Predatory Management Buyouts

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In a management buyout ("MBO"), the managers of a company typically partner with a financing source to acquire the firm that employs them. MBOs raise an important corporate governance concern not present in other corporate acquisitions: managers act as fiduciaries to target shareholders at the same time that they act as acquirors. According to corporate law fiduciary duty principles, managers must always privilege the interests of the corporation and its shareholders over their own personal interests. In direct opposition to those fiduciary duties are managers' incentives to acquire the company on the best terms possible. State corporate law's prevailing response to such a conflict is to rely on procedural safeguards to sanitize otherwise tainted transactions. Federal securities law further applies special disclosure requirements to MBOs. This article demonstrates that neither body of law produces the desired equivalent outcome of arm's-length bargaining and suggests mechanisms for protecting shareholders from predatory managerial behavior in MBOs, in which managers underpay for their targets.

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INTRODUCTION

Corporate executives who participate in a management buyout ("MBO") transaction experience a duality, much like the doppelgänger, or double, in literary fiction.[1] On the one hand, executives have a fiduciary duty under state corporate law to place the interest of their firms' shareholders above their personal interests. On the other hand, the executives are purchasing the business from those very shareholders and stand to benefit from doing so on terms that are self-serving.

In the case of an ordinary conflict-of-interest transaction, the conflict can be neatly addressed by adopting procedures to ensure that a neutral decision-maker at the target firm has the decision-making authority over the transaction. Removing the conflicted individual from the decision-making process also removes the taint of the conflict of interest from the related corporate decision. Existing jurisprudence treats MBO transactions similarly: It regards corporations undergoing MBOs that adopt a neutral decision-making process as having sanitized the conflict of interest in the transaction.[2] In this article, I argue that such procedural protections used in ordinary conflict-of-interest transactions are ill-suited to the problem of asymmetric information peculiar to MBO transactions and that enhanced procedural protections that equalize that disparity are needed to produce the result of arm's-length bargaining that is the touchstone of conflict-of-interest jurisprudence.

Part I of this article describes the structure of MBO transactions, including the dual role that managers play in them. It also presents recent evidence on the division of gains between targets and buyers in MBOs. Part II discusses the perverse incentives managers have to favor their own interests in MBOs, as well as managers' ability to do so. Part III describes existing legal constraints on managerial self-dealing in MBOs, concluding that they are largely ineffective. Part IV addresses potential objections to the argument that managers in MBOs can engage in self-dealing under existing law, and Part V offers solutions to address conflicts of interest in MBOs.

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[1] *See* KARL BECKSON & ARTHUR GANZ, LITERARY TERMS: A DICTIONARY 60 (1975).

[2] Such treatment is consistent with a more general trend in Delaware corporate law toward allowing the use of ex ante procedural protections to avoid ex post substantive judicial review. *See* D. Gordon Smith, *The Modern Business Judgment Rule* (BYU Law Research Paper Series No. 15-09, 2015), *available at* http://ssrn.com/abstract=2620536 (discussing Delaware courts' use of the business judgment rule and their general unwillingness to step in to make business decisions).

I. MANAGEMENT BUYOUT TRANSACTIONS

A. MBOs and the Need to Regulate Them

An MBO occurs when a company's executives, also referred to in this article as management,[3] initiate an acquisition of the same firm that they are running.[4] From a purely technical perspective, MBOs are no different from any other merger and acquisition transaction: They are a means of effectuating the transfer of ownership of a company, the "target," from the seller to the acquiror.[5] But from a shareholder-

[3] The distinction between the roles of corporate officers and corporate directors is often side-stepped. *See* Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 818 (2006) ("A key failing of the academic literature on takeovers is the almost universal conflation of the roles of corporate officers and directors."). By "management," "managers," or "executives," I mean the key officers of a company. These individuals conduct the day-to-day business of the firm and are the individuals with the most intimate knowledge of its operations. In the MBO context, the limited potential for independent directors to prevent self-interested behavior by management makes this distinction an important one. *See infra* Part III.A.

[4] A recent example of an MBO, which attracted substantial media attention, was the successful buyout of Dell Inc. by its founder and CEO Michael Dell in collaboration with private equity firm Silver Lake Partners. Michael J. de la Merced & Quentin Hardy, *Dell in $24 Billion Deal to Go Private*, N.Y. TIMES: DEALBOOK (Feb. 5, 2013, 9:22 PM), http://dealbook.nytimes.com/2013/02/05/dell-sets-23-8-billion-deal-to-go-private/ ("[T]he buyout . . . would be the biggest by far since the days of the recession."); Michael J. de la Merced & Quentin Hardy, *Long Battle for Dell Ends in Victory for Founder*, N.Y. TIMES: DEALBOOK (Sept. 12, 2013, 10:17 AM), http://dealbook.nytimes.com/2013/09/12/dell-shareholders-approve-24-9-billion-buyout/; David Gelles & Chris Nuttall, *Michael Dell Orchestrates $24bn Buyout Deal*, FIN. TIMES (Feb. 5, 2013, 3:19 PM), http://www.ft.com/cms/s/0/d91a528a-6ee1-11e2-8189-00144feab49a.html#axzz3VRQjP0Lw ("Michael Dell has orchestrated a $24.4bn leveraged buyout offer for the computer maker he founded nearly 30 years ago, joining forces with Microsoft and Silver Lake Partners in the largest take-private deal since the financial crisis.").

[5] Technically, the implementation of an MBO, as in any merger and acquisition transaction, can be accomplished through either of two basic approaches. First, the acquiror can make an offer directly to the corporation's shareholders to buy their shares. If the acquiror succeeds in buying a sufficient percentage of the target's shares, it can then eliminate the remaining shareholders through a second-step merger transaction with the target corporation. Second, an acquiror can either purchase the target's assets or merge with the target. In a stock purchase, participating shareholders implicitly consent to sell their shares by tendering them to the offeror. In an asset sale or merger transaction, state corporations codes require that a majority of the target's shareholders approve the transaction. Certain jurisdictions afford appraisal rights to shareholders who did not vote in favor of the acquisition. Appraisal rights allow qualifying shareholders to obtain a judicial determination of the fair value of their shares and to receive payment of that value, together with interest, in cash from the corporate entity surviving the merger. *See generally* STEPHEN M. BAINBRIDGE, MERGERS

protection perspective, MBOs raise troubling issues. In an MBO, there is substantial overlap between the company's management team and the buyer group that is acquiring the company. As a consequence of an MBO, management increases substantially its equity ownership interest in the firm at which it was previously employed, becoming one of the business's most significant residual owners. The target in an MBO may be a private or a public firm prior to the MBO transaction. If it was a private firm, then the firm continues to be privately held under its new ownership structure. If the firm was public, then the target's public shareholders are typically eliminated and the company is commonly referred to as having "gone private" through the MBO.[6]

One of the signature features of MBOs is that their structure employs significant leverage, making them a special case of the broader category of acquisitions known as leveraged buyouts ("LBOs"). The managers who participate in an MBO are often part of a larger buyer group that includes an LBO or private equity firm because managers rarely possess the financial resources necessary to complete the acquisition on their own. In an MBO, the buyer group, led by management, invests a limited amount toward the purchase price of the target and relies on debt financing secured by the assets of the target for the rest.

MBOs first attained economic significance in the 1980s, facilitated by the emergence of both the modern high-yield bond market and LBO firms. The high-yield bond market made it possible for managers, working with LBO firms, to use non-investment grade bonds secured by the target's assets to finance acquisitions with minimal levels of equity. Traditional sources of debt did not support such a capital structure because they required a more meaningful amount of equity to be invested in the target's business in order to support a loan's repayment. In contrast, high-yield bonds were designed to be repaid with the cash flow of the acquired company. In 1990, a crisis in the high-yield bond market severely reduced credit availability and put an end to the takeover wave of the 1980s.[7]

MBO activity resumed in the late 1990s, on this occasion supported by private equity funds.[8] Readily available credit, low interest rates,

AND ACQUISITIONS 16-25 (3d ed. 2012) (discussing the mechanics of acquisition transactions).

6 *See* NANCY L. SANBORN ET AL., GOING PRIVATE TRANSACTIONS: OVERVIEW 1 (2010), *available at* http://www.davispolk.com/files/uploads/davis.polk.going.private.pdf.

7 *See* Matthew D. Cain & Steven M. Davidoff, *Form over Substance? The Value of Corporate Process and Management Buy-Outs*, 36 DEL. J. CORP. L. 849, 857, 864-65 (2011).

8 *Id.* at 857-58.

and a return to greater leverage gave private equity firms the ability to compete effectively in the acquisition market. However, the private equity boom eroded in 2008 due to the collapse of financial markets.[9] In the current business cycle, MBOs are likely to be an important segment of merger and acquisition activity due to sustained low interest rates and record levels of capital commitments to private equity funds.[10]

MBOs raise serious state corporate governance and federal securities law concerns that merit attention. With regard to corporate governance, managers engage in self-dealing behavior when they acquire equity interests from the shareholders whose interests they serve as company employees. Self-dealing offends the very essence of the fiduciary duty of loyalty applicable to corporate managers. According to that duty, managers must place the best interests of the corporation and its shareholders ahead of their personal interests.[11] Yet, a manager who acquires an ownership interest (in the business she operates) from a non-manager shareholder has a strong incentive to do so at the best possible price and on the best possible terms for herself, and thus not in the best interests of shareholders. It is the province of the law governing mergers and acquisitions to provide mechanisms for protecting shareholders in such circumstances.[12]

MBOs can also undermine the policy goals of the federal securities laws to promote efficient capital formation and flows. Achieving these goals necessitates establishing a level playing field in securities transactions.[13] As corporate insiders, managers are regularly privy to material non-public information about their firms. Given their

[9] DAVID STOWELL, AN INTRODUCTION TO INVESTMENT BANKS, HEDGE FUNDS & PRIVATE EQUITY: THE NEW PARADIGM 365 (2010).

[10] *See* Carl Doerksen, *M&A and Timing — Has a New Cycle Begun?*, GENERATIONAL EQUITY (Oct. 14, 2013, 9:00 AM), http://blog.genequityco.com/bid/67937/M-A-and-Timing-Has-a-New-Cycle-Begun (discussing current and past market trends that encourage increased M&A transactions, including post-recession conditions combined with other factors).

[11] *See* WLR Foods, Inc. v. Tyson Foods, Inc., 869 F. Supp. 419, 421 (W.D. Va. 1994) (stating that a "corporation's directors and officers owe a duty of loyalty both to the corporation and . . . [its] shareholders").

[12] John C. Coates IV, *Mergers, Acquisitions and Restructuring: Types, Regulation, and Patterns of Practice*, *in* OXFORD HANDBOOK ON CORPORATE LAW AND GOVERNANCE 1 (forthcoming 2016), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2463251 (describing the "core goals" of M&A regulatory law, and identifying the protection of owners of public companies as one of these goals).

[13] *See generally* THOMAS L. HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 1.2 (West Publishing 2015) (discussing the scope and coverage of the federal regulatory scheme for securities).

presence on both sides of the transaction, managers will have incentives to acquire the firm for a self-serving price. Anticipating management's behavior, a rational investor would either refuse to invest in, or impose a discount on, the company's shares at the time of purchase. Because investors cannot know in advance if or when such a transaction might occur, the cost of raising capital through share issuances will thus rise for all firms. If managers and outside investors were to engage in a hypothetical arm's-length bargain, we would expect them to agree to contractual protections for the outside investors, and the law can minimize bargaining costs by "imposing such protections as a default."[14]

B. Empirical Evidence on the Division of Gains in MBOs

Like all acquisitions, MBOs can both create and distribute new value between buyers and sellers. Value can arise from numerous sources.[15] Firms that operate in similar industries have the ability to produce synergies through mergers and acquisitions. For example, two manufacturing companies that combine through an acquisition might be able to consolidate their operations in a single facility. An acquisition might also result in financial synergies. Financial synergies could involve reducing a firm's borrowing costs, increasing its debt capacity, or providing tax benefits. Another way to create value in an acquisition might be to improve the performance of an inefficient management team or replace it altogether. In circumstances where a public company goes private through an MBO, there is also potential value from eliminating the burdens on a public company imposed by the federal securities laws.[16] Such synergies provide firms with the ability to deploy their operating assets more productively.

Studies show that, as between the acquiror and the target company in acquisition markets, the target's shareholders tend to capture the lion's share of the gains, synergies or otherwise, created by the

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[14] Coates, *supra* note 12, at 10.

[15] *See generally* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 606-13 (1989) (discussing various sources of gains to shareholders in takeovers).

[16] *See* Ehud Kamar, Pinar Karaca-Mandic & Eric Talley, *Sarbanes-Oxley's Effects on Small Firms: What Is the Evidence?*, *in* IN THE NAME OF ENTREPRENEURSHIP?: THE LOGIC AND EFFECTS OF SPECIAL REGULATORY TREATMENT FOR SMALL BUSINESS 143, 152 (Susan M. Gates & Kristin J. Leuschner eds., 2007), *available at* http://www.rand.org/content/dam/rand/pubs/monographs/2007/RAND_MG663.pdf (discussing the impact of the Sarbanes-Oxley Act on small firms' accounting and audit costs).

transaction.[17] By extension, if existing law adequately checks management's conflict of interest in MBOs, then we would expect MBO transactions to exhibit a similar division. But if existing law fails to do so, then we would expect to see managers in MBOs capturing a greater share of the gains produced by an acquisition than do arm's-length acquirors in non-MBO transactions.

Recent empirical studies, which investigate the effect of managerial power on takeover premia and firm performance, are consistent with the latter scenario. One such study focused on the differing incentives of managers in an MBO in their capacity as, on the one hand, fiduciaries charged with maximizing shareholder value and, on the other hand, principals in a post-buyout firm with the objective of maximizing the expected future return on their investment.[18] The study's authors hypothesized that, given this tension, as managerial power increases, the greater ability managers will have to suppress the purchase price in the form of a lower acquisition premium. The authors found evidence consistent with their hypothesis. Using a management team's percentage stock ownership in the target as a proxy for its corporate power, their data showed a negative relationship between corporate power and transaction premium.[19] In other words, MBOs involving management teams with relatively greater influence within their companies were associated with reduced takeover premia.

Other recent empirical studies are consistent with a direct relationship between managerial power and managerial opportunism in MBOs. There is evidence, for example, that increased target premia are associated with MBO transactions that are subjected to greater competition in the marketplace in the form of auctions.[20] In contrast, non-MBO auction transactions do not improve target returns over negotiated transactions.[21] This finding is consistent with the view that

[17] ROBERT B. THOMPSON, MERGERS AND ACQUISITIONS: LAW AND FINANCE 5 (2010). Indeed, Professor Bernard Black argues that bidders systematically overpay for targets. Black, *supra* note 15, at 629 ("In sum, bidder willingness to overpay, together with substantial transaction costs, potential negative synergies, shareholder insistence on some premium, and manager reluctance to sell, make substantial overpayment possible.").

[18] Kai Chen et al., Hands in the Cookie Jar? The Case of Management Buyouts 7 (Mar. 18, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1364655.

[19] *Id.* at 3.

[20] John C. Easterwood et al., *Controlling the Conflict of Interest in Management Buyouts*, 76 REV. ECON. & STAT. 512, 518 (1994).

[21] *See* Sridhar Gogineni & John Puthenpurackal, *Target-Management-Involved Buyouts: Impact on Takeover Competition, Litigation Risk, and Shareholder Returns*, 37 J.

(1) managers in MBOs tend to behave opportunistically and (2) competition in the acquisition market constrains the ability of management to behave opportunistically in MBOs.

Another strand of empirical research on MBOs investigates evidence on the behavior of the publicly reported financial performance of firms before and after MBOs. These studies hypothesize that managers have an incentive to temporarily depress the value of their companies before initiating an MBO. As noted above, management substantially increases its equity ownership stake in an MBO transaction. As a result, the benefit to management from a reduced purchase price typically outweighs its interest in maximizing the value of its pre-MBO equity holdings. The studies find evidence consistent with the view that managers involved in MBOs engage in discretionary disclosure and earnings-management practices that have a negative influence on their firms' share prices prior to the MBO.[22]

The foregoing findings should not be surprising. In a perfectly competitive market for corporate control, target shareholders should capture most of the gains generated by an acquisition.[23] But MBOs depart from perfectly competitive acquisition markets. The next part discusses the mechanisms by which these imperfections allow managers in MBOs to use their positions in the acquisition process to the detriment of unaffiliated target shareholders.

II. THE TROUBLE WITH MANAGEMENT BUYOUTS

Like any other investor, managers would prefer to buy low and sell high. As buyers, they would like to purchase the target for the minimum premium necessary to induce a sale. The mechanisms by which managers can achieve this objective, however, are not fully understood.[24] It is important to develop a rigorous account of the

FIN. RES. 323, 334 (2014).

[22] *See* Nader M. Hafzalla, *Managerial Incentives for Discretionary Disclosure: Evidence From Management Leveraged Buyouts*, 14 REV. ACCT. STUD. 507, 508 (2009), *available at* http://link.springer.com/article/10.1007%2Fs11142-007-9061-0 (finding that evidence suggests the disclosure of MBO firms becomes significantly more pessimistic than LBO firms where management is not involved in the transaction); Xi Li et al., Earnings-Reducing Activities Before Management Buyouts 1-2 (Aug. 19, 2013) (unpublished manuscript), *available at* http://dx.doi.org/10.2139/ssrn.2022091 (finding that evidence suggests MBO target firms undertake earnings-reducing activities through discretionary expenses, losses from asset sales and discretionary accruals before MBOs).

[23] Easterwood et al., *supra* note 20, at 513.

[24] *See supra* Parts III–IV (discussing legal restrictions on managerial self-dealing and examining the ability of managers to engage in self-dealing under current law).

means available to managers for extracting value for themselves from target shareholders in MBO transactions in order to assess whether existing law is sufficient to prevent them from doing so. This Part describes the mechanisms by which managers in MBOs can extract value from the target company's other shareholders.

MBOs are transactions in which one party has information that the other does not. This condition is called "asymmetric information." Two types of asymmetric information can arise in MBOs: (1) information that relates to the managers of the target and (2) information that relates to the target. When managers can take actions that are not observable by the other party, the problem of opportunistic behavior due to moral hazard can arise. When managers have superior information about the characteristics of the target, the problem of opportunistic behavior due to adverse selection can arise.[25] These two concepts will be discussed in Sections A and B, respectively.

A. Moral Hazard in MBOs

Moral hazard occurs when a decision-maker has incentives to take risks beyond the level that she would have otherwise because some or all of the negative consequences of taking those risks are shifted to some other party. This Section describes the phenomenon of moral hazard in corporate governance generally and in conflict-of-interest transactions specifically, and then applies it to the context of MBOs. As elaborated below, MBOs present moral hazard concerns that are more severe than those that typically arise in the public company setting.

1. The Standard Principal-Agent Problem in Corporate Governance (the Base Case)

Moral hazard in the specific relationship between principals and agents is referred to as a principal-agent, or agency, problem. According to shareholder-primacy theory, shareholders of public corporations can be likened to principals, and officers and directors likened to their agents, in running the firm.[26] The principal-agent

[25] *See* JEFFREY M. PERLOFF, MICROECONOMICS 624-25 (7th ed. 2015) (referring to the main methods for solving adverse selection problems in the abstract as restricting the ability of the informed party to take advantage of hidden information and equalizing information among the parties).

[26] *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 547-48 (2003) [hereinafter *Director Primacy*]. Although officers and directors are not formally the agents of shareholders, see RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006) (defining "agency" in part as a

problem arises in this context for two reasons. First, shareholders do not control public firms. They own only the residual equity interest in those firms in the form of common stock; officers and directors operate and direct the business, respectively. The actions of officers and directors are difficult for shareholders to monitor. Second, officers and directors rarely own more than a small percentage of their companies. Accordingly, they do not have the same incentives as shareholders to maximize long-term share value. Officers and directors face incentives to trade off the private costs of their decisions against the corporate profits that such decisions generate at a different level than shareholders would choose. The difficulties that shareholders have in monitoring managers, combined with the differing incentives of the two groups, make it possible for officers and directors to engage in opportunistic behavior at shareholders' expense.

Where the principal is a seller who is represented by an agent, the principal-agent problem implies that the agent will not do her utmost to negotiate the best possible deal for her principal. In the absence of the principal-agent problem, such as where two principals negotiate against one another, each on her own behalf, each principal will attempt to maximize her share of the cooperative surplus, or joint value, that can be generated from reaching agreement. The joint value of transacting is the distance between the seller's reservation price (the lowest value the seller is willing to accept) and the buyer's reservation price (the highest value the buyer is willing to pay).

Consider a hypothetical negotiation between a buyer and a seller, each representing herself as principal. Assume that the seller's reservation price is $X and the buyer's reservation price is $2X. Between the two parties, there is $X of joint value ($2X – $X = $X) that a transaction can create. That surplus represents the combined benefits that the parties can obtain by entering into an agreement. In any deal struck between $X and $2X, say "$Y" where $X<$Y< $2X, the seller will benefit in the amount of $Y – $X and the buyer will benefit in the amount of $2X – $Y. Whatever the value of Y, the joint value of the transaction will be $X [($Y – $X) + ($2X – $Y) = $X]. Theoretically, a transaction is possible anywhere along the interval, or "bargaining zone," from $X to $2X. If the parties to the negotiation are self-interested and have similar access to information, risk tolerance,

relationship that arises when a "principal" formally agrees to act on behalf of an "agent"), the relationship between them nevertheless implicates agency problems, see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 842 (2005) (discussing the relationship between shareholders and officers/directors and their power dynamics).

and negotiating skills, then the deal struck by them should lie around \$1.5X; i.e., in the middle of the parties' bargaining zone.

When we relax these assumptions, however, the division of the cooperative surplus is less obvious. If, for example, one of the parties does not represent herself in the negotiation, but relies on an agent to negotiate on her behalf, then principal-agent theory teaches us that the outcome of the negotiations will be influenced by the agent's private objectives. A common manifestation of the principal-agent problem is shirking. The agent could put forth additional effort to negotiate the best possible deal for her principal, but doing so would require additional time and effort, which the agent would prefer to conserve. Instead, the agent expends only moderate effort in negotiating the transaction, and, consequently, her principal suffers a reduction in her share of the joint value.

To control agency costs, agency theory prescribes constraining managerial discretion such that it deviates from value-maximizing behavior as little as possible.[27] Incentive compensation contracts, for example, can induce managers to act more closely in line with the interests of their principals. An officer or director who is interested in pursuing a project that is privately attractive to her, but inefficient for the firm, for example, would think twice if she owned a significant equity stake in the company.

Requiring officers and directors to bear risk in their compensation arrangements involves a cost, however. Risk-averse officers and directors must be paid a premium in exchange for agreeing to accept an element of their compensation in risk-based form. As Professors Hamermesh and Wachter point out, "agency costs are an inevitable burden on publicly held companies . . . ."[28] They consist of the sum of (1) the costs of constraining opportunism by corporate officers and directors and (2) the residual inefficiencies of separating ownership and control that cannot be eliminated. The price of a public company's shares incorporates a discount attributable to these agency costs.

2. Conflicts of Interest: The Principal-Agent Problem Squared (the MBO Case)

The moral hazard in the principal-agent relationship described above results from the ability of corporate officers and directors to

[27] *See* Bainbridge, *Director Primacy*, *supra* note 26, at 551.

[28] Lawrence A. Hamermesh & Michael L. Wachter, *The Short and Puzzling Life of the "Implicit Minority Discount" in Delaware Appraisal Law*, 156 U. PA. L. REV. 1, 35 (2007).

pursue their private interests at the expense of shareholders when ownership and control of a corporation are separated. When an agent takes part in a transaction in which she has a direct conflict of interest, however, moral hazard in the principal-agent relationship is exacerbated. In conflict-of-interest transactions, an agent has particularly strong incentives to behave opportunistically. Such circumstances thus give rise to far greater potential for moral hazard than in the standard principal-agent context.

A conflict-of-interest exists for an agent when she either (1) herself sits on both sides of a transaction or (2) otherwise has an interest in the outcome of the transaction. The former type of conflict-of-interest is known as "self-dealing" and involves the situation in which an agent represents a principal in a transaction in which she has a direct financial interest. For example, the president of a company that procures supplies from a supplier owned by the president is engaging in a self-dealing transaction: The president has the corporate power to establish terms for the transaction that are advantageous to her interest as the owner of the supplier.[29] The latter type of conflict of interest, which encompasses MBOs, involves a situation in which an agent, although she does not personally sit on both sides of a transaction, has an indirect interest in the terms of the transaction through a relationship with the party on the other side.[30] Whether a conflict-of-interest involves direct self-dealing or an indirect personal interest, the conflict induces the agent to use her influence over the transaction to her advantage.

An agent with a conflict of interest is in a position to go beyond giving up cooperative surplus, as in the standard principal-agent context, and arrange the terms of an acquisition transaction in a way that favors her private interests at the expense of her principal. When an agent has a conflict of interest with her principal, that agent is less likely to maximize her principal's interests in negotiations over a transaction. Unsurprisingly, conflicts of interest produce outcomes that favor the conflicted party relative to hypothetical outcomes that would have emerged from arm's-length bargaining, in which an agent acts in the interest of her principal.

Recall that in an arm's-length negotiation, which does not involve any conflict of interest, any potential agreement must lie within the

29 *See* Guth v. Loft, Inc., 5 A.2d 503, 514-15 (Del. 1939).

30 *See, e.g.*, Martin Found., Inc. v. N. Am. Rayon Corp., 68 A.2d 313, 314-15 (Del. Ch. 1949) (finding that in a transaction for the sale of assets, some directors who voted to sell the assets were "interested" because they were directors and/or stockholders of the acquiring company).

bargaining zone. A potential agreement that lies outside of the bargaining zone would lie below or above one of the parties' respective reservation prices. It would therefore make that party worse off than she would be if she walked away from the deal. In analyzing the division of joint value between the parties to an arm's-length transaction, we assumed that the only benefit that accrued to the agent was the increase in leisure time and reduction in effort associated with shirking. In addition, we assumed that each side's reservation price was exogenous, or determined by factors outside the agent's control. When conflicts of interest are introduced into the negotiation framework, however, the conflicted party can influence the outcome of negotiations through two mechanisms. First, she can influence the share of the joint surplus she captures. Second, she can influence the location of her principal's reservation price. In theory, therefore, an agent who has a conflict of interest in a transaction cannot be presumed to be seeking to obtain the most advantageous deal for her principal. Rather, she will be prone to the dual moral hazards of shirking, making concessions that forfeit joint value, and of using her influence to cause her principal to set a less attractive reservation price, thereby increasing the joint value available for her to appropriate.

3. Management's Conflicts of Interest in MBOs

MBOs fall into the self-dealing category of conflict-of-interest transactions because they involve a manager who takes actions on behalf of a company with which she is simultaneously dealing on her own behalf.[31] On the one hand, the role of the target's manager in an acquisition is to act as an agent for the target and its shareholders in providing all potential buyers with information about the company, negotiating terms of the purchase agreement, and (if the manager is also a director) voting on the transaction. On the other hand, the manager acts on behalf of one of the potential buyers — the management-led buyer group — in negotiations. In its former capacity, management is obligated to obtain the best deal possible for the company and its shareholders. In its latter capacity, management is seeking to obtain the best possible deal for the prospective new owners of the company, which include itself. Because management's

[31] *See, e.g.*, *In re* El Paso Corp. S'holders Litig., 41 A.3d 432, 443-45 (Del. Ch. 2012) (criticizing El Paso's CEO for failing to disclose to the company's board of directors that he was negotiating the sale of the company while at the same time negotiating a potential management buyout for himself and other senior executives of one of the company's divisions from the buyer).

typical equity stake in an MBO is significantly greater than management's typical equity interest in public companies,[32] managers face incentives to reduce the value for which the target is acquired, other things being equal.

Now recall from the discussion of our base case how an agent with a conflict of interest has incentives to give up joint value within the bargaining zone. In an MBO, such an agent can capture even more value by causing the target's reservation price to shift downward, thus extending the bargaining zone to her own advantage. If an agent is able to depress the seller's reservation price, then the agent has the ability not only to capture a disproportionate share of joint value but also to expropriate additional value from the seller.

Reservation prices depend mainly on a party's best alternative to a negotiated agreement, or BATNA.[33] The seller's BATNA in an MBO will be to either remain independent or sell the company to another party. For any given BATNA, a transaction above the seller's reservation price would be a desirable outcome for the seller. Conversely, a transaction below the seller's reservation price would be an undesirable outcome and should not be undertaken.

Management is in an especially effective position to cause the seller in an MBO to reduce its reservation price, thereby enlarging the joint value available to be captured by management.[34] In the simple bilateral negotiation described above, the target's BATNA was to forego the acquisition premium associated with the MBO ($Y – $X) and pursue its strategic plan as an independent company or to put itself up for sale. If the target is a public company, its shares are freely traded through market purchases and sales. These transactions determine the firm's fair market value, or market capitalization, which is the price of an individual share multiplied by the number of shares issued and outstanding. A public company's fair market value represents the market's estimate of what the company's equity is worth based on the value implications of all available information.

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[32] *See* Phillip Leslie & Paul Oyer, *Managerial Incentives and Value Creation: Evidence from Private Equity* 2 (NBER Working Paper No. 14331, 2008), *available at* https://faculty-gsb.stanford.edu/oyer/documents/PrivateEquity_March2013.pdf (reporting that the highest paid executives at private-equity owned firms own about twice as much equity as their public company counterparts).

[33] *See* RUSSELL KOROBKIN, NEGOTIATION THEORY AND STRATEGY 36-37 (2d ed. 2009).

[34] *See* Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 740 (1985) (describing the different ways insiders can manipulate stock prices in a way that will benefit them); James R. Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C. L. REV. 121, 125 (1988).

According to finance theory, a company's fair market value greatly depends on the future cash flows that its business can be expected to generate adjusted for the time-value of money and risk.[35] Two key determinants of a company's value are its projected future earnings and the discount rate applied to them.[36] The discount rate is assumed here to be exogenous (i.e. treated as given). However, projected future earnings are within the scope of our analysis. The elements underlying projected future earnings fall into three distinct categories: (1) historical financial accounting information, (2) assumptions about future business conditions, and (3) management policies. Management has substantial influence over all three.

Historical financial accounting information is an important component of valuation analysis because a firm's past performance is generally regarded as the best indicator of its future performance. Representative base-year data are the foundation for projecting future results. For public companies, such data are readily available.[37]

In addition, the SEC encourages companies to disclose forward-looking information so that investors can better understand a company's future prospects and make informed investment decisions.[38] These statements do not relate strictly to historical or current facts, and they often include words such as "anticipates," "estimates," "expects," "projects," "intends," "plans," "believes," and terms of similar meaning used in connection with discussions of future operating or financial performance. Forward-looking statements are based on management's current expectations and assumptions regarding the company's future performance, the path of the economy, and future events. As with any projection or forecast, forward-looking statements are inherently susceptible to uncertainty and changes in circumstances.

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[35] ASWATH DAMODARAN, APPLIED CORPORATE FINANCE 517-18 (4th ed. 2014).

[36] *See* Repetti, *supra* note 34, at 138 (pointing out the usefulness of financial projections to investors).

[37] U.S. publicly traded companies are subject to the periodic reporting requirements of the Securities and Exchange Act of 1934, including Form 10-K. Form 10-K is a detailed annual report of the reporting company's operations. It includes information regarding the company's business, material legal proceedings, and management's discussion and analysis of the company's financial condition. Audited financial statements for the applicable year must also be included with Form 10-K. *See* STEWART M. LANDEFELD ET AL., THE PUBLIC COMPANY HANDBOOK: A CORPORATE GOVERNANCE AND DISCLOSURE GUIDE FOR DIRECTORS AND EXECUTIVES 18-19 (4th ed. 2011), *available at* https://www.perkinscoie.com/images/content/2/7/v2/27026/bus-12-03publiccompanyhandbook4thedition.pdf).

[38] *See* HAZEN, *supra* note 13, § 3.9[4].

The policies of managers are another essential element of the value of a firm. Key executives influence the value of an organization through their decision-making authority over matters relating to both the efficiency with which an organization deploys its resources and the firm's strategic direction. Under corporate law, the business of a corporation is managed by or under the direction of its board of directors. At public companies, the board of directors sets broad strategy, and day-to-day affairs are managed by its officers subject to the board's oversight.[39] It is common for the CEO of a company to sit on its board of directors. Collectively, a company's CEO and its other senior managers have substantial influence over both the strategic direction and the operations of the company.

In general, managers are likely to want to enhance the firm's market value, subject to the standard agency costs described in the base case above. When managers are contemplating an MBO, however, their incentives change. A lower market value reduces the seller's BATNA and, consequently, the seller's reservation price. Reductions in the seller's reservation price expand the bargaining zone in acquisition negotiations in favor of the acquiror. Perversely, as the acquiror in an MBO transaction, managers have incentives to temporarily depress their firm's market value by manipulating public perceptions of the firm's value.[40] In addition to actively seeking to depress a target's market value in order to acquire it at a more advantageous price, managers can select an opportune time to initiate an MBO. Stock market prices can depart substantially from their fundamental values for extended periods of time.[41] Management is in a unique position to assess whether movements in its company's stock price reflect changes in the company's underlying fundamental value or, rather, are

[39] *See* DEL. CODE ANN. tit. 8, § 141(a) (2016).

[40] *See* Bevis Longstreth, Comm'r, Sec. & Exch. Comm'n, Management Buyouts: Are Public Shareholders Getting a Fair Deal?, Remarks to the International Bar Association (Oct. 6, 1983), *in* SEC. & EXCH. COMM'N NEWS, at 13-14 (cataloging various techniques by which management can adversely affect the market price for its corporation's stock). The panoply of techniques available to management for temporarily depressing firm value is exemplified by those used by David Murdock, Dole Food Company Inc.'s Chairman and CEO, and his right-hand man Michael Carter, Dole's President and COO, to reduce Dole's public stock price in anticipation of a proposal by Murdock to take Dole private, including making "false disclosures about the savings Dole could realize after selling approximately half of its business," "cancel[ing] a recently adopted stock repurchase program," and providing Dole's special committee with "lowball management projections." *In re* Dole Food Co., Inc. S'holder Litig., No. 8703-VCL, 2015 WL 5052214, at *2 (Del. Ch. Aug. 27, 2015).

[41] *See* Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 650 (2003).

unrelated market movements. When managers believe that their firms' stock price substantially underrepresents the firm's fundamental value, they can capture the value of that disparity through an MBO.

Thus, moral hazard, a concern that arises in all public companies in which ownership is dispersed and shareholders cannot effectively monitor managers, is an especially pernicious problem in the MBO context. In an MBO, managers are incentivized to favor not only their interests as managers but also their interests as acquirors. As a result, mechanisms aimed at solving moral hazard in the MBO context must address a heightened risk that managers will act as unfaithful agents of the target company's shareholders.

B. Inverse Adverse Selection in MBOs

1. The Market for Lemons (the Base Case)

In addition to opportunism that can arise from moral hazard, discussed in Section A above, opportunism due to adverse selection can also occur as a result of asymmetric information in a relationship. Adverse selection refers to the tendency of the better-informed party to take economic advantage of its superior information when transacting with the lesser-informed party. Specifically, the better-informed party has an incentive to try to pass off inferior, or "adversely selected," products to its counterparty as being of higher quality than they really are.[42]

The problem of adverse selection is most often raised in the context of product markets, where sellers typically have better information about product quality (the unobserved characteristic) than buyers.[43] The classic example of a product market in which adverse selection occurs is the used-car market.[44] Used cars that are apparently the same on the outside can be very different on the inside. Some are lemons; they require above-average repairs. From experience, the seller knows whether her car is a lemon, but this information is not observable by the buyer. All the buyer knows about the quality of any particular used car is that it *might*, with some probability, be a lemon.

If buyers could differentiate between the two types of cars (lemons and non-lemons), they would willingly pay premium prices for the

[42] PERLOFF, *supra* note 25, at 624-25.

[43] *See* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 495 (1970) (discussing the costs to the economy of sellers passing off "bad wares as good wares").

[44] *See id.* at 489.

non-lemons. Unable to do so, rational buyers discount the amount they are willing to pay for all used cars to reflect the possibility that they will purchase a lemon. Sellers of non-lemons, knowing the quality of their used cars, will not sell them at the discounted price if that discounted price is below the sellers' reservation price. The tragedy of the market for lemons is that high-quality cars may not trade even if buyers value them more highly than sellers do. In summary, asymmetric information can cause a competitive market to lose desirable efficiency properties in the sense that some potential gains from trade are not realized.

2. The Market for Gems (the MBO Case)

MBO markets have characteristics that are the opposite of lemons markets: Instead of sellers having superior information to buyers, buyers have superior information to sellers. When buyers are the better-informed parties in a market, the results of the market for lemons are also flipped, leading to the problem of "inverse adverse selection."[45] In gems markets, buyers have better information about the product's quality than sellers. Some products are gems — they are of above-average quality. Buyers are privy to this information, but sellers are not. Thus, buyers have both an incentive to try to cherry pick superior, or "inversely adversely selected," products. The sellers know that some products are gems, but they cannot distinguish between a gem and a non-gem. Knowing that their products *might*, with some unknown probability, be gems, sellers apply a premium to all their products. Buyers of non-gems, knowing the quality of the sellers' products, will be unwilling to purchase them at a premium if the premium price exceeds their reservation price. The tragedy of the market for gems is that non-gems may not trade even if sellers value them less highly than buyers do. As in lemons markets, asymmetric information in gems markets can also cause competitive markets to lose desirable efficiency properties.

The market for MBOs has the characteristics of a gems market.[46] In an MBO, managers are the buyer of the company. At the same time, those managers are charged with running the company's day-to-day

[45] Giuseppe Dari-Mattiacci et al., *Inverse Adverse Selection: The Market for Gems* 2 (Amsterdam Ctr. for Law & Econ., Working Paper No. 2010-04, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1661090.

[46] *See generally* Jonas Samlin & Maja Walla Enander, *Public-to-Private Transactions — A Cross Country Comparison* (Apr. 12, 2006) (unpublished MSc thesis, Stockholm School of Economics), *available at* http://arc.hhs.se/download.aspx?MediumId=228.

affairs. As such, the buyer in an MBO is intimately familiar with the company's value — more so than the non-management individuals on the sell-side.

The identity of the seller in an MBO depends on the structure of the transaction.[47] If the MBO is structured as a stock purchase, the seller of the company consists of its shareholders. Each of these shareholders makes an individual decision whether to sell her shares. In negotiating their deal, managers and shareholders have asymmetric information. Managers have access to non-public characteristics about the corporation. In contrast, shareholders have access only to a company's public filings and a qualified statutory right to inspect a corporation's stock list and books and records.[48] Compounding this informational disadvantage is the collective action problem that shareholders face: Where shareholdings are widely dispersed, the costs associated with any single shareholder's information-gathering may exceed the benefits that the shareholder can capture. As a result, even information that *is* available to shareholders may not be fully utilized.

In an MBO that is structured as either an asset sale or a merger, shareholders are not a direct party to the MBO. Rather, the target company contracts with the acquiror to accomplish the transaction. Major transactions, such as the sale of a company in an MBO transaction, require the target's board of directors to approve the transaction. Because such transactions also implicate the fundamental nature of the target company shareholders' investment in the company, shareholder approval of the transaction is also required.

As already pointed out, manager-buyers in MBOs have superior information about the target company relative to the target company's public shareholders. They are also informationally advantaged relative to the non-management members of the target company's board of directors. Boards of directors are composed of both inside and outside directors. Inside directors are employees of the company, such as the CEO, while outside directors are not directly affiliated with the company. In an MBO, it is typical for the target company to appoint a special committee of the board that is composed of only outside directors. The purpose of the special committee is to evaluate and negotiate the transaction without concerns over conflicts of interest in

[47] *See supra* note 5.

[48] *See, e.g.*, DEL. CODE ANN. tit. 8, § 220(b) (2016); Security First Corp. v. U.S. Die Casting & Dev. Co., 687 A.2d 563, 566-67 (Del. 1997) (stating that Delaware stockholders have a right to a limited inquiry into a corporation's books and records when they have established a proper purpose).

the decision-making process.[49] In contrast to their inside counterparts, outside directors are not full-time employees of the target and thus must rely primarily on management for information.

The foregoing asymmetric information in MBO transactions, where buyers have better information about the target company than sellers, creates a gems market. Sellers know that manager-buyers possess information about hidden characteristics of the target that are unknown to them and that the manager-buyers will try to take economic advantage of the information. The inverse pattern of the market for lemons therefore plays itself out. To protect themselves against opportunistic behavior by buyers seeking to underpay for gems in the MBO market, sellers apply a premium to their companies to reflect the possibility that these companies may be gems. In these circumstances, gems may drive non-gems out of the market for MBOs. If buyers have a reservation price for non-gems that is lower than sellers' expected value of their targets, then sellers will realize that they can sell only gems to buyers.[50] Consequently, only gems will be bought and sold at the MBO market's equilibrium price. This equilibrium is economically inefficient, however, as non-gems will remain in the hands of sellers who value them less than potential buyers do.

C. The Coexistence of Moral Hazard and Inverse Adverse Selection in MBOs

As discussed in Part II, asymmetric information in MBOs simultaneously produces both the problems of moral hazard and of inverse adverse selection. In MBO markets, asymmetric information exists with respect to (1) the hidden actions of management as stewards of the target and (2) the hidden characteristics of the target that are known only to management.[51] Together, these informational asymmetries create conditions for predatory management buyouts. By "predatory management buyouts," I mean MBOs in which management buys gems — targets of above-average quality — for less than their fair market value. This is possible in MBO markets because, unlike in acquisition markets where no conflicts of interest or asymmetric information are present, buyers and sellers in MBO markets negotiate an agreement that depends solely on their respective reservation prices. Manager-buyers have incentives to usurp joint

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[49] *See infra* Part III.A.

[50] Non-gems will trade only if the reservation price for non-gems that buyers are willing to pay exceeds sellers' expected value of their targets.

[51] *See* PERLOFF, *supra* note 25, at 624.

surpluses and to depress sellers' reservation prices.[52] What we should expect from the joint presence of moral hazard and inverse adverse selection in the MBO market is therefore that management will systematically take economic advantage of information asymmetries to purchase targets that are gems on terms that are highly favorable to itself. An additional, efficiency-related, implication of the presence of inverse adverse selection in MBO markets is that not all efficient transfers of gems will take place.

III. The Imperfect Legal Constraints on Managerial Self-Dealing in MBOs

There are inherent conflicts of interest in public corporations, in which ownership and control are typically separated. One of the main objectives of corporate governance is to eliminate or mitigate these conflicts of interest, particularly those between officers and directors, on the one hand, and shareholders, on the other hand. Corporate and securities law employ various mechanisms to ensure that companies are managed in the best interests of their shareholders. Part III describes some of these mechanisms and explains why they are insufficient to cure the taint of conflicts of interest in MBOs.

A. State Fiduciary Duty Law

Acquirors in an arm's-length transaction are constrained from underpaying for targets by the business knowledge, negotiating skills, and bargaining power of their counterparties. Self-dealing transactions, on the other hand, take place against a dramatically different background. In the case of MBOs, the target company's senior managers are also its buyers. Management in an MBO transaction therefore plays two roles, diametrically opposed to one-another. As a consequence of the fiduciary duty of loyalty in state corporate law, management-as-agent of the company and its shareholders is obligated to act in the best interests of those constituencies. However, management-as-buyer is motivated to act in its own best interests.

State corporate law polices conflicts of interest in acquisition transactions in order to protect shareholders of the target company from being taken advantage of by the target company's officers and directors. The duty of loyalty prohibits managers from pursuing any interests other than those of the corporation and its shareholders in

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52 *See supra* notes 33–34 and accompanying text.

making business decisions. This principle is so central to corporate law that it is routinely expressed in the exacting and inflexible language in *Guth v. Loft*, the seminal self-dealing case:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. . . . A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty . . . . The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest.[53]

Indeed, interested transactions were once voidable in all circumstances at the election of the corporation on the theory that the corporation is entitled to the unconflicted management and oversight of its officers and directors. Officers and directors may not abdicate their duties to the corporation and its shareholders by bargaining with them in their own interest.[54] This view has been supplanted by the modern view that there are potential advantages to conflict-of-interest transactions and that judicial oversight, rather than outright prohibition, is the appropriate approach to regulating them.[55]

Conflict-of-interest transactions undermine the basis for the broad discretion accorded to officers and directors under the business judgment rule. This rule is often described as a legal presumption that the officers and directors of a corporation have made business decisions with due care by acting on an informed basis, in a deliberative manner, and in the good faith belief that their actions are in the best interests of the corporation and its shareholders.[56] When

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

[54] *See* STEPHEN M. BAINBRIDGE, CORPORATE LAW 142-43 (2d ed. 2009).

[55] DGCL § 144(a) provides a safe harbor from voidability for conflict-of-interest transactions that satisfy its requirements. Even though a transaction that meets a safe harbor under § 144(a) will be insulated from voidability under the common law arising from the conflict-of-interest, both the transaction and the target's managers remain subject to the common law of fiduciary duty. *See* DEL. CODE ANN. tit. 8, § 144(a) (2016).

[56] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985). Not all jurisdictions apply the business judgment rule to officers. *See, e.g.*, FDIC v. Perry, No. 11-5561-ODW, 2011 U.S. Dist. LEXIS 143222, at *8, *10 (C.D. Cal. Dec. 13, 2011) (stating that under California law, both the common law and California's statutory business judgment rule apply only to directors, not officers).

there is adequate reason to question that presumption, however, corporate law becomes wary and authorizes inquiry into motives.[57]

Conflicts of interest are a salient example of a context in which corporate law uses safeguards to satisfy itself that managers are discharging their fiduciary duties. While the deferential business judgment rule may be justified in the case of officers and directors who make corporate decisions when dealing at arm's length, it is inappropriate in conflict-of-interest transactions because such transactions allow managers to take advantage of their positions to further their own interests at the expense of those of the corporation and its shareholders. In these circumstances, the applicability of the business judgment rule as a standard of review for decision-making is made conditional on procedural safeguards. If these safeguards are not properly implemented, then the business judgment rule is summarily discarded in favor of heightened levels of judicial scrutiny.[58]

Under state corporate law, MBOs are subject to the same standard of review as other conflict-of-interest transactions.[59] A plaintiff may rebut the presumption of the business judgment rule by showing that a majority of a board's directors were conflicted. The presumption of the business judgment rule can be reinstated, however, through the implementation of appropriate sanitizing measures such as those described below. As in any other conflict-of-interest transaction, the key to upholding an interested transaction under the common law is the approval of a neutral decision-making body. Delaware courts have held that approval of a conflict-of-interest transaction by a disinterested majority of the board[60] or a special committee of independent directors[61] will withstand a fiduciary duty-based challenge under the business judgment rule. Similarly, the business

[57] In other words, the deferential business judgment rule "yields to the rule of undivided loyalty. This great rule of law is designed 'to avoid the possibility of fraud and to avoid the temptation of self-interest.' . . . It is 'designed to obliterate all divided loyalties which may creep into a fiduciary relation . . . .'" Bayer v. Beran, 49 N.Y.S.2d 2, 6 (N.Y. Sup. Ct. 1944) (citations omitted).

[58] *See* Smith, *supra* note 2, at 3 (describing the continuing role of the business judgment rule in conflict-of-interest transactions via the mechanism of procedural safeguards).

[59] *See, e.g.*, *In re* Shoe-Town, Inc. S'holders Litig., No. 9483, 1990 WL 13475, at *4 (Del. Ch. Feb. 12, 1990) (involving an MBO in which the court cited ordinary conflict-of interest cases; i.e., cases outside the MBO context, in reviewing claims of breaches of the duty of loyalty).

[60] REBECCA WALKER, CONFLICTS OF INTEREST IN BUSINESS AND THE PROFESSIONS: LAW AND COMPLIANCE § 16:6 (2015).

[61] *See id.*

judgment rule will remain the standard of review in a conflict-of-interest transaction if stockholders representing a majority of the disinterested shares outstanding approve the transaction.[62]

In order for any of these mechanisms to be effective, the body reviewing the transaction must be fully informed of the conflict of interest and all facts material to its consideration.[63] The Delaware courts will then deem the taint of the conflict of interest in the transaction to have been sanitized and, consequently, review the transaction under ordinary business judgment rule principles.[64] On the other hand, if no judicially approved ex ante procedural mechanism has been implemented in the transaction, the transaction will be subjected to substantive entire fairness review.[65]

To summarize, in MBOs, just as in ordinary conflict-of-interest transactions, the conflicted party's ability to behave opportunistically can be sanitized merely by designating one or more neutral decision-making bodies at the target company. The assumption behind this framework is that the potential for managerial opportunism will be removed as a result of the installation of the neutral decision-maker. In other words, the assumption is that conflicted managers will no longer be able to use their positions to purchase the target company below its fair market value.

B. Federal Securities Law

In addition to implicating the state common law of fiduciary duty, MBOs raise issues within the scope of the federal securities laws.[66] The federal securities laws are designed to facilitate efficient capital formation and flows. Achievement of these goals necessitates establishing a level playing field in securities transactions.

The SEC became concerned in the 1970s that "going private" transactions might involve self-dealing, undermining the confidence of investors in those deals.[67] "Going private" refers to entering into a

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[62] *See* Cain & Davidoff, *supra* note 7, at 874-75.

[63] *See* Malone v. Brincat, 722 A.2d 5, 9 (Del. 1998); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1283 (Del. 1989).

[64] *See* Smith, *supra* note 2, at 3 (describing how mitigating any "procedural infirmities at the board level" operates to restore business judgment rule review).

[65] *See infra* notes 139–41 and accompanying text.

[66] California and Wisconsin have further promulgated state regulations that apply to MBOs. *See, e.g.*, CAL. CORP. CODE § 1101 (2016); *id.* § 1203; WIS. ADMIN. CODE DFI § 6.05 (2016). Like Rule 13e-3, these regulations relate to the fairness of going-private transactions.

[67] *See* Christopher R. Gannon, *An Evaluation of the SEC's New Going Private Rule*, 7

transaction or series of transactions with a controlling shareholder or other affiliated person(s) that reduces the number of shareholders of a public company such that the company can terminate its public company status and related reporting obligations under the Securities Exchange Act of 1934.[68] For such purposes, an "affiliate" of the issuer is defined as "a person that directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with such issuer."[69] "Control," in turn, is generally understood to mean the power to direct the management or policies of the issuer.[70] The SEC has noted that determinations of control are a question of fact and are determined not only by reference to ownership of equity securities but also by reference to the ability to influence policy.[71]

According to the SEC, the terms of going-private transactions, including the consideration received by the target's public shareholders, could "be designed to accommodate the interests of the affiliated parties rather than determined as a result of arm's-length negotiations."[72] Furthermore, the SEC recognized that the timing of the transaction is within the control of the issuer, whose affiliates may choose a period of depressed market price to propose the transaction, resulting in exploitation of the unaffiliated security holders.[73] Absent regulation, the SEC believed that these concerns might lead to a loss of confidence in securities markets.

Thus, in 1977, the SEC proposed a new rule and related schedule with respect to going private transactions by public companies or their affiliates requiring that a covered transaction must be substantively fair to unaffiliated security holders. A number of commentators expressed the view that the SEC did not have the authority to adopt

J. CORP. L. 55, 56 (1981).

[68] *See* Interpretive Release Relating To Going Private Transactions Under Rule 13e-3, Exchange Act Release No. 17,719, 46 Fed. Reg. 22,571 (Apr. 20, 1981).

[69] 17 C.F.R. § 240.13e-3(a)(1) (2015).

[70] 17 C.F.R. § 240.12b-2 (2015).

[71] *See* SEC. & EXCH. COMM'N, COMPLIANCE & DISCLOSURE INTERPRETATIONS, GOING PRIVATE TRANSACTIONS, EXCHANGE ACT RULE 13E-3 AND SCHEDULE 13E-3, Question 201.05 (Jan. 26, 2009), *available at* https://www.sec.gov/divisions/corpfin/guidance/13e-3-interps.htm.

[72] Interpretive Release Relating To Going Private Transactions Under Rule 13e-3, Exchange Act Release No. 17,719, 46 Fed. Reg. 22,571 (Apr. 20, 1981).

[73] *Cf.* Roberta Romano, *Management Buyout Puzzles*, *in* LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES 199, 204 (Yakov Amihud ed., 1989) ("[M]anagers who take the firm private and later take it public again kn[o]w something about the firm's future projects that was not, and perhaps could not be, disclosed in the market at the time of the buyout.").

such a requirement.[74] In the absence of an explicit legislative mandate to regulate the fairness of going private transactions, these commentators maintained that the SEC should, as a matter of policy, refrain from substantive regulation of corporate affairs, a subject for state and not federal intervention.[75] Sensitive to these concerns, in 1979 the SEC ultimately adopted Rule 13e-3 and Schedule 13E-3 as a purely disclosure-based regime.

Rule 13e-3 applies to going-private transactions of an issuer or its affiliate.[76] With respect to affiliate transactions, Rule 13e-3 applies to mergers or acquisitions only if an affiliate of the issuer is a party to the transaction.[77] Thus, a transaction in which the issuer's senior management will obtain a substantial equity interest in the target's business as a result of the acquisition would come within the scope of Rule 13e-3. Transactions between the issuer and a non-affiliate are considered the product of arm's-length negotiations and therefore do not involve the potential for abuse and overreaching associated with the types of transactions intended to be covered by the Rule.

If Rule 13e-3 applies to an MBO, then the managers leading the transaction, as affiliates of the issuer, must file a Schedule 13E-3 with the SEC. The key disclosures included in Schedule 13E-3 are Items 7, 8, and 9.[78] These items relate to the purposes of the going private transaction, the basis on which the filer has drawn its conclusions on whether the transaction is fair to the target's unaffiliated security holders, and the content of any fairness opinion received from the issuer's financial adviser, respectively.[79]

Item 7 of Schedule 13E-3 requires disclosure of the purposes for the Rule 13e–3 transaction.[80] If the issuer or affiliate considered alternative means to accomplish the stated purposes, the alternatives and reasons for their rejection must also be identified. In addition, Schedule 13E-3 requires filers to describe the structure of the Rule 13e–3 transaction and why the transaction is being undertaken at the given time.[81] Finally, filers must describe the anticipated effects of the

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74 *See* Edmund H. Kerr, *Going Private: Adopting a Corporate Purpose Standard*, 3 SEC. REG. L.J. 33, 57-58 (1975).

75 *See id.*

76 17 C.F.R. § 240.13e-3(a)(3) (2015).

77 *Id.*

78 17 C.F.R. § 240.13e-100 (2015), sched. 13E-3, items 7-9.

79 *See id.* (incorporating by reference 17 C.F.R. §§ 229.1013-15 (2015)).

80 *Id.* at item 7 (incorporating by reference 17 C.F.R. § 229.1013 (2015)).

81 *Id.* at item 4 (incorporating by reference 17 C.F.R. § 229.1004 (2015)).

Rule 13e–3 transaction on the issuer, its affiliates, and unaffiliated security holders.[82]

Item 8 of Schedule 13E-3 requires the filer to state whether it believes the transaction to be "fair or unfair" to the unaffiliated security holders.[83] This belief must be supported by disclosure of the material factors upon which it is based and, to the extent practicable, the weight assigned to each factor. If any director dissented to, or abstained from voting on, the Rule 13e–3 transaction, that director must be identified and, if known, after making reasonable inquiry, the reasons for the dissent or abstention must be identified. In addition, Item 8 requires the filer to disclose (1) whether the transaction requires approval of a majority of unaffiliated shareholders; (2) whether a majority of non-employee directors "retained an unaffiliated representative to act solely on behalf of unaffiliated security holders for purposes of negotiating the terms of the . . . transaction and/or preparing a report concerning the fairness of the transaction[;]" (3) "whether or not the Rule 13e-3 transaction was approved by a majority of the [non-employee] directors[;]" and (4) if any other firm offer by a non-affiliate to acquire the company has been received in the past two years, a description of that offer and the reasons for its rejection.[84]

Item 9 of Schedule 13E-3 requires disclosure of whether a fairness opinion or similar report has been prepared relating to the transaction, details regarding any such document, and a statement making the document available to interested security holders or their representatives.[85]

If the SEC believes that a company subject to Rule 13e-3 has violated the Rule's provisions, the SEC may take administrative action against the company or bring a civil action against it in federal court. Private parties who believe they were injured by the company's violation of the Rule can also bring a civil action against the company for damages or injunctive relief.

In summary, Rule 13e-3 addresses concerns about self-dealing in MBO transactions through disclosure requirements. These requirements mandate that filers disclose certain information to unaffiliated shareholders via Schedule 13E-3. That disclosure, in turn, goes primarily to management's justification for its belief in the fairness of the transaction.

[82] *Id.*

[83] *See id.* at item 8 (incorporating by reference 17 C.F.R. § 229.1014 (2015)).

[84] *See id.* (incorporating by reference 17 C.F.R. § 229.1014(c)-(f) (2015)).

[85] *See id.* at item 9 (incorporating by reference 17 C.F.R. § 229.1015 (2015)).

C. The Residual Taint in MBOs

As explained in Parts III.A and III.B, even where the business judgment rule does not apply in the first instance because its preconditions are not satisfied, corporate law allows the use of ex ante procedural protections to avoid ex post substantive judicial review. MBOs are analyzed within this framework. This Part III.C argues that the procedural mechanisms that boards are allowed to implement in order to "sanitize" the conflict-of-interest taint present in MBOs are insufficient to restore arm's-length bargaining conditions to those transactions.

Recall that MBOs are subject to the same standard of review as other conflict-of-interest transactions. Ex ante approval by either (1) a disinterested majority of the full board or special committee of independent directors or (2) a majority of the fully informed disinterested shares outstanding sanitizes the transaction and causes it to be reviewable under the deferential business judgment rule. These procedural mechanisms are thought to restore arm's length decision-making to the board's functioning, which would otherwise have been deemed tainted by self-interest and made subject to substantive entire fairness review.

In conflict-of-interest transactions, "the law looks for a party one can trust to review the transaction [where] we cannot trust the [self-interested] directors."[86] Parties that qualify as being trustworthy in ordinary conflict-of-interest transactions include disinterested directors and disinterested shareholders who are fully informed. Accordingly, in such transactions, courts consider approval by either body to be adequate procedural protection that eliminates the need for heightened judicial review of the transaction under the entire fairness standard.

1. Enhanced Scrutiny in Non-MBO Acquisition Transactions

Courts will nevertheless conduct entire fairness review in ordinary conflict-of-interest cases where appropriate approvals are not obtained. Thus, in *Gantler v. Stephens*,[87] the Delaware Supreme Court considered a plaintiff-shareholder's claim that certain directors of a target company violated their fiduciary duties when they voted to reject an acquisition offer. The Court concluded that the defendant-directors were self-interested in the transaction. One of the target's directors was the president of a heating and air conditioning company

[86] *See* Franklin A. Gevurtz, *Removing* Revlon, 70 WASH. & LEE L. REV. 1485, 1511 (2013).

[87] 965 A.2d 695 (Del. 2009).

that provided heating and air conditioning services to the target. According to the Court, it was reasonable to infer that the sale of the target would result in the loss of a major client to the director's heating and air conditioning company. As a result, the director's decision to reject the acquisition offer was reviewed under the entire fairness standard. The Court's concern was animated not by the substance of the decision but rather by the fact that a neutral decision-maker had not made it.[88] Had disinterested shareholders properly ratified the board's decision to remain independent, however, the decision would have been deemed sanitized and consequently protected by the business judgment rule.

Importantly, courts have correctly recognized certain contexts in which conflicts of interest cannot be sanitized by the procedural protections that apply in ordinary conflict-of-interest transactions. In these circumstances, courts invoke an intermediate standard of review, between the deferential business judgment standard and the searching standard of entire fairness, referred to as enhanced scrutiny.[89] Enhanced scrutiny is deployed to review "specific, recurring, and readily identifiable situations involving potential conflicts of interest where the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors."[90]

The Delaware Supreme Court first implemented enhanced scrutiny in *Unocal Corp. v. Mesa Petroleum Co.* in the context of a board that had employed defenses against a hostile takeover.[91] In light of the board's inherent concerns of preserving its incumbency, the Court stated that an "omnipresent specter" lurks that target directors may conduct their decision-making to further their own interests or those of incumbent management rather than those of the corporation and its shareholders.[92] Enhanced scrutiny requires that the defendant fiduciaries bear the initial burden of proof of showing that their motivations were proper and that their actions were reasonable as a condition to business judgment rule review.[93] If the directors do not carry their burden, then the entire fairness test applies.

[88] *See id.* at 707.

[89] WILLIAM E. KNEPPER & DANA BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 14.04 (8th ed. 2015) (describing the standard of enhanced scrutiny).

[90] J. Travis Laster, *The Effect of Stockholder Approval on Enhanced Scrutiny*, 40 WM. MITCHELL L. REV. 1443, 1448-49 (2014).

[91] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949, 954 (Del. 1985).

[92] *Id.* at 954.

[93] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995).

Similarly, the procedural protections applied in ordinary conflict-of-interest transactions are varied when a board's so-called "Revlon duties" are triggered. In *Revlon v. MacAndrews & Forbes Holdings*,[94] the Delaware Supreme Court addressed the duties of the board of directors of a company that was for sale. As in the *Unocal* context, in which a company is defending itself against a hostile takeover, the board may not act to further its own interests at the expense of those of the corporation and its shareholders.[95] The board's strategic options could not, once the sale of the company was set in motion, include favoring a bidder of its own choosing. Instead, the duty of the board had to pivot to maximizing the company's value in the sale transaction.[96]

Unocal and *Revlon* stand for the proposition that actions taken by the board that would warrant business judgment rule protection in one context do not necessarily warrant such protection in another. While in each case the board's decision was potentially eligible for business judgment rule protection, such protection was conditioned on threshold procedural requirements deemed appropriate to the concerns justifying enhanced scrutiny of the board.[97] Enhanced review consisted of a threshold judicial determination of whether the board acted reasonably in the specific circumstances involved before according deference to its decision.

The Delaware Supreme Court's decision in *Kahn v. M&F Worldwide Corp. (M&F Worldwide)*[98] underscores the point that the procedural protections required to sanitize conflict-of-interest transactions will be dialed up in transactional settings that pose heightened risks of opportunism by corporate fiduciaries. In *M&F Worldwide*, a controlling shareholder consummated a going-private transaction that was conditioned upon the prior approval of both an independent special committee and a vote of a majority of the stockholders unaffiliated with the controlling stockholder. The Court analyzed the use of these procedural protections and concluded that, used *in combination*, they produced conditions that allowed the parties to

94 Revlon v. MacAndrews & Forbes Holdings, 506 A.2d 173 (Del. 1986).

95 *See* KNEPPER & BAILEY, *supra* note 89, § 14.05 (emphasizing the paramount importance that board decisions in the acquisition context be "tied to the best interests of the corporation and its shareholders").

96 *Revlon*, 506 A.2d at 182.

97 *See In re* MFW S'holders Litig., 67 A.3d 496, 527 (Del. Ch. 2013), *aff'd*, 88 A.3d 635 (Del. 2014) ("The innovative standards that emerged in *Unocal* and *Revlon* required more judicially intensive review, but gave heavy credit for empowering the independent elements of the board."). For a discussion of the *Unocal* standard as a conditional version of the business judgment rule, see BAINBRIDGE, *supra* note 54, at 391.

98 88 A.3d 635 (Del. 2014).

bargain at arm's length.[99] In other words, only one or another of the protections was insufficient when a controlling shareholder was the acquiror. Determining the standard of review in a conflict-of-interest transaction thus requires a thorough analysis of the particular conflict at issue and a similarly thorough analysis of whether and how that conflict can be sanitized through procedural means.

2. The Case for Enhanced Scrutiny in MBO Transactions

MBOs bear both similarities and differences to the foregoing acquisition contexts. They are similar in that they both raise conflict-of-interest concerns. In *Unocal*, the conflict concerned questions about whether the board was erecting defensive measures to protect shareholders from an inadequate hostile tender offer or whether it was doing so to protect itself. In *Revlon*, the concern was whether the board would be inclined to favor a bidder that was more attractive to it but not necessarily to shareholders. In *M&F Worldwide*, the Court took note of the fact that a controlling shareholder can dominate both shareholder-level and board-level decisions to further its own interests. Just as board decision-making is compromised in each of these contexts, it is also compromised when a board sits in judgment of management's acquisition offer in an MBO. Moreover, in each of the foregoing instances, arm's-length bargaining cannot be achieved through the simple mechanism used in ordinary conflict-of-interest transactions of interposing either a disinterested board/special committee or disinterested shareholders between the conflicted party and the acquiror.

The justifications for enhanced scrutiny in *Unocal, Revlon,* and *M&F Worldwide* have already been discussed. In the case of MBOs, strengthening the existing minimal procedural protections required in an ordinary conflict-of-interest setting is similarly justified. Put simply, arm's-length bargaining is compromised in MBOs because managers can influence the terms on which a transaction takes place to their advantage even without serving on or dominating the board or special committee conducting the sale process.

Yet, MBOs differ in kind from other contexts that have attracted concerns over managerial opportunism and thus merit individualized attention. This difference arises from the fact that, unlike in third-party sale transactions, the buyer and seller in an MBO overlap. As a result, mechanisms for neutralizing conflicts of interest that apply only to the sell-side of the transaction, such as those used in *Unocal, Revlon,*

[99] *See id.* at 654.

and *M&F Worldwide*, cannot completely correct for a buyer's possession of superior information about unobservable characteristics of the target. Asymmetric information about the target possessed by management in an MBO leads to the inverse adverse selection problem described in Part II, in which all targets apply a premium to their companies because they fear that better-informed buyers will take advantage of their superior information by seeking to buy attractive businesses (gems) at below fair market value prices.

In other words, MBOs implicate concerns over self-dealing that go beyond both ordinary conflict-of-interest transactions and transactions that receive enhanced scrutiny. The conflicted party's ability to behave opportunistically can be sanitized merely by designating one or more neutral decision-making bodies at the target. These decision-making bodies must be fully informed as to all material information regarding the conflict and the transaction.[100] Whether or not they are is closely related to the fiduciary duties of disclosure of corporate officers and directors as part of their basic fiduciary duties of care and loyalty.[101] Directors with a personal interest in a board decision have a duty to disclose to the board material information in their possession bearing upon that decision. Additionally, directors are obligated to disclose all material information relating to any shareholder action they solicit. Such disclosure requirements follow federal securities law in determining materiality.[102] As a result, they suffer from the same deficiencies as the federal disclosure obligations discussed below and in Part IV.A.[103]

Opportunism can arise whenever managers have superior information about the target's business relative to their counterparties. In the case of an MBO, the potential for managerial opportunism easily survives the designation of a neutral decision-maker at the target. Because the taint of self-interest in MBOs is not solely a function of the identity of the target's decision-making body, sanitizing the conflict of interest in MBOs requires additional safeguards.

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[100] *See, e.g.*, 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, BALOTTI AND FINKELSTEIN'S DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.16[A] (2016).

[101] Solomon v. Armstrong, 747 A.2d 1098, 1128 (Del. Ch. 1999).

[102] *See* Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985) (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976)) (for the purpose of defining materiality).

[103] *See* Repetti, *supra* note 34, at 158 (discussing how *Rosenblatt*'s disclosure requirements will not assist management in bailouts or buyouts); *infra* Part IV.A.

Like corporate fiduciary duty law, federal securities law is only partially responsive to the concern that MBOs permit participating managers to exploit unaffiliated target shareholders. Rule 13e-3 requires filers to disclose certain information relevant to the fairness of the proposed transaction.[104] The information required to be disclosed in Schedule 13E-3 will not, however, necessarily produce a fair outcome. The essence of Rule 13e-3 is to require filers to disclose information via Schedule 13E-3 relating to a going private transaction that allows unaffiliated shareholders to assess whether the transaction involves "abuse" or "overreaching."[105] Schedule 13E-3 disclosure appropriately focuses attention on matters relevant to the fairness of the proposed transaction.[106] It falls short, however, of eliciting all material facts necessary for unaffiliated shareholders to make an informed determination of the value of their shares.

Under Item 8 of Schedule 13E-3, for example, filers must state whether they believe that the transaction is fair or unfair to unaffiliated security holders.[107] Such a determination need only be a reasonable belief.[108] Moreover, according to the SEC, that determination can depend on various factors that carry different weights.[109] It is thus highly subjective and susceptible to the same self-serving motives that it is designed to combat.

Item 8 also requires filers to disclose the factors that that they considered in arriving at their subjective fairness determinations.[110] Yet, in the instructions for doing so, there is no requirement that filers disclose so-called "soft," or future-looking information, including projections of revenues, income, or earnings.[111] This is a notable

[104] 17 C.F.R. § 240.13e-100 (2015), sched.13E-3, item 8 (incorporating by reference 17 C.F.R. § 229.1014 (2015)).

[105] *See* Interpretive Release Relating to Going Private Transactions Under Rule 13e-3, Exchange Act Release No. 17,719, 46 Fed. Reg. 22,571 (Apr. 20, 1981).

[106] For the view that Rule 13e-3 accomplishes its intended purposes, see Gannon, *supra* note 67, at 65-73.

[107] 17 C.F.R. § 240.13e-100, sched. 13E-3, item 8 (incorporating by reference 17 C.F.R. § 229.1014 (2015)).

[108] *Id.*

[109] 17 C.F.R. § 229.1014(b) (2015).

[110] *See* 17 C.F.R. § 240.13e-100, sched. 13E-3, item 8 (incorporating by reference 17 C.F.R. § 229.1014(b) (2015)).

[111] Victor Brudney, *A Note on Materiality and Soft Information Under the Federal Securities Laws*, 75 VA. L. REV. 723, 723 n.2 (1989) (defining soft information in future-oriented terms); *see also* Victor Brudney, *Dividends, Discretion, and Disclosure*, 66 VA. L. REV. 85, 115-16 n.89, 116 n.92 (1980).

omission given that such data constitutes a key input in traditional valuation analysis.[112]

If a fairness opinion or similar report has been prepared relating to the transaction, it must be disclosed pursuant to Item 9 of Schedule 13E-3.[113] Note, however, that such reports are not mandated.[114] Moreover, even when a fairness document has been prepared, its conclusions likely depend heavily on information provided by management to the professionals who draft it.

In short, state corporate fiduciary duty law and federal securities law are insufficient to produce the equivalent of arm's-length bargaining in MBOs. The procedural gate-keeping mechanisms that courts have constructed to deal with conflicts of interest do not achieve their intended purposes in the MBO context. In addition, federal securities law gives managers ample room for undervaluing the target company in an MBO. Consequently, conditions of asymmetric information inherent in MBOs justify enhanced procedural safeguards on the buy-side in order to equalize the informational disparity that exists between management and non-management directors and shareholders.

IV. Objections to the Need for Enhanced Scrutiny of MBOs

A. Third-Party Bidders Will Compete Away Management's Ability to Behave Opportunistically

In a competitive market for corporate control, managerial overreaching in MBOs will be constrained by the presence, or prospect, of third-party bidders. The intuition behind this proposition is that if managers bid substantially below the fair market value of the target, alternative bidders will exceed that bid with competing offers. Even at a higher value, these alternative bidders will be incentivized to acquire the target so long as their bids are below their respective reservation values. According to this line of reasoning, in order to acquire the target, management must offer terms for it that are equivalent to those that would be offered in an arm's-length transaction.

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[112] The SEC proposed amendments to Rule 13e-3 and Schedule 13E-3 requiring disclosure of such projections, but those amendments were not adopted. *See* Martin Lipton & Erica H. Steinberger, Takeovers & Freezeouts § 9.04[1][e][v] (2013).

[113] 17 C.F.R. § 240.13e-100, sched. 13E-3, item 9 (incorporating by reference 17 C.F.R. § 229.1015 (2015)).

[114] 17 C.F.R. § 229.1015 (2015) (requiring issuers to state "whether or not" a fairness report exists, with no indication that such reports are mandatory).

The limits on the effectiveness of the market for corporate control have been elaborated elsewhere.[115] These limits are especially pronounced in the context of MBOs. One reason that the market for corporate control may not function effectively in the MBO setting is simply that a competing third-party, or external, bidder may never surface. The presence of management as a potential acquiror of the target may chill third-party bidding if external bidders perceive a heightened risk of being unable to consummate a transaction that does not involve management participation.

To be sure, the board's fiduciary duties limit it from blatantly favoring one bidder over another in the sale process. Nevertheless, the board retains considerable latitude in deciding to remove the company from the market and remain independent. While the third-party bidder will then have the option to respond by circumventing the board by initiating a hostile bid directly to shareholders, hostile bids are expensive to conduct. They also may not succeed, especially where management possesses substantial shareholdings. An external bidder faces the further risk that key managers will exit the company if a third-party bidder were to acquire it. These concerns, which are not shared equally by management-bidders, conspire to limit the effectiveness of the market for corporate control in MBOs.

And even if third-party bidders do emerge to contest an MBO, their mere participation in the sale process does not guarantee that an MBO will ultimately be concluded on competitive terms. In addition, the acquisition process typically allows for potential bidders to conduct due diligence on the target in order to inform themselves of its value to them. Due diligence in the acquisition setting is essentially the process of assessing the potential risks and rewards of a proposed transaction by inquiring into all relevant aspects of the target's business.

Conducting due diligence of a public company is facilitated by the ready availability of the forms, reports, and documents filed by the target with the SEC. Due diligence of a public company also involves investigating the target through confidentially reviewing non-public documents and interviewing senior management. As discussed in Part II.A, management has the ability to temporarily depress the target's share price in anticipation of an MBO. Management exercises substantial discretion over the non-public information conveyed to

[115] For example, the market for corporate control has arguably been an imperfect constraint on suboptimal corporate management. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 55-56 (2004).

potential bidders during the due diligence process.[116] Such discretion includes, for example, the gloss that management applies to the target's results and the level of optimism on which its projections for the target's future results are based. It also includes management's indications of its willingness to remain employed by, or otherwise support, the target should a third-party acquiror assume control. In combination, knowledge of the target's fundamental (long-run) value and non-public information regarding the target constitute superior information in the possession of managers relative to other bidders. As a result, MBO markets, even if contested, are not perfectly competitive.

B. The Anti-Fraud Provisions of the Federal Securities Laws Prohibit Managers from Acquiring Their Companies' Securities at a Discount to Fair Market Value

Although Rule 10b-5,[117] promulgated under section 10(b) of the Securities Exchange Act of 1934,[118] does not specifically address going-private transactions, it prohibits trading on the basis of non-public information and is consequently a potential instrument for curbing the ability of managers to profit from acquiring the securities of the target in an MBO on the basis of their privileged status as insiders. Under Rule 10b-5, an insider must disclose material non-public information or refrain from trading on it.[119] Under current doctrine, traders do not incur insider-trading liability merely because they hold an informational advantage over their counterparties.

The Supreme Court in *Chiarella v. United States*[120] specifically rejected such a "parity-of-information" doctrine.[121] Instead, the Court limited the application of the "disclose or refrain" principle to situations in which either (1) the trader is someone in whom the party alleging harm placed trust and confidence or (2) the trader is an agent or a fiduciary of the complaining party.[122] Insider-trading liability under Rule 10b-5 is therefore premised on the existence of a relationship of trust and confidence between the trader and the

116 For an extreme example of how management can sabotage the due diligence process, see Gantler v. Stephens, 965 A.2d 695, 707 (Del. 2009).

117 17 C.F.R. § 240.10b-5 (2015).

118 15 U.S.C. § 78j(b) (2012).

119 *See* Dirks v. S.E.C., 463 U.S. 646, 653-54 (1983); Chiarella v. United States, 445 U.S. 222, 227-29 (1980); Shapiro v. Merrill Lynch, 495 F.2d 228, 236 (2d Cir. 1974); S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 848 (2d Cir. 1968).

120 *Chiarella*, 445 U.S. 222.

121 *Id.* at 233.

122 *See id.* at 232.

shareholders of the stock in which she trades. This reading of Rule 10b-5 reaches anyone under a duty to place shareholder welfare before her own, which, of course, includes corporate managers.

Insiders are prohibited from trading on non-public information only if it is "material," however.[123] In determining materiality, courts consider whether there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision.[124] The Supreme Court in *Basic v. Levinson*[125] considered the materiality of uncertain facts. It adopted an approach to determining materiality in such a context that looked, on a case-specific basis, to both the probability of occurrence and the relative magnitude of the matter.[126] In doing so, it expressly refrained from addressing whether "contingent or speculative information, such as earnings forecasts or projections" could be material.[127]

Courts have generally been reluctant to deem such soft information[128] as "material" under Rule 10b-5. Management is under no obligation to disclose its speculative predictions about the future value of the target.[129] Thus, absent specific requirements to disclose such information, there is only limited disclosure of soft information under the federal securities laws in connection with an MBO. That disclosure occurs under Rule 13e-3 and Schedule 13E-3, which, as explained in Part III.B, falls short of providing independent board or special committee members and unaffiliated shareholders full information regarding the value of the target.

C. The Appraisal Remedy Provides Dissenting Shareholders with Fair Value for Their Shares

Appraisal rights provide "dissenting shareholders" — those who vote against or abstain from voting on certain acquisition transactions — with a statutory right under applicable state law to receive compensation for their shares.[130] In Delaware, for example, stockholders who have perfected their appraisal rights are entitled to

[123] STEPHEN M. BAINBRIDGE, SECURITIES LAW: INSIDER TRADING 34 (2d ed. 2007).

[124] Basic Inc. v. Levinson, 485 U.S 224, 231-32 (1988).

[125] *Id.* at 238.

[126] *Id.* at 238-39.

[127] *Id.* at 232 n.9.

[128] *See supra* note 100 and accompanying text.

[129] HAZEN, *supra* note 13, § 12.9[7][A].

[130] States vary with respect to the legal structures for which appraisal rights are available. *See* 1 LOU R. KLING & EILEEN T. NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 4.08 (2002).

the fair value of their shares without regard to any value arising from the merger, together with interest.[131] While appraisal rights serve a valuable role in merger law, they are a poor substitute for the process of arm's-length bargaining.

The historical rationale for the appraisal remedy is that, at one time, state corporate statutes required unanimous shareholder approval for fundamental corporate transactions, such as mergers. Requiring unanimous shareholder approval enabled hold-outs — shareholders who refused to vote in favor of the transaction — to engage in strategic behavior with regard to a majority group of shareholders who supported the transaction. As statutes were amended to permit fundamental corporate transactions upon a majority, rather than unanimous vote, state legislatures enacted the appraisal remedy to protect minority shareholders who were obligated to participate in the transactions against their will.

The primary function of the appraisal remedy, then, is to protect minority shareholders from unwillingly having to participate in a transaction to which they object.[132] Under modern appraisal statutes, minority shareholders who do not vote in favor of a transaction to which appraisal rights attach are granted the right to receive in cash the fair value of their shares, together with interest, as an alternative to participating in the transaction.

The appraisal process has been criticized as being ineffective on the bases of length, expense, and unpredictability.[133] It also has two other serious limitations from the perspective of minority shareholders who do not support an MBO. First, management can structure the transaction to avoid appraisal rights entirely. State statutes vary with regard to what types of transactions trigger appraisal rights, but certain states, including Delaware, grant appraisal rights in mergers but not asset purchases.[134] Second, even assuming the appraisal remedy is available to dissenting shareholders, the way in which statutes instruct courts to determine fair value of shares in appraisal proceedings does not reflect what those shares would be worth in a competitive acquisition market.

131 DEL. CODE ANN. tit. 8, § 262(h) (2016).

132 *See* THERESE H. MAYNARD, MERGERS AND ACQUISITIONS CASES, MATERIALS, AND PROBLEMS 132 (3d ed. 2013).

133 *See, e.g.*, Steven Epstein et al., *Delaware Appraisal: Practical Considerations*, BUS. LAW TODAY, Oct. 2014, at 2, *available at* http://www.americanbar.org/content/dam/aba/publications/blt/2014/10/keeping-current-epstein-201410.authcheckdam.pdf (attributing limited use of the appraisal remedy in the past to these factors).

134 *See* KLING & NUGENT, *supra* note 130, §§ 2.06[1], 4.08[1].

Essentially, the concept of "fair value" in appraisal proceedings measures the value of a shareholder's interest in the target had the transaction not occurred. On its face, this formulation appears counterintuitive: Why should a dissenting shareholder be denied the value of her shares attributable to the acquisition transaction? The answer to this question relates to the underlying right that the appraisal remedy was designed to address. That right is the entitlement of a dissenting stockholder "to be paid for that which has been taken from him, viz., his proportionate interest in a going concern."[135]

If the dissenting shareholder had succeeded in preventing the target from being acquired, as would have been possible under the unanimous approval requirement that pre-dated modern appraisal statutes, then the shareholder would have continued as an owner of shares in a going concern. Those shares would not have increased in value as a consequence of an acquisition transaction. It is for this reason that the Delaware appraisal statute, for example, directs the Court of Chancery to appraise fair value "exclusive of any element of value arising from the accomplishment or expectation of the merger . . . ."[136]

While a dissenter's monetary remedy in appraisal comports well with the purpose of appraisal statutes to compensate dissenters for the interests from which they have been deprived, it is overly restrictive as to conflict-of-interest contexts such as MBOs. Appraisal rights are the exclusive remedy of dissenting shareholders except where there has been a breach of fiduciary duty in the transaction.[137] Where a target shareholder is complaining not about the fact of the sale, as in an appraisal proceeding, but, rather, about the terms of the transaction being overly favorable to the buyer, as in a fiduciary-duty challenge, appraisal rights are not fully responsive to the concerns being raised. In a fiduciary-duty lawsuit, the focus of the claim is not on *fair* value (the shareholders' proportionate share of the value of the corporation were it to remain independent). Rather, it is on the *best* value that the fiduciary could obtain for the shareholders. "Best value" includes "whatever share of merger gains, including synergies, the company's directors are able to extract from the buyer through negotiation or a competitive bidding process, or both."[138] Such elements of value are simply not accounted for in the valuation process pursuant to appraisal.

[135] Tri-Cont'l Corp. v. Battye, 74 A.2d 71, 72 (Del. 1950).

[136] DEL. CODE ANN. tit. 8, § 262(h) (2016).

[137] *See* Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099, 1103-05 (Del. 1985).

[138] Lawrence A. Hamermesh & Michael L. Wachter, *Rationalizing Appraisal Standards in Compulsory Buyouts*, 50 B.C. L. REV. 1021, 1054 (2009).

V. Solutions to the Problem of Asymmetric Information in MBOs

The fiduciary duty of loyalty under state corporate law requires that officers and directors carry out their responsibilities in the interest of the corporation and its shareholders without regard to any conflicting personal interests. In circumstances that do not raise conflict-of-interest concerns, courts have readily applied the deferential business judgment rule in reviewing board action. But where circumstances raise concerns that officers or directors may be furthering their own interests at the expense of the corporation's shareholders, courts have fashioned mechanisms designed to protect shareholders from opportunistic behavior. In doing so, courts have allowed procedural protections aimed at replicating conditions of arm's-length bargaining to be used to avoid substantive entire fairness review. Procedural protections that the courts determine cleanse the taint of self-interest in board decision-making result in business judgment review.

As discussed in Part III.C, courts have placed their full faith in a neutral decision-making body — namely, disinterested directors or disinterested shareholders — to serve as a proxy for an uncompromised target board of directors. This mechanism, however, is not up to the task of sanitizing the conflict-of-interest inherent in MBO transactions. While replacing conflicted directors with disinterested directors is effective in protecting against opportunistic behavior by managers on the sell-side, it fails to address the ability of conflicted managers to behave opportunistically on the buy-side. In particular, as discussed previously, conflicted managers remain capable of both timing a transaction to their advantage and exploiting soft information in negotiations.

The additional procedural safeguard used in the controlling shareholder transaction at issue in *M&F Worldwide*[139] — approval of the deal by an informed vote of a majority of disinterested shareholders — does not add any meaningful protection for public shareholders in an MBO. Like disinterested directors, those shareholders are at an informational disadvantage with respect to the value of their company. Indeed, unlike in controlling shareholder transactions, there is no need in an MBO for disinterested shareholders to provide a check on a board that may be dominated by the controlling shareholder. In an MBO, both disinterested directors and disinterested shareholders have less complete information than management about the target and its prospects.

[139] 88 A.3d 635 (Del. 2014).

As a result, existing procedural devices used to address conflicts of interest in non-MBOs are ill-suited to addressing conflicts of interest in MBOs. There is a crucial distinction between the two settings that a full solution to the MBO conflicts problem must address. In a non-MBO, the acquiror is a third-party, meaning that it is not affiliated with the target. In an MBO, however, the acquiror includes key corporate insiders of the target. To replicate arm's-length bargaining conditions in an MBO, it is therefore not enough to remove the conflicted party from the decision-making process within the target organization. Achieving arm's-length bargaining conditions depends on the further condition that both the buyer and the seller be symmetrically informed with regard to the target.

1. Previously Advanced Solutions

Echoing the common law rule making all interested-director transactions voidable at the election of the corporation,[140] it has been suggested that MBOs should be absolutely prohibited.[141] Such a solution would be extreme, however. Like conflict-of-interest transactions outside the MBO setting, MBOs have potential efficiency benefits that can enhance social welfare.[142]

A key source of value-creation in MBOs arises from reducing agency costs. Managerial incentives in companies that have gone private as a result of an MBO tend to be more high-powered than those that are the product of incentive compensation arrangements within public companies.[143] Compensation arrangements following MBOs enhance managers' incentives to maximize shareholder returns in two ways. First, managers are less incentivized to shirk. Second, greater sensitivity of managerial compensation to firm performance increases managers' willingness to assume risk in making business decisions.[144]

[140] *See supra* notes 53–54 and accompanying text (discussing the *Guth* case, which dealt with direct self-dealing).

[141] Dan R. Dalton, *The Ubiquitous Leveraged Buyout (LBO): Management Buyout or Management Sellout?*, BUS. HORIZONS, July–Aug. 1989, at 36, 41.

[142] *See* Joseph A. Grundfest, *Management Buyouts and Leveraged Buyouts: Are the Critics Right?*, *in* LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES, *supra* note 73, at 241, 242; Roberta Romano, *Management Buyout Puzzles*, *in* LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES, *supra* note 73.

[143] Grundfest, *supra* note 142, at 243-44.

[144] *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225, 243 (1990); *see also* Joseph G. Haubrich, *Risk Aversion, Performance Pay, and the Principal-Agent Problem*, 102 J. POL. ECON. 258, 263-66 (1994) (noting that, in the presence of managerial risk-aversion, even low pay-performance sensitivities can provide meaningful incentives, but finding that for most

Thus, MBOs can enhance managerial incentives through more efficient compensation contracts that induce and reward performance.

Other commentators have suggested that the sale process for MBOs be conducted solely through mandatory auctions.[145] There are multiple methods that can be employed in selling a business, ranging from a privately negotiated sale to a public auction. In a negotiated transaction, the seller bargains exclusively with one party. The process is confidential and rapid. It does not, however, generally provide the seller with much leverage. In contrast, a robust auction can serve to elicit bids from multiple buyers that reveal their various reservation values for the target.[146] Competitive bidding thus deserves consideration as a way to curb managerial overreaching in MBOs.

While market competition can serve as a mechanism for increasing a target's purchase price in an acquisition, it is not a panacea. In cases controlled by *Revlon*, for example, target boards are required to adopt a sale process that involves confirming that they have maximized value for shareholders. Courts have been careful not to mandate an auction as the sole mechanism for accomplishing this end, however, in large part because auctions can be disruptive to a target's business.[147]

The broader point is that market competition, whether through mandatory auctions or otherwise, cannot deal fully with the problem of predatory MBOs. Introducing market competition into the MBO process can ensure that potential acquirors who place a higher value on the target than management is proposing for the company will be able to outbid the MBO group. Nevertheless, management is still in a position to manipulate downward the reservation prices of both the seller and third-party bidders and thereby acquire the target below its

plausible risk aversion parameters, meaningful pay-performance sensitivities are greater than the values observed by Jensen and Murphy).

145 *See* Dari-Mattiacci, *supra* note 45, at 14-15 (arguing that "auctions may effectively solve the inverse adverse selection problem"); Lowenstein, *supra* note 34, at 742, 779; Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1061 (1997); Bill Shaw, *Resolving the Conflict of Interest in Management Buyouts*, 19 HOFSTRA L. REV. 143, 163-65 (1990); Nicholas Williams, *Procedural Safeguards to Ensure Fairness in the Management Buyout: A Proposal*, 21 COLUM. J.L. & SOC. PROBS. 191, 212-15 (1988). *Contra* Richard A. Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. REV. 630, 653-56 (1985) (disagreeing with mandatory auction proposals on the grounds that bidding will be chilled if management retains the right to take the company off the market).

146 DAVID EASLEY & JON KLEINBERG, NETWORKS, CROWDS, AND MARKETS: REASONING ABOUT A HIGHLY CONNECTED WORLD 251 (2010).

147 *See, e.g.*, *In re* Lear Corp. S'holder Litig., 926 A.2d 94, 104, 119 (Del. Ch. 2007) (acknowledging legitimate corporate concerns that an auction would disrupt the target's business).

true fair market value. In addition, management can choose to initiate the transaction at an advantageous time. Finally, as long as the MBO group has asymmetrically superior information relative to the target board, a gems market for the target will exist, so that not all economically efficient transactions will take place.

Professors Oesterle and Norberg have recommended that an MBO group be required to disclose to target shareholders its reservation price and future plans for the target if the board does not establish a special negotiating committee that is provided with all material information relevant to valuation (other than the buyout group's plans for the firm).[148] As the authors note, they would apply this requirement as a penalty only in the event a special committee is not established.[149] In addition, some courts have stated explicitly that the fiduciary duty of disclosure does not require affiliated buyers to reveal their private valuations of the target.[150] Similarly, federal securities law does not require affiliated buyers to reveal their reservation prices for the target.[151] It is unlikely that such a requirement could be implemented practically, in any event. Parties have strong economic incentives to conceal their reservation prices and would therefore be unlikely to disclose them accurately. In addition, going to such an extreme would result in allocating the entire joint value from the acquisition to the seller's shareholders. As a result, relative to third-party bidders, the MBO group would be disadvantaged in its negotiations, and even efficient MBOs — those in which management would be willing to pay the highest premium for the target — would be chilled.

Alternatively, courts could enhance their scrutiny of MBOs by adopting the entire fairness standard of review for MBOs without regard to whether procedural safeguards are used in the transaction. Such an approach would constitute a rejection of the notion that procedural protections can be effective in MBOs. Rather than relying on procedural mechanisms, such as independent boards or special committees, or disinterested shareholder voting, to fulfill the neutral decision-making function of an unconflicted board of directors, courts would substantively review MBOs under the entire fairness standard.

The entire fairness standard of review, considered the strictest form of judicial scrutiny in business law, places the burden of proof on the

[148] Dale A. Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 255 (1988).

[149] *Id.* at 256.

[150] *See, e.g.*, *In re* Lear Corp. S'holder Litig., 967 A.2d 640, 651 (Del. Ch. 2008).

[151] *See supra* notes 102–14 and accompanying text (discussing prohibitions on insider trading).

board of directors to demonstrate that "entire fairness" of the transaction.[152] In order to carry its burden, the board must prove that it engaged in *both* a procedurally fair sale process and obtained a substantively fair price.[153]

There is a strong trend in Delaware jurisprudence, however, toward using procedural protections in lieu of substantive review in merger and acquisition transactions. The judiciary has repeatedly commented on its institutional limitations in determining the attractiveness of a particular transaction. Indeed, the incorporation of a process component into even entire fairness review is indicative of the courts' reluctance to engage in substantively evaluating the economics of business transactions.

In addition to running counter to the judicial trend away from substantive review of the fairness of transactions, invoking entire fairness review does not address the underlying problem of asymmetric information in MBO transactions. A process, even when perfect, cannot overcome the problem of asymmetric information. Just as a flawed process can lead to an inadequate price, so too can asymmetric information. In other words, under prevailing judicial notions of what constitutes fair process in acquisition transactions, predatory MBOs would be able to pass muster. Fair process, in turn, is considered indicative of fair price.[154] Thus, like market competition through mandatory auctions discussed above, entire fairness review is likely to allow managers in MBO transactions to purchase the target company on self-serving terms.

2. Proposed Solutions

The foregoing solutions, which have been proposed to rectify the managerial opportunism associated with MBOs, suffer from the same weaknesses as existing law. In each case, attention is focused primarily on neutralizing the conflict of interest that managers experience on the sell-side of the transaction; *i.e.*, their interest in transferring ownership of the business at a price below its fair market value.

[152] *See* Weinberger v. UOP, Inc., 457 A.2d 701, 709-10 (Del. 1983).

[153] Cinerama, Inc. v. Technicolor, Inc. (*Technicolor Plenary IV*), 663 A.2d 1156, 1163 (Del. 1995).

[154] BALOTTI & FINKELSTEIN, *supra* note 100, § 4.19 n.1132 ("Evidence of fair dealing has significant probative value to demonstrate the fairness of the price obtained."). Interestingly, the converse is not true. *See In re* Nine Sys. Corp. S'holders Litig., No. 3940-VCN, 2014 WL 4383127, at *47 (Del. Ch. Sept. 4, 2014) (court could not reach a conclusion that the transaction was entirely fair solely on the basis of fair price where process undertaken was grossly inadequate).

Establishing a neutral decision-maker on the sell-side of an MBO transaction is necessary but not sufficient, however, to achieving arm's-length bargaining conditions.

Restricting opportunistic behavior in MBOs also requires implementing measures to neutralize the conflict of interest that managers experience as bidders on the transaction's buy-side. In that capacity, managers are also in a position to take advantage of asymmetric information they possess. A complete solution to the problem of predatory MBOs thus requires, in addition to removing managers from the decision-making apparatus in the buyer organization, equalizing access to information relevant to the valuation of the target.

There are two approaches that the law can take to equalizing access to such information.[155] One is to make fuller information available to the seller's designated neutral decision-maker and all potential bidders. The other is to restrict the information available to them. The objective in each case is to ensure that conflicted managers are not able to use their privileged positions as corporate insiders to their advantage in acquisition negotiations.

The first approach to preventing managers from exploiting asymmetric information in MBOs — fuller disclosure — would involve going beyond existing disclosure requirements under corporate and securities law to encompass all soft information in management's possession. As discussed in Parts III and IV, existing corporate and securities law disclosure obligations require only minimal disclosure of soft information by the MBO group.[156]

A fuller disclosure regime in the context of MBOs would require participating managers to disclose to the neutral decision-making party of the target all soft information, including projections of revenues, income, or earnings that the managers anticipate the target will achieve after having gone private. This formulation recognizes that acquisitions create value. In a strategic acquisition — one in which the buyer is likely to be an acquirer active in the same industry as the target company — value is created mainly through synergies that arise from the transaction. MBOs fall into the category of financial acquisitions — those in which buyers are motivated primarily by the opportunity for investment returns. Financial acquirors generally create value through efficiencies available from implementing financial and operational controls on the business. Such efficiencies constitute

[155] *See* PERLOFF, *supra* note 25, at 231.

[156] *See supra* Parts III.B, IV.

agency cost savings that arise from the unification of ownership and control. These savings represent a portion of the joint surplus that the MBO could generate and should rightfully be available to target shareholders in MBO negotiations.

As a legal matter, the foregoing fuller disclosure solution could be readily incorporated into existing corporate law. In order to fulfill their duty of disclosure under the fiduciary duties of care and loyalty, managers who engage in an MBO would be required to reveal soft information in their possession. As a related matter, a board or group of unaffiliated shareholders serving as the target's neutral decision-making authority for purposes of approving the transaction would not be deemed fully informed if it were not provided with such information. An independent board may well negotiate effectively on behalf of the target's shareholders, but the deal it ultimately strikes is still susceptible to manipulation by asymmetrically informed management. Similarly, effective shareholder ratification presumes that shareholders have all information necessary for them to value the target. As a condition precedent to obtaining business judgment level review in MBOs, there would therefore need to be fuller disclosure by managers.

A fuller disclosure regime could also be incorporated by the SEC into the federal securities laws pursuant to its rule-making authority under Section 13(e) of the Securities Exchange Act of 1934. Rule 13e-3 already provides important protections to target shareholders in MBO transactions. Specifically, target shareholders receive information via Schedule 13E-3 about managers' beliefs regarding the fairness of the transaction. They also receive any fairness opinions or similar reports prepared relating to the transaction.[157] It would be a short commute for the SEC also to require financial projections to be disclosed and filed as part of Schedule 13E-3.

Note that "fuller disclosure," as contemplated above, would not go so far as to require management to reveal its reservation price for the target. Management would continue to be permitted to withhold that information and purchase the target at a price that provides it with a share of the joint value associated with the transaction. A policy of fuller disclosure would, however, limit differences in the valuations of the participants in the transaction. These differences would be confined to sources of gain attributable to the unique characteristics or strategic plans of an acquiror and not to hidden characteristics of the target that are asymmetrically known by the MBO group.

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157 *See supra* notes 73–75 and accompanying text.

An alternative approach to equalizing information among buyers and sellers in MBOs is to take the opposite approach to that of providing fuller disclosure to the decision-makers in the transaction. This would involve restricting the information to which those decision-makers have access. Recall that our aim is to ensure that conflicted managers cannot take advantage of their positions as corporate insiders to advantage themselves in acquisition negotiations. Such an outcome can also be obtained if the conflicted decision-maker is removed entirely from the decision-making process within the buyer organization so as not to be able to take advantage of any asymmetric information in its capacity as a buyer. As already mentioned, existing law does a good job of encouraging fiduciaries with conflicts of interest to withdraw from decision-making within the target. It is now rare to observe an MBO that does not make use of the procedural safeguards of an independent special negotiating committee to represent the target in the transaction, an unaffiliated-shareholder vote, or both.

Restricting the ability of asymmetrically informed managers to take advantage of hidden information about the target requires turning equal attention to the position of those managers as decision-makers within the MBO group. Just as the law already encourages fiduciaries with conflicts not to participate in deliberating or negotiating on behalf of the target in MBO transactions, it could similarly encourage conflicted managers to remove themselves from participating in the acquisition process on behalf of the MBO group. Equalizing information in this way would also limit management's ability to self-deal in the MBO process.[158]

CONCLUSION

At present, state corporate law and federal securities law do not adequately prevent management from exploiting its access to asymmetric information about the target in its capacity as the buyer in an MBO transaction. As a result, existing law leaves open an important avenue by which management can exploit unaffiliated target company shareholders. It also gives rise to a market for gems in the MBO segment of merger and acquisition transactions. Inherent in MBO transactions is a tension between (1) management's fiduciary duty

[158] Although predatory management buyouts can in theory be addressed either through fuller disclosure or buy-side procedural safeguards, from an economic efficiency perspective, the former approach is superior because it promotes more accurate pricing and thus more efficient resource allocation.

under state corporate law to place the interests of the target company's shareholders above its personal interests and (2) management's self-interest in purchasing the target company on favorable terms. Under existing corporate law, MBOs are treated no differently than ordinary conflict-of-interest transactions. State corporate law procedures that install a neutral decision-maker within the target to approve the MBO are deemed to sanitize conflicts. Federal securities law takes a disclosure-based approach to MBO transactions, requiring managers to disclose the purposes of the transaction and information relating to its fairness. The foregoing measures are insufficient, however, to produce the equivalent of an arm's-length transaction. Rather, conditions of asymmetric information inherent in MBOs justify enhanced procedural safeguards on the buy-side in order to equalize the asymmetric information that exists as between management on the one hand and non-management directors and shareholders on the other.