approved."[216]

The rival bidder sought to enjoin the "lock-up" option.[217] The Court of Appeals reversed a denial of the requested preliminary injunction invalidating the "lock-up" options, finding that the outside directors, although not shown to have acted fraudulently, in bad faith or out of self-interest, had nevertheless failed to exercise their duty of care.[218]

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211 *Id.*

212 Hanson Trust PLC v. ML SCM Acquisitions, Inc., 781 F.2d 264, 271 (2d. Cir. 1986).

213 *Id.* at 272.

214 *Id.*

215 *Id.*

216 *Id.* at 277.

217 Hanson Trust PLC v. ML SCM Acquisitions, 781 F.2d 264, 272 (2d. Cir. 1986).

218 *Id.* at 276-77. The Court went on to explain:

> In the context of a self-interested management proposing a defensive LBO [leveraged buyout], the independent directors have an important duty to protect shareholder interests, as it would be unreasonable to expect management, with financial expectancies in an LBO, fully to represent the shareholders. . . .We do not say that the independent direc-

The Court expressly declined to afford the actions of the directors the protection of the business judgment rule.[219] Although the Court held that the actions of the outside directors did not rise to the level of gross negligence found in *Smith v. Van Gorkom*,[220] it did find that the SCM directors had failed to take "many of the directorial steps that underlie the finding of due care," as shown by their "apparently content[ing] themselves with their financial advisers' conclusory opinion that option prices were 'within the range of fair value,' "[221] and by their failing to read or review various agreements, relying instead on their advisers' descriptions.[222]

In *Mills Acquisition Co. v. Macmillan Inc.*,[223] the Delaware Supreme Court similarly enjoined a management-led buyout although the transaction had been approved by a Special Committee of supposedly disinterested directors who had been assisted by a highly-regarded outside law firm and two leading investment banking firms.[224] The Court found that the outside directors had improperly permitted the management-supported

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> tors of SCM were required to appoint an independent negotiating committee of outside directors to negotiate with Merrill, as the court suggested in *Weinberger v. UOP, Inc.*, though that certainly would have constituted one appropriate procedure under the circumstances. But in approving *post hoc* the LBO negotiated and proposed by management directors with a not insubstantial potential 15% equity interest in the arrangement, the independent directors should have taken at least some of the prophylactic steps that were identified as constituting due care in *Treadway*.
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> SCM's board delegated to management broad authority to work directly with Merrill to structure an LBO proposal,. . .and then appears to have swiftly approved management's proposals. . . [w]hen management has a self-interest in consummating an LBO, standard *post hoc* review procedures may be insufficient. . .the Board appears to have failed to ensure that negotiations for alternative bids were conducted by those whose only loyalty was to the shareholders.

Id. at 277 (citations omitted).

219 As the Court explained, "Directors are also held to a standard of due care. . .where their 'methodologies and procedures' are 'so restricted in scope, so shallow in execution, or otherwise so *pro forma* or half-hearted as to constitute a pretext or sham,' then inquiry into their acts is not shrouded by the business judgment rule." *Id.* at 274 (citations omitted).

220 488 A.2d 858 (Del. 1985).

221 *Hanson Trust PLC*, 781 F.2d at 274.

222 *Id.* at 275.

223 559 A.2d 1261 (Del. 1989).

224 *Id.* at 1279.

transaction to go forward while throwing roadblocks in the way of a rival bid.[225] Recognizing that Macmillan was a likely target of an unsolicited takeover bid, management had initially proposed a corporate restructuring in which the key managers would end up with absolute majority control of the restructured company.[226]

Subsequently, a third party, the Robert M. Bass Group, Inc., emerged as a potential bidder, having acquired a 7.5% equity stake.[227] Management thereupon called a board meeting where a "rather grim and uncomplimentary picture of Bass and its supposed *modus operandi* in prior investments was painted by management."[228] In fact, "management's characterization of the Bass Group, including most, if not all of the underlying 'factual data' in support thereof, 'was less than accurate.' "[229] As the Vice Chancellor found, "[t]here is no evidence that Macmillan management made any effort to accurately inform the board of [the true] facts."[230] Macmillan's board was content "completely [to rely] on management's portrayal of Bass . . . neither management nor the board engaged in a reasonable investigation of the Bass group."[231]

Due to the significant financial stake of the key managers in the proposed restructuring, management decided, in February or March of 1988, to establish a Special Committee of the Board to

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225 *Id.* at 1283.

226 During a litigation subsequently brought to enjoin this restructuring, the directors took the position that no relationship existed between the management-proposed restructuring and the board's approval of the creation of an ESOP [Employee Stock Ownership Plan], which gave control of the stock to be issued to the ESOP to management. *See* Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227 (Del. Ch. 1988). In rejecting this claim, the Vice-Chancellor observed that if the directors were unaware of the implication of their actions for the restructuring, "it can only be because management failed appropriately to disclose these implications." *Mills Acquisition Co.*, 559 A.2d at 1266. The Court noticed the "apparent domination of the allegedly 'independent' board by the financially interested members of management, coupled with the directors' evident passivity in the face of their fiduciary duties" *Id.*

227 Mills Acquisition Co. v. Macmillan Inc. 559 A.2d 1261, 1266 (Del. 1989).

228 *Id.*

229 *Id.* at 1267 n.7.

230 *Id.* at 1267.

231 *Id.* (quoting Robert Bass Group, Inc. v. Evans, 552 A.2d 1227, 1240 (Del.Ch. 1988)). In response to the Bass interest, the Board also agreed to lower the trigger percentage necessary to cause the invocation of an already-existing "poison-pill" anti-takeover defense.

serve as an "independent" evaluator of the plan. The Special Committee was "hand-picked" by Evans, Macmillan's self-interested chief executive officer.[232] The Committee was not actually formed until a May 11, 1988 board meeting, a circumstance which the court found "significant because the events that transpired between the time that the Special Committee was conceived and the time it was formed illustrate the actual working relationship between management and the allegedly "independent" directors."[233] Well before the Special Committee was formed, Evans and others in management interviewed, and thereafter, maintained extensive contact with Lazard Freres & Co., which was to become the Special Committee's financial adviser.[234] In fact, the Lazard professionals worked for over 500 hours "before their 'client,' the Special Committee, formally came into existence and retained them."[235] The Special Committee also first met with representatives of the law firm of Wachtell, Lipton, Rosen & Katz, who were to act as the Committee's counsel, at a meeting to which these attorneys had been invited by the chief executive officer.[236]

Eventually, the Special Committee voted to approve the management-proposed restructuring and to reject a Bass proposal to acquire Macmillan's shares for a price of $64 per share.[237] Lazard valued the recapitalization at $64.15 per share, which it found to be "fair." A second investment banking firm, Wasserstein, Perella & Co., also retained to advise the Special Committee, valued the recapitalization proposal at between $63 and $68 and also found it to be fair.[238] Both advisers recommended rejection of the rival Bass $64 per share offer. The restructuring plan that was presented and approved by the board, which conferred control upon management, was chosen by the chief executive officer alone.[239] The Special Committee, in voting to approve it and to reject the Bass offer, relied upon the advice of Lazard, unaware of the investment banking firm's extensive prior

232 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1267 (Del. 1989).
233 *Id.* at 1267.
234 *Id.* at 1267-68.
235 *Robert Bass Group, Inc.*, 552 A.2d at 1233-34.
236 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1268 (Del. 1989).
237 *Id.* at 1268.
238 *Id.* at 1270.
239 *Id.*

contacts with management.[240] The Committee was not given any negotiating authority regarding the terms of the restructuring. The chief executive officer "apparently designated himself to 'negotiate' that matter with the board."[241] The Committee did not negotiate with management over any aspect of the transaction, including management's ownership levels in the restructured enterprise.[242]

Immediately upon receiving the Board's rejection of its proposal, the Bass Group offered $73 per share for all of Macmillan's stock, or, in the alternative, a restructuring comparable to that which the board had approved except that its worth was $5.65 more per share and the public and management shareholders were treated alike.[243] Within two days, Lazard Freres concluded that it could furnish an "adequacy" opinion that would justify the Special Committee in rejecting the $73 per share rival offer (later raised to $75 per share) as being inadequate. This was because Lazard had indicated in an earlier opinion that the pre-tax break-up value of Macmillan was between $72 and $80 per share.[244] The investment banking firm of Wasserstein Perella expressed a similar opinion, having previously valued the company at between $66 and $80 per share.[245]

Upon application, the Vice Chancellor enjoined the management-promoted restructuring, finding that both of the revised third-party offers were clearly superior.[246] Immediately upon the court's decision, management began holding discussions with the buyout firm of Kohlberg Kravis Roberts & Co. (KKR) with a view to developing defensive measures to thwart the offer from the Bass Group, including a management-sponsored buyout.[247] The court found that nothing indicated that this was done pursuant to

240 *Id.*

241 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1268 (Del. 1989).

242 *Id.* at 1270.

243 *Id.*

244 *Id.*

245 In its opinion the Delaware Supreme Court noted acidly that "[t]hese valuation ranges, obviously intended to accord with management's restructuring. . .will assume an interesting significance [in the second phase] when less than three months later, these same advisers, at [the chief executive officer's] behest, found [the rival] $80 all cash offer inadequate." *Id.* at 1271.

246 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1271 (Del. 1989).

247 *Id.* at 1272.

any authority from the board; "[i]f anything, it was Evans acting alone in his own personal interest."[248] Evans also authorized Macmillan's investment advisers to explore a possible sale of the business.[249] After receiving expressions of interest from KKR concerning a buyout, Evans and his senior managers suggested that "*they would endorse the concept and structure of the buyout to the board of directors even though KKR had not yet disclosed to Evans and his group the amount of its bid.*"[250] When later called upon to review these actions, the Delaware Supreme Court found that the search process that had been initiated by Evans "appears to have been motivated by two primary objectives: (1) to repel any third party suitors unacceptable to [management], and (2) to transfer an enhanced equity position in a restructured Macmillan" to the management group.[251] The Delaware Supreme Court concluded:

> While these goals may not have constituted *prima facie* breaches of the duty of loyalty owed by senior management to the company and its shareholders, it is evident that such objectives undoubtedly led to the tainted process which we now confront.[252]

Shortly thereafter, a rival suitor, Robert Maxwell, entered the bidding by proposing a consensual, all-cash merger with Macmillan at a price of $80 per share.[253] This was $5 more than the outstanding Bass offer, which had been increased from $73 to $75 per share. The company did not respond to Maxwell's bid for five weeks.[254] Instead, during this period management intensified its discussions with KKR concerning a buyout in which senior management, particularly the chief executive officer, would have a substantial ownership interest in the new company.[255] The management-favored bidder was, upon execution of a confidentiality agreement, "given detailed, internal, non-public financial information of Macmillan, culminating in a series of formal 'due diligence' presentations to KKR representatives by Macmillan senior management."[256] After more than three

248 *Id.*
249 *Id.*
250 *Id.* at 1273 (emphasis added).
251 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1272 (Del. 1989).
252 *Id.*
253 *Id.*
254 *Id.*
255 *Id.*
256 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1272 (Del. 1989).

weeks of silence, Maxwell made an $80 per share all cash tender, conditioned solely upon receiving the same non-public information which management had given KKR.[257] Alternatively, Maxwell offered to purchase a division of the company. No Macmillan representative "ever attempted to negotiate with Maxwell."[258]

Despite the fact that only shortly before both of the target's investment advisers had given opinions that the management restructuring, valued at $64.15 was fair, they now issued new opinions that the Maxwell $80 bid was unfair and inadequate.[259] Accordingly, the Maxwell offer was rejected by the Macmillan board.[260] On August 30, a meeting was finally arranged with Maxwell at which Maxwell was given some, but not all, of the information furnished to the rival bidder.[261] On September 6, representatives of the company and KKR met to finalize the buyout in which Macmillan senior management would obtain up to a 20% interest in the acquiring entity.[262] A firm bid was to be submitted by the end of that week.[263] Macmillan's financial advisers were instructed to notify six remaining potential bidders that all bids were due by September 9.[264] Maxwell was given less than 24 hours to prepare its bid.[265] On the morning of September 9, Maxwell was given a limited due diligence review with respect to certain operations.[266] Despite repeated requests, Maxwell was not given complete information until September 25, almost two months after the favored rival had received this information.[267]

The auction led many to speculate on the propriety of action between the rival bidders and the target corporation. In fact, the Court severely criticized the conduct of the auction procedure.[268]

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257 *Id.*
258 *Id.* at 1272.
259 *Id.* at 1273.
260 *Id.*
261 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1272 (Del. 1989).
262 *Id.*
263 *Id.*
264 *Id.*
265 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1272 (Del. 1989).
266 *Id.*
267 *Id.*
268 *Id.* at 1281. The Court declared that

> the directors wholly delegated the creation and administration of the auction to an array of [the chief executive officer's] handpicked investment advisers. It is undisputed that Wasserstein, who was originally re-

KKR, having been tipped off as to Maxwell's high bid, bid slightly more.[269] The board, upon learning of this "tip," determined that it was immaterial. Macmillan's advisers never suggested that Maxwell increase its bid, although Maxwell had indicated it would top any KKR bid.[270] KKR also extracted from Macmillan a lock-up agreement on certain assets that would produce a disadvantageous tax liability to the company if it were ever exercised, which would happen only if a rival bid was accepted. KKR also obtained Macmillan's agreement to pay its break-up fees and expenses if a rival bidder prevailed.[271] Finally, the board, based on the advisers' opinion that the KKR bid topped the rival bid, approved the KKR bid.[272]

Maxwell sought to enjoin the lock-up agreement, as well as any payment to KKR of break-up fees and expenses.[273] The Chancery Court denied the injunction on the grounds that although "KKR was consistently and deliberately favored throughout the auction process, Maxwell was not prevented from, or otherwise misled to refrain from, submitting a higher bid."[274] On appeal, the Delaware Supreme Court reversed. The Supreme Court found that the record in the case disclosed conduct that failed "all basic standards of fairness."[275] Further, that "[w]hile any one of the breaches of fiduciary duty, standing alone, should easily foretell the outcome, what occurred here, including the lack of oversight by the directors, irremediably taints the design and execution of the transactions."[276]

The Court noted that although Wasserstein Perella was originally retained as adviser, not to the company, but to senior management, the Lazard firm, retained by the board, gave Wasserstein Perella primacy throughout the process, including in the conduct of the auction. The Court went on to explain that the auction was

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> tained as an investment advisor to Macmillan's senior management, was a principal, if not the primary 'auctioneer' of the Company. . .the board. . .acceded to Wasserstein's, and through him [the chief executive officer's] primacy.

Id.

269 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1276 (Del. 1989).

270 *Id.* at 1273.

271 *Id.* at 1275-76.

272 *Id.* at 1277-78.

273 *Id.* at 1278.

274 Mills Acquisition Co. v. Macmillan Inc., 559 A.2d 1261, 1278 (Del. 1989).

275 *Id.* at 1280.

276 *Id.* at 1280-81.

skewed in favor of KKR, the buyer allied with management. To support this the Court noted that the favored bidder repeatedly received significant material advantages to the exclusion and detriment of Maxwell which served to obstruct, rather than enhance, the bidding process, and that once the board had decided to abandon the restructuring in favor of a sale of the entire company, "there was no justification for denying Maxwell the same courtesies and access to information as had been extended to KKR."[277]

In granting the requested injunction, the Delaware Supreme Court was severely critical of the role played by the so-called outside directors.[278] The attempt to invoke the "business judgment" defense was easily rejected.[279] The Court declared that judicial reluctance, under this doctrine, to assess the merits of a business decision

> ends in the face of illicit manipulation of a board's deliberative processes by self-interested corporate fiduciaries. Here, not only was there such deception, but the board's own lack of oversight in structuring and directing the auction afforded management the opportunity to indulge in the misconduct which occurred. In such a context, the challenged transaction must withstand vigorous judicial scrutiny under the exacting standards of entire fairness.[280]

XI. Conclusion

It is undeniable that leveraged buyouts in general, including those involving management participation, have enriched share-

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277 *Mills Acquisition Co.*, 559 A.2d at 1281-82. The Court also noted

> that the tone and substance of the communications between Macmillan and Maxwell dispel any doubt that Maxwell was seen as an unwelcome, unfriendly and unwanted bidder. [The chief executive officer], a self-interested fiduciary, repeatedly stated that he had no intention of considering a merger with Maxwell, and that he would do everything to prevent Maxwell from acquiring Macmillan.

Id. at 1280.

278 *Id.* at 1280. The Court determined:

> The board was torpid, if not supine, in its efforts to establish a truly independent auction, free of Evans' interference and access to confidential data. By placing the entire process in the hands of Evans, through his own chosen financial advisers, with little or no board oversight, the board materially contributed to the unprincipled conduct of those upon whom it looked with a blind eye.

Id.

279 *Id.* at 1280-81.

280 *Id.* at 1279.

holders over the past decade to the extent of hundreds of billions of dollars. It is also a fact that the failure of many buyouts due to overleveraging may simply prove that the prices paid were excessive and that the shareholders in these transactions may have received more than which they were entitled. Indeed, there have recently been attempts to recover, under fraudulent conveyance laws, allegedly excessive amounts paid out to former shareholders.[281]

These observations could justify the conclusion that to place obstacles in the way of such transactions, beyond the demand for more consistently effective oversight by the disinterested directors, will harm the shareholders. This harm may be greater in magnitude than any injury which they may suffer from the failure of corporate insiders to fulfill their fiduciary responsibilities because of the temptations attaching to their actual or potential participation in buyouts. Under this view, even the well-documented descent of insider behavior to the level of the bazaar merchant anxious to pay as little as possible for what he would buy would not be worthy of censure or discrete legal sanction, but would simply represent one individually unique facet of the overall bargaining process.

The difficulty with accepting this, the clarion of the marketplace, as a necessary and sufficient response is that it fails to address the extent to which the inevitably corrupting nature of the entire process may operate to deprive shareholders of the opportunity to derive the fullest benefit over the long term from the exploitation of the corporate assets bought up by the insiders. If one accepts the premise that short-term price appreciation is not the only appropriate measure of corporate performance, then it is appropriate to ask why sound corporate policy would sanction the acceptance of an offer when it is made by a self-interested insider animated by the long-term perspective which is supposed to infuse the corporation's own decision-making process. More to the point, corporate managements are *entitled to reject* unwanted offers from third parties even when such offers exceed prevailing or historical share prices where they believe that such offers fail

281 *See, e.g.*, Wieboldt Stores v. Schottenstein, 90 B.R. 488 (N.D. Ill. 1988). *See generally* Kathryn V. Smyser, *Going Private & Going Under: Leveraged Buyouts and The Fraudulent Conveyance Problem*, 63 IND. L. REV. 781 (1987-88).

adequately to reflect enterprise values to be realized over the long term.[282]

In the *Time* case, the board, "having developed a strategic plan of global expansion to be launched through a business combination with Warner,"[283] was held not to be under a fiduciary duty to "jettison its plan and put the corporation's future in the hands of its shareholders"[284] by removing obstacles to a hostile tender offer. Particularly, in the case of a corporation where the directors have fulfilled their statutory duty to set a "corporate course of action, including time frame, designed to enhance corporate profitability" and which is in the corporation's "best interests without regard to a fixed investment horizon,"[285] is then not a breach of fiduciary duty entailed when an insider attempts to derail that course to the extent of depriving non-insider shareholders of the right to participate in its completion? If corporate directors have the right to stay the course, is there not a reciprocal or correlative duty on the part of corporate insiders not to interfere with or divert that course to personal advantage, which duty is broader than, and separate and distinct from, other fiduciary responsibilities that may be implicated by the particular manner in which the buyout is conducted?

If trustees are not allowed to compete with the interests of their beneficiaries because of the temptations which are perceived to flow from the right to purchase trust assets, why is it different with corporate fiduciaries, whose functioning is such as to present even greater range of opportunity for manipulation or subversion in the service of personal interest? To pose this question is not to ignore the fact that corporate insiders are fiduciaries with duties vastly different from those of the trustees of a private trust and, therefore, that different measures of performance and different standards of accountability may apply. But to recognize these distinctions does not mandate the application of differing standards for the avoidance of conflict-of-interest.[286] In

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282 *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

283 *Id.* at 1149.

284 *Id.* at 1149-50.

285 *Id.* at 1150.

286 *See* Terry Dale Liquidating Trust v. Barness, 611 F. Supp. 1006 (S.D.N.Y. 1984)(discussion of standards for corporate insiders). *See also* Bruch v. Firestone Tire and Rubber Co., 828 F.2d 134 (3rd Cir. 1987), *cert. granted*, 485 U.S. 986

particular, there seems no reason to conclude that applying similar prohibitions against self-dealing would derogate from the effective performance of duties by corporate insiders. Unless, one were to assume the typical corporate executive possesses a hidden private agenda which demands, as an independent and indispensable element, the right, at a propitious moment to negotiate with the corporation for the acquisition of corporate assets for the insider's personal advantage.[287]

If one accepts the proposition that there is something inherently suspect about an ethos of corporate stewardship which unquestioningly accepts the right of insiders to compete with shareholders by offering to buy particular corporate assets, or to take the entire business "private," does this concern apply equally where it is not the insider but a third party who actually initiates the process? Here, the insider may be motivated by a reluctance, or even unwillingness, to work for the third-party suitor, and he may be prepared to protect what he perceives as his interest by offering a higher price, instead of pursuing, to the possible detriment of the shareholders, the alternative of opposing the third-party's offer. Under these circumstances, do the interests of the corporation any longer dictate restricting the insider's ability to bid?

The quick answer would seem to be that where the insiders have played no role, direct or indirect, in promoting the buyout proposal, there should be no such automatic inhibition. However, once the insider is thus permitted to act for himself, the reality remains that his position confers on him advantages not only in his competition with the third party, but also in his relationships with the independent directors. Moreover, if the cor-

(1987), *aff'd in part, rev'd in part*, 489 U.S. 101 (1989)(discussion of standards for trustees).

287 See Peter Passell, *Those Big Executive Salaries May Mask Bigger Problem*, N.Y. TIMES, Apr. 20, 1992, at A1. A leading critic of executive compensation has made a similar point in refusing to accept as justification for otherwise excessive executive salaries the argument that without such compensation, the executive cannot really be expected to perform to acceptable levels. His response, equally applicable to the subject of this article, is that executives are, and are no more than, employees of the shareholders and that there is no reason to assume that a chief executive (who in the case under discussion had received $83 million in compensation) would have "given less than his best if he had been paid one-tenth as much." *Id.* (citing the observations of Professor Graef Crystal of the University of California at Berkeley).

poration has the sort of long-term strategic plan for the enhancement of values which its management and board are in fact charged with providing, then the self-interested intervention of the insiders, even if only in response to an outside bid, is subject to the criticisms noted above. The Delaware Supreme Court focused precisely on the existence of such a long-term strategic plan to justify the position of the directors in rejecting the third party offer in the *Time* case.[288]

From the corporation's perspective, there is but one possible justification for allowing the insider to compete for the purchase of corporate assets, or for the corporation itself: that his participation will bring a higher price. Is the prospect of a marginally higher bid above the best price offered by a third party worth the temptation to which the insider becomes inevitably subject if he knows that he may enter the bidding for his own account? Is this concern any less relevant because the insider is already disabled from acting in a wholly disinterested manner because of the prospect of employment loss or decline in status? Is this concern sufficiently neutralized, or even negated, because the insider is already assured of benefiting from a "golden parachute," which would be triggered should the sale to the third-party go forward?

Moreover, especially where a corporation has in place a real plan for value enhancement over some defined time period, the insider's fiduciary responsibility lies first in working towards the implementation of that plan. This is irrespective of the receipt or pendency of a third-party offer, until such time as the board determines, such as by concluding that the offer exceeds any reasonable expectation for internally-generated growth in share value, that the assets or business should instead be sold. The insider's responsibility does not include expending time and effort scurrying about to line up outside partners or financing, with whom or which to make a counteroffer. Once the board elects to move towards a sale, the insider's duty shifts, but, again, not to the promotion of his own counteroffer but instead to utilizing his unique role and employing his incomparable knowledge for the purpose either of negotiating an improvement in the offer already made, or of drawing other interested parties into the competition, or both.

[288] Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989).

Whether circumstances will ever arise which justify the insider to proceed for his own account must ultimately depend upon one's view as to whether human nature will permit the transcendent objective. That is, the operation of the corporation free, to the maximum possible extent, of conflict between insider and shareholder interests, safely to co-exist with the subordinate strategy of allowing insiders to compete in the buyout process in order to achieve the highest possible price once directors theoretically free of self-interest have determined that corporate goals are served by a sale.

In his influential article[289] Chancellor Allen concludes that monitoring such transactions through an effective special committee of independent directors, aided by disinterested and properly functioning advisers, is superior to the alternative of "later judicial review for substantive fairness because courts are more poorly equipped than are business persons to assess business risks and rewards."[290] He acknowledges that things do not always work out as they should, and that it remains to be determined by "some future systematic inquiry whether the benefits associated with successful invocation of the device outweigh the costs to shareholders of the failures."[291]

Chancellor Allen's observations are specifically related to his discussion of the independent directors' effectiveness as a monitoring force. But, towards the end of his commentary, he alludes to a broader issue.[292]

These remarks suggest a measure of uncertainty about the broader societal implications of the forces which have fueled the insider buyout wave, absent which, this type of transaction simply could not have flourished as it has. Adherents of buyouts con-

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289 Allen, *Independent Directors, supra* note 69.

290 *Id.* at 2062.

291 *Id.*

292 *Id.* Chancellor Allen explained:

> The cost to shareholders of a failed or corrupt process would be reflected in a sub-optimal price. The cost to the economy as a whole would be the inefficiency of transferring the assets (the firm) to one other than the buyer with the most socially productive use. In our system we tend to treat the willingness to pay the highest price as a good proxy for delivering the highest social good — an assumption the correctness of which could, of course, sustain debate.

Id. n.31.

tend that apprehensions about breach of duty are ultimately outweighed, by the success of buyouts in effecting the profitable redeployment of capital. Buyouts are said to assist in creating healthier capital markets, whereas impediments to buyouts are considered vestigial sources of financial inefficiency.[293]

The choices of values implicit in this analysis have, of course, wider significance. The bias reflected is consistent with an emphasis favoring financial strategies and maneuvers avowedly calculated to realize quick profits. This is in preference to longer-term efforts to enhance values through intensified research, entrepreneurial innovation, greater worker productivity, better executive decision-making and generally improved corporate performance. This predisposition has dominated throughout the era in which management buyouts have flourished.

Chancellor Allen's ambivalent reflections on buyouts inevitably connect any evaluation to the larger policy context: if the predominant business philosophy, emphasizing short-term profits in the financial markets, is to be questioned for having sapped the nation's long-term economic health, so also must be the economic justification for buyouts.

Once the macroeconomic philosophy which rationalized buyouts, the supremacy of the financial markets as ultimate arbiter of behavior, becomes suspect, buyouts must be examined in the light of consequences other than their ability to generate quick stock market profits. Such consequences include affording insiders the luxury of choosing, in their unilateral discretion, personal interest at the expense of fiduciary duty. Nothing less is at stake once the governance model has shifted from requiring insiders to work single-mindedly to implement corporate business plans for the optimal benefit of the corporation and its shareholders, to allowing insiders to seize corporate opportunities for personal gain, and thereby to frustrate the legitimate expectations of those they serve.

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[293] For a discussion specifically extending the macroeconomic justifications for takeovers generally to management buyouts, the conflicts of interest notwithstanding, *see* Booth, *Limits of Fiduciary Duty*, *supra* note 38. *See also* Oesterle and Norberg, *Shareholder Wealth*, *supra* note 13.