Resolving the Conflict of Interest in Management Buyouts

Bill Shaw
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I. INTRODUCTION

During the 1980's, the securities market saw tremendous growth in the area of mergers and acquisitions. Whether in reaction to the threat of a hostile takeover or as a result of an affirmative desire to enhance the profitability of the enterprise, numerous devices have appeared to finance corporate reorganizations. One such device is the management buyout.

The management buyout is "a species within the corporate genus of leveraged buyout." The typical leveraged buyout involves the sale of assets or shares of an existing company to a new entity formed for that specific purpose, followed by a distribution of cash or securities of the new entity to the public shareholders. Generally, the acquiring entity borrows the cash to "take-out" the existing shareholders and uses the assets of the acquired company as collateral. Lenders are often willing to furnish the cash in the hope of large returns. In the management buyout, the senior management of the acquired company holds the equity in the acquiring company. Essentially, management uses the resources, the credit and the proxy mechanism of the firm to eliminate public ownership.

Management buyouts produce benefits for all parties involved.

2. See id. at 519; Lowenstein, Management Buyouts, 85 Colum. L. Rev. 730, 732 (1985). Management may use either a one-step or a two-step merger to effect the buyout. A one-step merger is appropriate where management owns a controlling block of shares prior to the buyout which it transfers to a new entity. A two-step merger requires a tender offer to acquire a controlling block of shares prior to the buyout. After acquiring enough shares, management forces the minority shareholders to receive cash for their shares under state merger statutes. Id.; see also Note, Corporate Morality and Management Buyouts, 41 Wash. & Lee L. Rev. 1015, 1018-19 (1984) (authored by Stuart Robin Kaplan) (discussing several going-private techniques).
3. See DeMott, supra note 1, at 519; Lowenstein, supra note 2, at 732; Comment, Regulation of Leveraged Buyouts to Protect the Public Shareholders and Enhance the Corporate Image, 35 Cath. U.L. Rev. 489, 491 (1986) (authored by Gregory J. Schwartz); Panel discussion on "Leveraged Buyouts and Hostile Takeovers: Sound Corporate Restructuring or Wall Street Alchemy?" (May 16, 1989) (Federal News Service, NEXIS, Fednew) [hereinafter Panel Discussion] (Chairman Ruder discussing the financing of takeovers and leveraged buyouts).
4. See DeMott, supra note 1, at 531.
5. Id. at 519.
6. See Lowenstein, supra note 2, at 734.
7. See Booth, Management Buyouts, Shareholder Welfare, and the Limits on Fiduciary Duty, 60 N.Y.U. L. Rev. 630, 641 (1985). For a complete discussion of the benefits of management buyouts, see Lowenstein, supra note 2, at 754-67 (stating that although the management buyout has many advantages it also has signifigant transaction costs, including less ac-
First, and most important, is the premium above market value that public shareholders often receive in exchange for their shares.\(^8\) Because of this premium, public shareholders make a substantial profit on the sale of the shares. Likewise, management acquires a good investment. Free from the regulatory restraints placed on public entities,\(^9\) management, as the new owner, can focus on the long-term prospects of the firm and is more likely to realize substantial gains in the future.\(^10\) These gains result from more effective management which was not possible under the pressures of public shareholders and a short-term market. Overall, management buyouts may increase social welfare by efficiently allocating resources and reducing agency costs.\(^11\)

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8. See Oesterle & Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 222-27 (1988) (arguing that a company which has experienced a management buyout will be more efficient because the managers will have a financial interest in improving their own performance). There are numerous explanations for this premium. See id. at 222-34. First, management always values the firm’s stock higher than the shareholders because management views the stock as less risky and because management has an employment stake in the firm. See id. at 217; Repetti, *Management Buyouts, Efficient Markets, Fair Value, and Soft Information*, 67 N.C.L. REV. 121, 131 (1988) (discussing why management places greater value on the corporation’s stock). For a further discussion of why management values the company’s stock higher than does the market, see Booth, supra note 7, at 634-36. The second reason for the premium is that the management buyout produces significant tax benefits, such as increased interest deductions arising from the increased debt. See DeMott, supra note 1, at 534; Note, *Leveraged Buyout, Management Buyout, and Going Private Corporate Control Transactions: Insider Trading or Efficient Market Economics?*, 14 FORDHAM URB. L.J. 685, 711 (1986) (authored by Patrick S. Dunleavy) (going private produces an interest expenditure which in turn creates a corresponding decrease in taxable income). Lastly, going private allows management to focus on the long-term profit of the firm instead of the short-term market and shareholders. DeMott, supra note 1, at 537.


10. See Note, supra note 8, at 710-11; Gannon, supra note 9. A look at some management buyouts shows that the returns can be overwhelming. For example, insiders took Metromedia private for $1.1 billion and two years later sold less than all of its assets for $5.5 billion. SFN, Inc. went private for $450 million in 1985, and one year later, insiders sold out for $944 million. See Hector, *Are Shareholders Cheated by LBOs?*, FORTUNE, Jan. 19, 1987, at 99-100. The Metromedia transaction produced a return of 400% while SFN insiders realized 109.78%. Id. at 104. These returns are not available elsewhere in the money market. But see Booth, supra note 7, at 643 (suggesting that the returns may not be so extraordinary).

Notwithstanding the benefits of the management buyout, problems do arise in using this technique to finance an acquisition. The substantial debt incurred and corresponding interest payments create a sometimes overwhelming burden. In addition, the buyout can cause some disruption in the corporate climate. Perhaps the most significant problem that arises in this context is the conflict of interest inherent in the transaction itself.

II. CONFLICT OF INTEREST IN MANAGEMENT BUYOUT DEFINED

It is a well-settled principle of corporate law that management owes a fiduciary duty to the corporate shareholder. This duty requires managers to work for the good of the corporate enterprise.

(1982). On the other hand, the agent's gain at his principal's expense may eventually result in higher initial capital costs as investors discount shares for the possibility of later becoming the victim of an unfair buyout. See Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations, 71 Calif. L. Rev. 1072, 1083-84 (1983). These higher capital costs may discourage new start-up businesses and prevent established firms from acquiring needed capital.

12. See DeMott, supra note 1, at 535-36; Panel Discussion, supra note 3.

13. This disruption is particularly likely in the face of a hostile bid. Management may see such a bid as a threat to its future employment and respond with its own bid. See Oesterle & Norberg, supra note 8, at 212. In fact, internal stakeholders, such as managers and employees, bear the greatest risk in transfers of ownership such as a management buyout. See di Norcia, Mergers, Takeovers, and a Property Ethic, 7 J. Bus. Ethics 109, 115 (1988).

14. See Oesterle & Norberg, supra note 8, at 214; Repetti, supra note 8, at 122; Williams, supra note 7, at 191-92; Note, supra note 2, at 1016-17; Panel Discussion, supra note 3 (discussing the conflict of interest issue in a management buyout and disclosure rule 13(c)(3) of the security laws).


16. See Repetti, supra note 8, at 122; Note, Review of Board Actions: Greater Scrutiny for Greater Conflicts of Interest, 103 Harv. L. Rev. 1697, 1698 (1990) (reviewing the duties of a corporation's board of directors). The fiduciary obligation requires fair conduct on the
As part of its fiduciary obligation, management must refrain from self-dealing and, by hypothesis, ignore its own self-interest when that interest diverges from the interest of the shareholder.\textsuperscript{17}

As a result of the fiduciary responsibility owed by management, the buyout transaction by its nature creates a significant conflict of interest.\textsuperscript{18} In the management buyout, management sits on both sides of the transaction;\textsuperscript{19} it acts as the buyer and the seller, or rather as the agent of the selling shareholders.\textsuperscript{20} Since the buyer and seller in any transaction have differing goals, there will obviously be a conflict. While management has the fiduciary duty to obtain the best price for the shareholder, management, as the buyer, has the incentive to keep the price paid for the shares as low as possible.\textsuperscript{21} In this sense, there is a real potential for overreaching by management.\textsuperscript{22} To lower the price it pays for the shares, management may

\textsuperscript{17} Booth, supra note 7, at 639; W. Knepper & D. Bailey, LIABILITY OF CORPORATE OFFICERS & DIRECTORS §§ 3.02, 3.23 (4th ed. 1988); Stern & Kerr, supra note 15, at 404.

\textsuperscript{18} See Dunfee, Professional Business Ethics and Mergers and Acquisitions, in The Ethics of Organizational Transformation 15 (W. Hoffman, R. Frederick & E. Petry, Jr. eds. 1989); Repetti, supra note 8, at 122; Grierson, How to Avoid Potential Conflicts of Interest; Management Buyouts, Fin. Times, Mar. 28, 1989, at 23 (discussing the lack of arm's length negotiations and lack of equal access to facts as primarily contributing to a conflict of interest in a MBO).

\textsuperscript{19} See Lowenstein, supra note 2, at 732; Oesterle & Norberg, supra note 8, at 215; Williams, supra note 7, at 191-92; Note, supra note 8, at 713; Note, supra note 2, at 1017.

\textsuperscript{20} No one actually represents the shareholders. See Oesterle & Norberg, supra note 8, at 220; Williams, supra note 7, at 192 nn.4 & 5; see also Coffee, The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders, and Bust-Ups, 1988 Wis. L. Rev. 435, 448 (noting that directors are traditionally viewed as agents of shareholders).

\textsuperscript{21} See Repetti, supra note 8, at 122; Willcox, The Use and Abuse of Executive Powers in Warding Off Corporate Raiders, 7 J. Bus. ETHICS 47, 49 (1988); Note, supra note 2, at 1018; Knight, RJR Nabisco Chief Says He Bid Low for Firm; CEO's Comments Raise Conflict of Interest Issue in Buyout, Wash. Post, Nov. 29, 1988, at D1, col. 3 (reporting on a corporate president's statement that he is negotiating the best deal for the executive, not the shareholders).

\textsuperscript{22} See Dunfee, supra note 18, at 12 (stating that enormous returns create a temptation to conceal plans, coerce reluctant directors and misrepresent critical information). Note that while most commentators believe that the management buyout allows management to take advantage of the shareholder, one writer argues that it is the shareholder that takes advantage of management in the threat of a takeover and the management buyout is only a method of enforcing an implicit obligation owed to the managers. See Coffee, Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 24 (1986). Coffee argues that there exists an implicit contract between the shareholders and managers which defers management compensation until the end of the manager's career. This deferral works to the advantage of the shareholders as management works hard for the firm to advance within the corporate structure. On the other hand, if new owners come in, they can refuse to honor this implied
try to depress the market value of the stock by making imprudent business decisions or by not pursuing viable corporate opportunities.  

In addition to control of the firm, management also possesses knowledge of the selling company that is far superior to the knowledge of the shareholder. Thus, there is a risk that shareholders will be undercompensated for their shares. When management has control over the information used to judge the fairness of the offer, they have an incentive to exploit this information and get a bargain price for the stock. In fact, buyers often make offers that are fair, but lower than their reservation price, i.e., the price they are ultimately willing to pay. Shareholders, on the other hand, demand that management, as a fiduciary, disclose its ultimate valuation of the firm based on the information available to the insiders to ensure that management will not “lowball” the bid in a management buyout.

In a buyout, management walks a tightrope. However, it should not be judged too leniently. The stakes are high and informationally dysfunctional shareholders are placed at risk.

Given the inside position of management, the buyout may be viewed as a type of insider trading, that is, buying stock based on contract, and management will lose its job and deferred compensation. As a result, shareholders take advantage of managers by deferring compensation and then turning the company over to new management. Id.

23. See Lowenstein, supra note 2, at 743 (noting that management has the ability to depress the market price of stock, but it is doubtful whether management actually does so); Repetti, supra note 8, at 125 (stating that management may depress market value to avoid paying a higher price for stock in a buyout); Berkowitz v. Power Mate Corp., 135 N.J. Super. 36, 43, 342 A.2d 566, 570 (1975) (noting that depressed market prices induce insiders to repurchase public stock at a price far below the original cost). But see DeMott, supra note 1, at 539 (arguing that management may want to increase the cash flow of the company, which would increase market price, to attract financial partners in a management buyout).

24. See DeMott, supra note 1, at 555; Karns & Schnadler, Requiring Basic Disclosure of Preliminary Management Buyout Negotiations: Re-defining Rule 10b-5 “Materiality” After RJR Nabisco, 19 MEM. ST. U.L. REV. 327, 343 (1989) (suggesting that due to lack of information, shareholders do not receive fair market value for their shares); Knight, supra note 21.

25. See Note, supra note 8, at 718.

26. See, e.g., Knight, supra note 21 (starting at $75.00 a share in a management buyout of RJR Nabisco, while knowing it would be negotiated up).

27. See Oesterle & Norberg, supra note 8, at 244; Karns & Schadler, supra note 24, at 345-47 (discussing the RJR Nabisco bid in an attempted management buyout).

28. See DeAngelo, Accounting Numbers as Market Valuation Substitutes: A Study of Management Buyouts of Public Stockholders, 61 ACCT. REV. 400, 404-05 (1986) (discussing the various ways management can conceal financial information); infra notes 29-38 and accompanying text.
"soft" material information before public disclosure. On the basis of this information and its tactical advantage, management unilaterally sets the price paid for the shares. Often there are no other bidders seeking to purchase the enterprise for the simple reason that the outsiders do not have the superior information. Management clearly has the inside track. Furthermore, managers generally sit on the board of directors, which will ultimately decide whether or not to approve the proposed sale. Even if only independent outside directors (those having no direct stake in the buyout) are the ones allowed to approve the buyout, the close relationship between the inside and outside directors will likely favor the management proposal.

In addition to the appropriation of "soft" information, management may also gain from a public offering in the future. While shareholders receive a premium for their shares, there is no mechanism to assess the gain that would have been realized by the shareholders absent the buyout. Although some of the value is passed on through the premium over market price that is paid for the stock, the insiders receive most of the gain at the direct expense of the public shareholders. In this sense, management profits from doing what it was supposed to do in the first place; run a profitable enter-

29. See Booth, supra note 7, at 633; Oesterle & Norberg, supra note 8, at 218; Hiler, The SEC and the Courts' Approach to Disclosure of Earnings Projections, Assets, Appraisals, and Other Soft Information: Old Problems, Changing Views, 46 MD. L. REV. 1114, 1116 (1987) (describing "soft information" as "subjective analysis or extrapolation, such as projections estimates, opinions, motives or intentions"). See generally W. KNAPPER & D. BAILEY, supra note 17, at § 16.04 (discussing disclosure of soft information); Note, supra note 8, at 689-706 (discussing insider trading from a historical perspective, short-swing profits, and developments in the case law).

30. See Note, supra note 9, at 918; Note, supra note 8, at 713; Note, supra note 2, at 1018.

31. See Repetti, supra note 8, at 123-24 (noting that outside buyers cannot accurately value the corporation).

32. Williams, supra note 7, at 208 (suggesting that directors would be able to legitimately favor the management proposal if the preference is reasonably related to the interests of the shareholders and any financial assistance given to the managers is of a magnitude that would be upheld as severance compensation for the managers); see Coffee, supra note 22, at 90; see also Chazen, Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?, 36 BUS. LAW. 1439, 1453-54 (1981) (discussing directors' request for an adequacy opinion to support either an acceptance or rejection of an offer). But see DeMott, supra note 1, at 554 (noting that directors cannot ensure management proposal will trump other bidders).


34. See Note, supra note 9, at 906.
As a result, management may look only to its own interest in the firm and not that of shareholders. Such "self-dealing" might include the misappropriation of corporate assets by insiders. Like confidential information, destroying the public market for the firm's share is like appropriating a potential market for the firm. The corporate insider appropriates a real corporate asset to the exclusion and detriment of the public shareholder, that is, the profit to be made in taking the company public again.

III. CURRENT APPROACHES TO MINIMIZE THE CONFLICT AND WHY THEY ARE INADEQUATE

A. Fairness Opinions

In management buyouts, a device frequently used to address the conflict of interest is the fairness opinion. Often directors seek a fairness opinion from an investment banker to satisfy their fiduciary responsibility. A fairness opinion represents the investment banker's opinion as to whether the price offered is fair or adequate. Analogous to an independent auditor's opinion as to the fair presentation of the financial statements, the fairness opinion represents the view of a neutral third party outside the enterprise. By design, the investment banker prepares the fairness opinion for the selling shareholders to enable them to make an informed decision to sell. While

35. See Oesterle & Norberg, supra note 8, at 218-19.
36. Note, supra note 9, at 926.
37. Id. at 927.
38. Id. at 927-28.
39. Bebchuk & Kahan, Fairness Opinions: How Fair Are They and What Can Be Done About It?, 1989 DUKE L.J. 27, 28 (noting that under the business judgment rule, directors can rely on the fairness opinion of an investment banker in approving or rejecting a bid); see Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 YALE L.J. 119, 131 (1986) (authored by Robert J. Giuffra, Jr.). In Smith v. Van Gorkam, 488 A.2d 858 (Del. 1985), the Delaware Supreme Court held that the directors breached their fiduciary duty by approving a merger without adequate information because the directors did not seek a fairness opinion. Id. at 876-77. A fairness opinion may act as a "surrogate for full disclosure" to the shareholders and the market for assessing the adequacy of the price offered. DeMott, supra note 1, at 545.
41. Note, supra note 39, at 126. See generally Feuerstein, Valuation and Fairness Opinions, 32 BUS. LAW. 1337 (1977) (outlining the steps in rendering a fairness opinion).
42. See Note, supra note 39, at 122-23 (stating that fairness opinions assist and justify...
fairness opinions have "positive potential," there are problems with their use, namely the discretion afforded investment bankers in preparing the opinions and the conflict of interest experienced by the bankers.

Investment bankers have substantial discretion in deciding if the price offered in a management buyout is fair. Because the fairness opinion is highly subjective, the investment banker can often engage in opportunistic behavior, such as getting the highest price for an opinion favorable to management concerns. They are able to do this for several reasons. First, there is no clear definition of what is a "fair price," thus investment bankers may choose the definition that supports the opinion needed. Likewise, bankers use different methods of measuring fair price. The measurement can be based on a wide variety of information, assumptions and measurement techniques. More importantly, the investment banker bases the opinion on the information supplied, for the most part, by management. This information may be incomplete or inaccurate such that the fairness opinion as a whole is misleading.

While the degree of discretion given investment bankers makes fairness opinions less reliable, the conflict of interest arising in the interaction between management and the bankers also seriously impedes the integrity of the opinion. Often, the fee structure given to the investment banker creates an incentive for the banker to prepare a management opinion. Fees contingent on the approval of the directors' decisions and persuade shareholders to tender shares).

43. See Bebchuk & Kahan, supra note 39, at 51-52; see also Williams, supra note 7, at 205 (noting that a fairness opinion is not complete protection from overreaching by management, but it is a useful step).
44. See Bebchuk & Kahan, supra note 39, at 29-30; Note, supra note 39, at 128.
46. Id. at 30; Note, supra note 39, at 128.
47. See Bebchuk & Kahan, supra note 39, at 30. "Fair price" is not the highest price obtainable for the shares, but it is a price within a range that a reasonable prudent board would accept for the company. Id. at 33 n.34; see also Chazen, supra note 32, at 1455 (discussing the difference between a fair price and the best price); Bebchuk & Kahan, supra note 39, at 31-32 (noting that the term "fair price" may carry different values, such as the value of a company as an independent entity, the value received if auctioned to the highest bidder, or the value resulting from bilateral arm's length bargaining).
48. Bebchuk & Kahan, supra note 39, at 34; Chazen, supra note 32, at 1443-52.
49. Bebchuk & Kahan, supra note 39, at 36-37.
50. Id. at 52.
51. See id.
52. See id.
53. Id. at 38; Note, Platinum Parachutes: Who's Protecting the Shareholder?, 14 Hofstra L. Rev. 653, 669 n.120 (1986) (authored by Susan L. Martin).
buyout almost ensure an opinion favorable to management assuming one can be prepared within reason. Furthermore, where the investment banker is involved in other aspects of the transaction, such as providing financial support for the deal, an unfavorable opinion jeopardizes future fees to be paid to the banker; therefore, the push is for a favorable opinion.

Outside the fee structure, investment bankers feel some pressure to render a pro-management opinion because of the desire to attract new clients and retain old clients. Unfavorable opinions are simply not good for business. Likewise, investment bankers often feel a certain amount of loyalty to the incumbent management of the enterprise with whom they have worked in the past. The fee structure, the business attitude and the loyalty factor all create an incentive to produce a fairness opinion favorable to the management proposal. In fact, fairness opinions may be of greater benefit to management in establishing the fairness of the buyout than to shareholders in assuring they receive a fair price.

B. Appraisal Rights

In most states, dissenting shareholders who do not wish to sell to management have a statutory right to require the court to place a value on their shares. This is known as the right of appraisal. Appraisal rights generally require that shareholders be paid...

54. Bebchuk & Kahan, supra note 39, at 38; see, e.g., Anderson v. Boothe, 103 F.R.D. 430, 436 (D. Minn. 1984) (holding that "a contingent fee arrangement between a target company and its investment banker could have the potential to taint the fairness opinion of the investment banker.").

55. Bebchuk & Kahan, supra note 39, at 38; DeMott, supra note 1, at 533-34; Oesterle & Norberg, supra note 8, at 211-13; Williams, supra note 7, at 204.

56. See Oesterle & Norberg, supra note 8, at 211, 249-50 (criticizing fairness opinions as being biased in favor of management); Williams, supra note 7, at 204-05 (discussing the lack of objectivity in a fairness opinion rendered by a banker with prior ties to management).

57. Bebchuk & Kahan, supra note 39, at 41.

58. Id. at 42-43.

59. Supra notes 52-58 and accompanying text.

60. See Note, supra note 2, at 1037.


equivalent value for their shares. While appraisal rights provide some protection to shareholders in a management buyout, appraisal is, for the most part, an inadequate remedy. A solution involving appraisal rights assumes that a dissenting shareholder has the resources to seek judicial review of the buyout. Often shareholders do not have the time or the inclination to appraise the value of their stock. In court, shareholders face litigation delays and a small likelihood of success. Even if a shareholder is successful in receiving the equivalent value for his shares, to be made completely whole, he must still find an equivalent investment, which may be difficult to do. In other words, appraisal rights award shareholders the equivalent in cash, but not an equivalent investment.

Perhaps the most glaring deficiency in the appraisal remedy is the risk that the shareholder will be undercompensated. Courts are not skilled at valuing stock, and they face the same difficulties in valuation that others face. The courts' emphasis on past earnings and market price is likely to undercompensate the shareholder by ignoring possible increases in value. It is difficult to determine the true value of stock when the current price of the firm's stock is depressed, particularly when it is depressed at the hands of inept or manipulative management. The shareholder may seek to have the court look at past trends of the business rather than the current market price, but the kind of information that would boost market price is in the hands of insiders who are not likely to divulge it. The outside shareholder simply has no way of proving with certainty

63. Note, supra note 2, at 1024; Fischel, supra note 62, at 876.
64. For a discussion of the inadequacy of appraisal, see Booth, supra note 7, at 650-53; Note, supra note 2, at 1025-27.
65. See Booth, supra note 7, at 641 (characterizing shareholders as passive investors); Porrata-Doria, The Restructuring of the Relationship Between Shareholders and the Corporate Entity: Reflections on Berle & Means, 94 Dick. L. Rev. 99, 104-05 (1990) (discussing Professors Berle & Means' theory of the relationship between a corporation's shareholders and management where the shareholders lack any control); Repetti, supra note 8, at 132 (commenting on shareholders' lack of knowledge).
67. Brudney, supra note 66, at 1023.
69. See Brudney & Chirelstein, supra note 68.
70. See Brudney, supra note 66, at 1024-25; Brudney & Chirelstein, supra note 68.
71. Brudney, supra note 66, at 1024-25.
what the enterprise is truly worth. Moreover, the appraisal price does not permit the shareholder to reap the benefits of the buyout because the court values the shares of the old entity, not the new enterprise. In general, appraisal rights are a poor substitute for other protection as they preclude challenge in all but the most egregious cases. Appraisal rights are simply “not responsive to the problem of fiduciary abuse.”

C. Rule 13e Disclosure

The Securities and Exchange Commission (SEC) has promulgated disclosure rules that apply to some management buyouts. In a management buyout, Rule 13e requires disclosure of whether the issuer believes the transaction to be fair to minority shareholders. In addition, the issuer must disclose on schedule 13E-3 the material factors upon which that belief is based and the weight assigned to each factor. Of course, these disclosures are, once again, under the control of management and, as a result, may be incomplete or even inaccurate. The SEC permits the use of a fairness opinion to satisfy this requirement.

While the disclosure requirements of Rule 13e are admirable, the rule requires only that management give an informed opinion of the transaction, and it is unlikely that management will give anything but a favorable rating to its own deal.

72. See Brudney & Chirelstein, supra note 68, at 306.
73. See Booth, supra note 7, at 652; Brudney & Chirelstein, supra note 68, at 305.
74. See Brudney, supra note 66, at 1025.
75. Brudney & Chirelstein, supra note 68, at 306.
76. See 17 C.F.R. § 240.13e-3 (1990). In addition, two states, Wisconsin and California, have rules governing going-private transactions. See Wis. Admin. Code § 6.05 (Dec. 1990); Cal. Corp. Code § 1101 (West 1984). These rules, however, provide only minimal protection to shareholders. See Williams, supra note 7, at 200-01. The Wisconsin rule has four requirements: (1) the terms of the transaction are fair to all; (2) the price paid is greater than the public offering price; (3) there is shareholder approval; and (4) there is full disclosure. Id. Note that California requires that the State Commissioner of Corporations approve the fairness of the transaction. Id.
77. See 17 C.F.R. § 240.13e-100 (1990). For a complete discussion of Rule 13e, see Gannon, supra note 9, at 63-73; Repetti, supra note 8, at 143-44; Williams, supra note 7, at 196-200; Note, supra note 8, at 715-18; Note, supra note 2, at 1034-36.
79. See id. (requiring a disclosure of whether a report, opinion or appraisal was rendered by a third party including, but not limited to, the fairness of the transaction and the content of the third party’s findings).
80. Williams, supra note 7, at 199-200.
D. Independent Negotiating Committee

To reduce the conflict of interest, directors often establish a special committee of disinterested directors to evaluate the management proposal. This approach ranges from a formal separate committee to an excusal of interested directors from meetings concerning the buyout. Under the business judgment rule, the presumption of good faith is heightened when a majority of the board considering the buyout is not part of management, but is composed of outside directors. Obviously review of the management proposal by management itself is essentially self-approval and, thus, "blatantly unfair." Using an independent committee, then, may avoid the appearance of impropriety.

Generally, approval by the independent directors should be a reliable indicator of the fairness of the management proposal because the directors have knowledge of the firm's value and their primary duty runs to the shareholders. Two factors, however, may undermine this theory. Sometimes outside independent directors do not really know the value of the firm as well as inside management does, and outside directors rely on information provided by management just as shareholders do. In addition to this lack of relevant information, there is also a risk that the outside directors' loyalty to management may outweigh their sense of obligation to the shareholders. As a result, a truly independent committee may be difficult to establish. Still, approval by an independent negotiating committee with strong, active directors, rather than rubber stamps for management, may provide substantial protection of shareholder interests.

81. Id. at 205-06; Note, supra note 39, at 133 n.81. Courts have endorsed the use of a special committee. See DeMott, supra note 1, at 544 (citing Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); Hanson Trust PLC v. ML SCM Acquisition Inc., 781 F.2d 264 (2d Cir. 1986); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983)).
82. Williams, supra note 7, at 206.
83. Id.
84. Id.
85. See id. at 207; see also Dunfee, supra note 18, at 12 (noting that approval by outside independent authority with no direct interest may resolve conflict).
86. Williams, supra note 7, at 207.
88. Oesterle & Norberg, supra note 8, at 242-43; Williams, supra note 7, at 208.
89. Williams, supra note 7, at 208-09.
E. Shareholder Vote

Yet another method of addressing the conflict is the shareholder vote: making the management buyout contingent upon approval by a majority of the selling shareholders. The price offered must be high enough to convince a majority of shareholders to accept the proposal. With the shareholder vote, a shareholder can accept or reject the proposed price without tendering his shares. Consequently, there is no fear of being abandoned to the uncertainty of appraisal by the courts or a freeze-out in a successful tender offer. If management wins a majority, all shareholders sell at the original offer price; if not, no one sells.

As a method of ensuring the fairness of the management buyout, however, the shareholder vote may be of limited usefulness. Generally, the shareholder vote does not establish a price within the same range that an arm’s length negotiation would produce. First, shareholders have no ability to bargain with the buyout group, that is, the shareholder vote is a “take it or leave it” proposition. Second, as discussed above, shareholders have little information with which to assess the fairness of the proposal. What information shareholders do have comes from management, with the exception of the “disinterested” fairness opinion. Lastly, management can almost be assured of a favorable vote because scattered shareholders cannot rely on group action and because management can control the timing and circumstances under which approval of the transaction is sought.

On the other hand, the shareholder vote may be the best protection of shareholders for the simple reason that it takes the decision

90. Booth, supra note 7, at 658.
91. See Chazen, supra note 32, at 1471 (noting the fact that the shareholders have the option to reject an offer).
92. Booth, supra note 7, at 658.
93. Chazen, supra note 32, at 1476.
94. Id.
95. See id. at 1475; Lowenstein, supra note 2, at 735-36.
96. See Booth, supra note 7, at 659; see also Chazen, supra note 32, at 1475. (noting that if management walks away, shareholders may never get a better offer upon which to vote).
97. Chazen, supra note 32, at 1475.
98. Williams, supra note 7, at 209-10. Shareholders are not likely to spend the time and money to appraise the management buyout proposal; the cost of doing so outweighs any added benefit. See id. at 210-11.
99. Brudney & Chirelstein, supra note 68, at 300; Grierson, supra note 18 (noting that, in reality, collective shareholder strength is rare).
away from management and those close to management and gives it to the shareholders themselves. While shareholders may vote as management tells them to vote, this is not always true of institutional investors; therefore, the vote may be a cheaper and more reliable approach. The shareholder vote is also less coercive than a tender offer. It causes management to value the company higher than it would otherwise and may effectively deter management from overreaching by subjecting its conduct to serious scrutiny. If the shareholder vote is used in conjunction with the independent negotiating committee to get the inside information and with an investment banker to analyze the information, the vote may be the superior tool for judging management buyouts.

IV. PROPOSED SOLUTIONS TO MINIMIZE THE EFFECTS OF THE CONFLICT: PRO AND CON

A. Ban on Management Buyouts

Some commentators advocate a complete prohibition against the management buyout. In their view, the conflict of interest cannot be overcome by any measure. Management simply cannot be expected to represent the interests of shareholders when it is looking out for its own interest. Obviously, this proposal is the most extreme. As discussed above, the management buyout does provide benefits to both parties in the transaction. Shareholders receive a premium price per share, and management stands to make substantial gains in the future. A complete ban on management buyouts would deprive shareholders of the high profit that shareholders might reap. While it is true that the conflict of interest cannot be elimi-
nated, it can be minimized by the procedural safeguards discussed below. A complete ban on management buyouts is an unsatisfactory and simplistic solution to a complex problem.

B. Enhance Credibility of Fairness Opinions

One weakness in the procedural protection afforded shareholders is the misuse of the fairness opinion. As discussed above, fairness opinions can be helpful to shareholders and others in evaluating the fairness of a proposal. In fact, some commentators suggest that the cornerstone of fairness to shareholders is an honest, informed and complete opinion. To enhance the credibility of fairness opinions, they should be drafted by a reputable investment banker who is paid without regard to the success of the proposal and who has no financial stake in the transaction or prior ties to management. These limits help to ensure the objectivity of the one rendering the opinion. Alternatively, if it is not possible to abide by these constraints, the fairness opinion should, at the very least, disclose to the shareholder the relationship between management and the investment banker. In addition, the opinion should disclose a price evaluation and a detailed explanation of the information, assumptions and methods used to arrive at the conclusion. In this regard, the opinion should give a range of prices and provide some sensitivity to variations in the assumptions used. The fairness opinion should state unequivocally whether the price is fair. Likewise, the opinion should be

110. See id. at 778 (noting that some conflict is inescapable).
111. See infra, notes 113-89 and accompanying text.
112. Lowenstein, supra note 2, at 778 (recognizing the need for a "principled" solution).
113. Oesterle & Norberg, supra note 8, at 249.
114. Id. at 251; see Note, supra note 39, at 119-41 (discussing the importance of a properly prepared complete opinion).
115. Note, supra note 39, at 119-41; Williams, supra note 7, at 230. Similar to the rule for accountants rendering opinions on financial statements, contingent fees should not be allowed in rendering fairness opinions. See Bebchuk & Kahan, supra note 39, at 50 n.113.
116. See Williams, supra note 7, at 205.
117. See Feuerstein, supra note 41, at 1339; Bebchuk & Kahan, supra note 39, at 53. Bebchuk and Kahan provide numerous suggestions for enhancing the credibility of fairness opinions, many of which are discussed here. However, their suggestions are directed at judicial scrutiny of fairness opinions. I suggest that investors not wait for the courts, but that regulation, or self-regulation, be imposed.
118. See Feuerstein, supra note 41, at 1338-40; Oesterle & Norberg, supra note 8, at 252.
120. See Oesterle & Norberg, supra note 8, at 252.
made public some time before the buyout occurs to permit the shareholders to evaluate its conclusions.\textsuperscript{121}

As an additional safeguard, the fairness opinion should be subject to thorough review by a special independent committee.\textsuperscript{122} The committee should determine whether the information disclosed to the investment banker is accurate and whether the investment banker followed accepted valuation procedures.\textsuperscript{128} In fact, the committee might consider hiring a second investment banker to review the opinion.\textsuperscript{124} While this procedure would be helpful, it involves additional cost and may even be impossible to implement.\textsuperscript{126}

Finally, some commentators suggest that investment bankers should be held liable as fiduciaries to the corporation for an opinion drafted while under a conflict of interest or without adequate investigation or information.\textsuperscript{128} In this sense, liability would be analogous to that which is placed on accountants who render opinions on financial statements.\textsuperscript{127} This would require the adoption of standards by which to judge a banker's conduct. While liability may be the end result of the imposition of such standards on investment bankers in rendering fairness opinions, it is the standards that are important. Investment bankers should adopt internal procedures on an industry-wide basis to enhance the integrity of their opinions and their profession. Until such time as such procedures become a reality, courts may find it appropriate to apply a strict liability or, perhaps, a negligence standard of tort liability.\textsuperscript{128}

\textsuperscript{121} Williams, supra note 7, at 231.
\textsuperscript{122} See Oesterle & Norberg, supra note 8, at 255.
\textsuperscript{123} See id. at 251-52 (discussing the contents of a proper fairness opinion).
\textsuperscript{124} Bebchuk & Kahan, supra note 39, at 50-51. Note that while a second investment banker may be more neutral, one might be hard to find. Banks may be unwilling to second-guess a colleague and may fear ostracism by the financial community.
\textsuperscript{125} See id.; Note, supra note 39, at 135-39.
\textsuperscript{127} Note, supra note 39, at 135-39.
\textsuperscript{128} A negligence standard consists of five elements: a duty; breach of that duty; cause in fact; proximate cause; and damages. T. Vandall, Strict Liability 44-46 (1989) According to Restatement (Second) of Torts § 552 (1976), a person is liable for negligent misrepresentation if, in the course of his business or profession, he fails to exercise reasonable care or competence in obtaining or communicating information to one who justifiably relies on that false information and suffers a pecuniary loss. If the investment banker was not reasonable in rendering his opinion according to community standards, he would be considered to have breached his duty of care. Note, supra note 39, at 135.
C. Strengthening Independent Negotiating Committee/Limits on Directors

Some writers advocate that the independent negotiating committee discussed above play a greater role in management buyouts. At the same time, others suggest that there should be limits as to what directors can do. The ideal committee should have no direct ties to management, and its sole goal should be to make certain that shareholders receive the maximum value for their stock. Compensation for the committee would be tied to the premium over the market price that it negotiates for the shareholders. The committee should act solely on behalf of the shareholders and bargain for them when necessary. In fact, the committee should include a specially elected shareholder representative to further protect shareholder interests.

The committee should solicit an independent fairness opinion from an unbiased investment banker. Using an independent negotiating committee, management should not have to reveal its reservation price so long as the committee has all information material to evaluating management’s bid. Moreover, the committee should encourage third-party bidders and should only maintain structural blocks against the acquisition in order to encourage more bids. In addition, the committee should transmit the fairness opinion to the shareholders along with a report of the independent committee stating approval or disapproval of the management bid, discussing other proposals and stating the reasons for its position.

The strict liability theory is not predicated on fault or a reasonable care standard, but rather on the policy of who should bear the loss. T. VANDALL, supra, at 43, 47. Causation and damages need only be present and exercise of due care is irrelevant. M. FRANKLIN & R. RABIN, CASES AND MATERIALS ON TORT LAW & ALTERNATIVES 469 (4th ed. 1987).

See, e.g., Oesterle & Norberg, supra note 8, at 255-58 (limiting management and directors use of devices that give the management group an advantage); Williams, supra note 7, at 205-09 (using independent committees as an internal control on the MBO).

DeMott, supra note 1, at 556.
Oesterle & Norberg, supra note 8, at 258.
Id.
Id. at 258-59.
Id. at 258 & n.178 (citing examples of successful negotiations by independent committees with no allegiance to management).
Oesterle & Norberg, supra note 8, at 257.
Id. at 256.
Id. at 255; see supra text accompanying notes 25-26.
See Oesterle & Norberg, supra note 8, at 256-57.
Williams, supra note 7, at 231. For a discussion of why the committee may prefer the management bid over others, see supra note 32 and accompanying text.
D. Requiring More Disclosure

Requiring disclosure of relevant information by management would also lessen the potential conflict of interest and address fiduciary concerns.\(^\text{140}\) Management has an obligation to disclose its final purchasing price to the shareholders and also any future plans for the enterprise.\(^\text{141}\) If management wants to negotiate as an ordinary buyer, then it must delegate its role as fiduciary, that is, as the seller's agent in the buyout.\(^\text{142}\) It can accomplish this through the creation of an independent negotiating committee.\(^\text{143}\) Requiring additional disclosure to shareholders may prevent overreaching by management.\(^\text{144}\)

Management should be required to disclose the purpose of the buyout, the amount and nature of the expected benefits and the mode of sharing the benefits of the buyout.\(^\text{145}\) This disclosure should aid shareholders and/or a committee in assessing the legitimacy of the proposal.\(^\text{146}\) Likewise, liability should attach to any misstatement in these disclosures.\(^\text{147}\)

One writer advocates SEC rules requiring enhanced disclosure to shareholders in management buyouts.\(^\text{148}\) In his view, a perfect

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\(^\text{140}\) In Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983), the Delaware Supreme Court observed that directors must disclose to shareholders all "germane" information, that is, information that a reasonable shareholder would consider important in deciding whether to sell. \(\text{Id.}\) at 710. While Weinberger did not concern a management buyout but rather a tender offer between related companies with interlocking directorates, the principle is the same. In Weinberger, the Court stated that when the same persons are on both sides of a transaction, they must exhibit the "utmost good faith and the most scrupulous inherent fairness of the bargain." \(\text{Id.}\) Fairness, in this sense, means fair dealing (including complete candor and due care) and fair price (including all relevant economic and financial factors). \(\text{Id.}\) at 711.

\(^\text{141}\) Oesterle & Norberg, \textit{supra} note 8, at 255.

\(^\text{142}\) \textit{See supra} notes 20-23 and accompanying text (discussing management conflict of interest and potential for overreaching when management acts as buyer and seller's agent).

\(^\text{143}\) \text{Id.; see also} Oesterle & Norberg, \textit{supra} note 8, at 255.

\(^\text{144}\) One commentator believes that courts should shift the burden of fairness to management even without a showing of self-dealing. \textit{See Note, supra} note 2, at 1042. In his view, the business judgment rule gives management too much leeway in making these decisions. \textit{Id.}

\(^\text{145}\) Brudney, \textit{supra} note 66, at 1039. As previously discussed, the only mandatory disclosure requirement is found in SEC Rule 13e, wherein management is obligated to disclose whether the buyout proposal is fair and the basis of this belief of fairness on a schedule 13E-3 form. 17 C.F.R. \S 240.13e-3 (1990); \textit{see also supra} notes 76-81 and accompanying text.

\(^\text{146}\) \textit{See supra} notes 76-79 and accompanying text.

\(^\text{147}\) \textit{Id.}

\(^\text{148}\) \textit{See Repetti, supra} note 8, at 164. The SEC has promulgated certain rules dealing with the disclosure of pro-forma financial statements and asset evaluations. \textit{See} 17 C.F.R. \S\S 229.10b, 230.175(a), 240.3b-6 (1990); Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) \$8 81,939, 82,117 (June 25, 1979). Since these rules do not \textit{require} release of such information, they would not be binding on management in a buyout

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market requires perfect information. Disclosure of information would attract more bidders and reduce shareholders' reliance on management for information. SEC rules requiring disclosure would allow monitoring by the SEC and would permit a tailoring of the rules to ensure that shareholders are not misled by the disclosures. Likewise, SEC rules would have national effect and would avoid the necessity of case-by-case determinations.

Additionally, management should be required to disclose asset appraisals and financial projections to quantify the effect of management's plans for future profits. Disclosing only the plans is not enough. Management should also be required to disclose and explain any differences between the information given to co-investors and creditors and that given to shareholders. Otherwise, management would have a vested interest in portraying the company negatively to shareholders and positively to financiers.

In the past, the SEC has discouraged the disclosure of asset appraisals and financial projections and other soft information for fear that this information would be misleading. Recently, however, the SEC has begun to favor such disclosures. But there are some disadvantages to disclosing soft information. Requiring disclosure may result in the revelation of strategic plans, thus putting the firm at a competitive disadvantage. Consequently, requiring disclosure may deter management from bidding so that they may avoid revealing these plans. Fear of potential liability for disclosures that result in

situation. As discussed above, Schedule 13E-3 under Rule 13e requires the disclosure of some soft information; however, this rule applies under limited circumstances. See 17 C.F.R. § 240.13e-3 (1990); see also supra notes 76-81 and accompanying text.

149. Repetti, supra note 8, at 129.
150. Id. at 135-36.
151. Id. at 164.
152. Id. at 164-65.
153. Id. at 136.
154. Id.
155. Id. at 137.
156. Id.
157. Id. at 140.
158. Id. at 140-41. Generally courts do not view soft information as material and, therefore, do not require disclosure. Id. at 145; see Panter v. Marshall Field & Co., 646 F.2d 271, 292 (7th Cir.), cert. denied, 454 U.S. 1092 (1981); Vaughn v. Teledyne, Inc., 628 F.2d 1214 (9th Cir. 1980). For a complete discussion of the judicial approach to the disclosure of soft Information, see Repetti, supra note 8, at 145-54.
159. Repetti, supra note 8, at 167.
160. Id. at 168.
misstatements also deter disclosure of soft information. But finally, there is the risk that shareholders may actually be misled by the information.

Notwithstanding these difficulties, full and accurate disclosure can be tremendously helpful in assessing the fairness of a buyout. One set of suggested SEC rules would require the disclosure of projected future income along with the liquidation value of the firm. In this disclosure, management would state the assumptions upon which information is based, provide a sensitivity analysis and disclose similar information to that which is provided to others with an explanation of any variations. The sensitivity analysis would reveal the most likely projection of income along with an assumed projected income fifteen percent greater and fifteen percent less than the most likely projection. With such disclosure, shareholders can evaluate the effect of the unexpected on the range of fair prices. With this information, the fairness opinion and the report of an independent committee, shareholders can make an informed decision to sell.

E. Mandated Auction

The fairness of a management buyout may also be enhanced by the presence of other bidders. Often, the marketplace can ensure a fair price to shareholders. For this reason, many commentators suggest that management should be required to compete in open bidding with all bidders on an equal footing, resulting in a mandated auction of the company. Through such an auction, shareholders

161. Id.
162. Id. at 169.
163. Id. at 165.
164. Id.
165. Id. at 165-66.
166. Williams, supra note 7, at 212. Open bidding lets the market determine fairness more effectively than courts through appraisal. See Lowenstein, supra note 2, at 784. On the other hand, if corporate insiders substantially underbid for the firm (i.e. bid lower than its true value) and outsiders rely on that bid to produce their own valuation of the stock, shareholders may still miss out on the optimal value for their shares. See Oesterle & Norberg, supra note 8, at 244-45.
167. See, e.g., DeMott, supra note 1, at 556; Lowenstein, supra note 2, at 731; Williams, supra note 7, at 212-15. For an additional discussion of competitive bidding, see Booth, supra note 7, at 653-56.
168. For a complete discussion of the mandated auction, see Lowenstein, supra note 2, at 779-84. See Panel Discussion, supra note 3 (Chairman Ruder supporting Delaware's mandatory auction facilitated by independent directors).
can be protected if third-party bidders are protected.\textsuperscript{169} In fact, evidence indicates that shareholders benefit from competitive bidding by sharing in the gains: as the number of bidders increases, the premium to shareholders also increases.\textsuperscript{170}

To foster competitive bidding, the company’s decision to sell must be irrevocable,\textsuperscript{171} and the corporation must remain “in play” for a reasonable time.\textsuperscript{172} The management proposal should be publicly announced,\textsuperscript{173} and management must not be able to pre-empt bidding with defensive measures.\textsuperscript{174} An appointed special committee may accept management’s bid with the understanding that it is free to consider other bids as well.\textsuperscript{175} In addition, management must disclose to other bidders all non-public information.\textsuperscript{176} Prospective bidders, however, must agree to treat the information as confidential.\textsuperscript{177} The other bidders would also be given time to secure financing and present proposals.\textsuperscript{178} As a consequence, other bidders will join the auction and management will either raise its bid or pull out of the transaction.\textsuperscript{179} Either way the shareholders are likely to receive a higher price than they would in the absence of an auction.

The goal of a mandated auction is a fair price;\textsuperscript{180} however, a fair price is not always easily discernible. Fairness has a different meaning when applied to an acquisition by management (equivalent value) as compared to an unaffiliated buyer (reasonable value).\textsuperscript{181} In

\textsuperscript{169} Williams, \textit{supra} note 7, at 213.
\textsuperscript{170} See Lowenstein, \textit{supra} note 2, at 738.
\textsuperscript{171} Id. at 779.
\textsuperscript{172} Williams, \textit{supra} note 7, at 213.
\textsuperscript{173} DeMott, \textit{supra} note 1, at 556.
\textsuperscript{174} Williams, \textit{supra} note 7, at 213. Note that management can pre-empt other bidders by owning enough shares to block a change in control or by using a cash tender offer to acquire those shares. \textit{See} Lowenstein, \textit{supra} note 2, at 741-42.
\textsuperscript{175} See generally Lowenstein, \textit{supra} note 2, at 780 (discussing a proposed rule of open bidding and commenting on the recent Cone Mills Corporation buyout).
\textsuperscript{176} DeMott, \textit{supra} note 1, at 556; \textit{see} Lowenstein, \textit{supra} note 2, at 731. The American Law Institute advocates a similar proposal wherein there is competitive bidding, disclosure to other bidders, and a reasonable time in which to bid. \textit{See} Williams, \textit{supra} note 7, at 231.
\textsuperscript{177} DeMott, \textit{supra} note 1, at 556.
\textsuperscript{178} Id.; \textit{see also} Lowenstein, \textit{supra} note 2, at 731 (advocating a law mandating open bidding).
\textsuperscript{179} Lowenstein, \textit{supra} note 2, at 780.
\textsuperscript{180} Lowenstein argues that “at some point the issue is price, and at some price the shareholders will not care whose money they take.” \textit{Id.} at 739.
\textsuperscript{181} Chazen, \textit{supra} note 32, at 1448. This difference in meaning is primarily historical. In an acquisition by an affiliated party, a statement that the terms are fair historically meant that shareholders receive the equivalent in value of the shares given up. \textit{Id.} In an acquisition by a nonaffiliate, fairness meant reasonable in relation to other bids. \textit{Id.}
a management buyout involving other bidders, either standard may be applied to evaluate the bids because the transaction involves both affiliated and unaffiliated persons.\textsuperscript{182} An acquisition may also be unfair if the value the shareholder receives is not within a range of prices that the shareholder might have received had an unaffiliated buyer purchased the entire company in an arm’s length negotiation.\textsuperscript{183} While this third-party sale value is difficult to discern, it is a workable measure that acts as a safe harbor for evaluating fairness.\textsuperscript{184} In this sense, the third-party sale value may be the lowest bid that management should be allowed to make.\textsuperscript{185} A mandated auction may secure at least this value for shareholders.

In addition to producing a fair price, a mandated auction should deter overreaching and ensure that shareholders are not prejudiced by dealing with insiders.\textsuperscript{186} Furthermore, it would provide the time and information necessary for competitive bidding.\textsuperscript{187} As a result, the auction is the "fairer" method.\textsuperscript{188} However, other types of competitive bidding may also ensure fairness.\textsuperscript{189}

\subsection*{F. Post-Buyout Remedies}

As discussed above, a perceived abuse in the management buyout is the opportunity afforded management to appropriate the future gains from the buyout by a subsequent public offering or sale.\textsuperscript{190} One way to avoid the misappropriation of future gains attributable to a subsequent public offering of the acquired stock is to offer shareholders cash and warrants in the initial going-private

\textsuperscript{182} See generally id. (discussing corporate acquisitions by affiliated controlling shareholders and unaffiliated purchasers).
\textsuperscript{183} Id. at 1439.
\textsuperscript{184} Id. at 1477.
\textsuperscript{185} See id. at 1477-79, 1481.
\textsuperscript{186} Lowenstein, \textit{supra} note 2, at 781.
\textsuperscript{187} Id.
\textsuperscript{188} Id.
\textsuperscript{189} Another such proposal analogous to the auction is mandated arbitration. In such a case, management submits a premium offer and shareholders may hire a private financial analyst to evaluate the offer and/or derive another fair price. Both values are submitted for arbitration where the arbitrator must choose one of the two values. If the shareholder agrees to arbitration, he must agree to a ten percent decrease if the arbitrator chooses management’s figure. The threat of a ten percent decrease should deter shareholders from submitting an unreasonably high value figure, and the possibility that the arbitrator will choose the higher value should deter management from making an unreasonably low initial offer. See Note, \textit{supra} note 8, at 720-21 (concluding the result will be "fairness" without the prohibition of potentially value-increasing transactions).
\textsuperscript{190} See \textit{supra} text accompanying notes 31-35.
transaction.¹⁹¹ If the company ever goes public again, the warrants would allow the shareholders to repurchase their stock at the price they sold out.¹⁹² One commentator suggests that the warrants should have a reasonable life of ten years.¹⁹³ While the warrants may never be exercised, they do provide a method of redistributing the profits of a subsequent public offer.¹⁹⁴ Thus, the incentive to engage in deceptive behavior for the purpose of depressing market price and lowering the selling price would be diminished as the selling shareholders would have a way of sharing in any gains subsequently produced by the firm.¹⁹⁵

Another suggested remedy for appropriation of gains by management is post-buyout disclosure requirements by which to judge the fairness of the transaction. Once a firm goes private, no outsider can ever know whether the price paid was fair.¹⁹⁶ Since lack of information accounts for this ignorance, the firm should promise to issue a certified financial statement covering the first year after the going-private transaction.¹⁹⁷ With such a statement, shareholders can judge whether the buyout was fair, and managers would be less likely to deal unfairly due to the risk of eventual discovery.¹⁹⁸

This proposal even includes subsequent public sales of stock. If the firm goes public again within a specified time, management should agree to offer rescission of the buyout transaction to prior shareholders.¹⁹⁹ Alternatively, if the company is sold within twelve months of the buyout at a premium above the price paid by management, then the premium should be paid to the prior shareholders with the premium declining with the passage of time.²⁰⁰ This approach attempts to ensure that shareholders receive fair value for their shares by assuming that a subsequent gain attributable to the enterprise should have been paid to the shareholders in the initial buyout transaction.

¹⁹¹ See Note, supra note 9, at 929-30.
¹⁹² Id.
¹⁹³ See id. While ten years is a reasonable time period to hold the warrants open, research suggests that most managers expect to liquidate their investment in just over four years. See Kitching, Early Returns on LBOs, HARV. BUS. REV., Nov.-Dec. 1989, at 74, 80.
¹⁹⁴ Note, supra note 9, at 930.
¹⁹⁵ See supra note 23 and accompanying text.
¹⁹⁷ Id. at 1040.
¹⁹⁸ Id.
¹⁹⁹ Id.
²⁰⁰ Id.
V. A Workable Approach to the Conflict of Interest

From the above analysis, it is clear that the conflict of interest inherent in all management buyouts can be minimized through several different approaches. The workable approach would require instituting policies to increase the credibility of the fairness opinion along with more disclosure to shareholders by an independent investment banker, an independent committee, and management followed by a shareholder vote. There is much to be said for letting the shareholders decide their own fate.201

To enhance the usefulness of fairness opinions, an independent committee composed of outside directors should choose an investment banker with no prior ties to management to render the opinion.202 Alternatively, if there are ties to management, these should be disclosed to shareholders in the opinion. Investment banker fees contingent on the success of management's bid should be strictly prohibited.203 In this regard, a separate fund should be established to cover these fees. This separate account should be funded by management as a type of earnest money. If other bidders are present, they should share in this cost. Under such a scheme, corporate assets would not be used for the benefit of management.204

The opinion itself should be simple and direct. While more disclosure may be helpful, too much disclosure may be damaging. The opinion should state the investment banker's conclusion as to whether the price per share offered by management falls within a range of fair prices.205 A limited sensitivity analysis should also be provided. A brief explanation of the assumptions, information and methods used should be provided; however, the banker should submit a more extensive explanation of this information to the independent committee.206

Thus, the investment banker would submit two corresponding fairness opinions: a summary opinion and an extensive analysis opinion. The more extensive opinion would be directed solely to the independent directors and any shareholders who request the report. This approach is necessitated by the fact that shareholders generally do

201. See supra notes 100-05 and accompanying text.
202. See supra text accompanying note 136.
203. See supra text accompanying notes 53-55.
204. See supra notes 34-36 and accompanying text (discussing the potential for self-dealing by management).
205. See supra text accompanying note 120.
206. See supra notes 118-22 and accompanying text.
not have the time or resources to evaluate this information.\textsuperscript{207} Because this assumption may not hold true for some institutional investors, shareholders may request the longer opinion.

In the extensive opinion, the investment banker should disclose all information upon which the opinion is based, including asset appraisals, income projections and other soft information.\textsuperscript{208} Additionally, a complete sensitivity analysis should be disclosed showing the effect of variations in the information provided on the range of fair prices.\textsuperscript{209} With these disclosures, the independent committee can evaluate the accuracy of the information provided by management and assess the procedures used by the investment banker.\textsuperscript{210}

In addition to the fairness opinion, the independent committee should also submit a report to the shareholders with its own evaluation of the fairness opinion and the fairness of the proposal.\textsuperscript{211} In this report, which should also be simple and direct, the committee may include any additional information it feels shareholders should know before making a decision, such as the presence of other bidders. In fact, if other bidders are present, both the fairness opinions and the committee report should do a comparative analysis of the bids. With the summary fairness opinion and the committee report, shareholders should have enough information to evaluate the proposal. Upon making this evaluation, shareholders should be allowed to vote on the management proposal as well as other proposals.\textsuperscript{212}

After preparing a report to shareholders, the independent committee would also serve as a negotiator with and overseer of management. Prior to submission to shareholders, the independent committee should negotiate the terms of the buyout with management based on the conclusions of the fairness opinion. For example, if management's bid falls below the range of fair prices, the committee should disclose that fact at the negotiating table and allow management to submit a higher bid or explain why the range of fair prices is not justified. Overseeing management, the independent committee should initiate mechanisms to ensure that management does not engage in acts to depress the market price.\textsuperscript{213} One such mechanism

\begin{footnotes}
\item[207] See supra note 65.
\item[208] See supra text accompanying note 118.
\item[209] See supra text accompanying note 119.
\item[210] See supra text accompanying note 123.
\item[211] See supra text accompanying note 139.
\item[212] See supra text accompanying notes 90-105.
\item[213] See supra note 23 and accompanying text.
\end{footnotes}
would include direct reporting requirements. Management should justify any changes in market price six months before and after the bid as well as any changes/abandonment of business plans in that time period. The committee should approve all major business decisions. Essentially management must forego substantial involvement in the business while the bid is pending.

This proposed workable approach would not mandate an auction; however, the independent committee may take steps to create competitive bidding. For example, the committee should accept management’s proposal with the understanding that the bid will be publicized and others will also be allowed to bid. Management should not be able to purchase the company under the table; however, the committee should not require other bidders before accepting management’s bid.

VI. CONCLUSION

Management buyouts create many opportunities for both shareholders and managers. Shareholders generally receive a premium well above market price for their shares while management secures future gains from a more profitable enterprise. While management buyouts benefit all parties involved, they do hold an inherent conflict of interest in that management sits on both sides of the transaction as both buyer and seller. Management has the incentive to keep the purchase price as low as possible, but, acting as a fiduciary, management has the duty to get the highest price for shareholders. The conflict is obvious.

Many proposals suggest ways to minimize this conflict and thereafter secure a better price for shareholders. These proposals focus primarily on increasing the quality of information given to shareholders in fairness opinions, removing management from the seller’s side of the negotiating table and installing an independent committee in its place. The committee then would foster and promote competitive bidding. A workable approach to the conflict would do much the same thing: require a simple, direct fairness opinion from an independent investment banker, a report by an independent committee and a shareholder vote on the management bid. While the conflict cannot be eliminated, it can be minimized through a combination of the above safeguards. As a consequence, management buyouts may

214. See supra text accompanying notes 171-89.
215. See supra text accompanying notes 173-75.
not be so offensive to the fiduciary responsibility of management. The ultimate result of minimizing the conflict of interest and fostering management buyouts would be economic efficiency for the firm and for the country as a whole as managers are changed into entrepreneurs with a stake in the success of the firm and shareholders secure fair returns.