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WHEN THE SLEEPER WAKES:
REFLECTIONS ON CORPORATE GOVERNANCE
AND SHAREHOLDER RIGHTS

J.A.C. Hetherington*

In H.G. Wells’ novel When the Sleeper Wakes,¹ a nineteenth-century Englishman falls into a coma which continues for 200 years. During this period his modest property increases to an immense fortune as a result of the incredible power of compounding (and presumably some flaws in the tax laws). The novel describes the events that occur when the Sleeper wakes to find himself the proprietor of an industrial empire roughly equivalent to the Fortune 500 industrial and 500 financial corporations combined. Difficulties ensue as the Sleeper gradually comes to understand the monstrous totalitarian society that the managers of his property have created in his name. Ultimately the Sleeper perishes in a successful effort to bring about a revolution to destroy this terrifying social order.

The thesis of this Article is that the American shareholder is in some ways very much like the Sleeper. Shareholders of publicly held companies are not in a coma, but they are widely scattered and unorganized; they consequently lack a united voice to speak for their interests. The result has not been silence but a confusion of other voices purporting to speak for shareholders’ interests. The participants in the never-ending discussion include academic lawyers, corporate reformers, the corporate bar, and, most prominently, the Securities and Exchange Commission. Those taking part in the discussions about the role and responsibilities of publicly held firms commonly assume that managers are not firmly and directly under the shareholders’ control. The managers, so the conventional wisdom goes, have the legal right—or at least the power—to pursue goals other than the economic interests of shareholders. This means that some portion of the company’s wealth is diverted to other “more socially desirable” ends.

Part I of this Article offers an overall view and critique of the two principal themes of the literature on corporate social responsibility and democracy: The separation of ownership and con-

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1. H.G. Wells, When the Sleeper Wakes (1899).
trol and the corporate manager's responsibility to maximize profits. An analysis of the interests and perspectives of the principal participants in the perennial discussion of these questions follows in Part II. That section concludes with a discussion of the Securities and Exchange Commission's dominant role in these areas. The third part of the Article briefly considers two areas in securities and corporate law that have given rise to demands for changes said to be necessary to protect the investing public, principally against abuses by insiders: Trading on nonpublic information and going private transactions. The purpose is not to repeat or summarize what has been said in the abundant literature, but to examine the underlying assumptions about the needs and interests of shareholders. The thesis is that the perspectives and interests of the forces influencing the law's development differ from those of the American shareholder.

I

There are two facts about shareholders and managers of publicly held companies on which commentators of all shades of opinion agree. The first is the existence of the separation of ownership and control. While the extent of the separation has been questioned, it is generally agreed that absent a proxy fight, takeover attempt, or other special circumstance shareholders of publicly held companies play an entirely passive role in the election of directors. The second is that managers of publicly held firms do in

2. M. EISENBERG, THE STRUCTURE OF THE CORPORATION 37-51 (1976). In 1969, 425 of the firms in the 1965 Fortune list of the largest 500 industrials had a "10-percent-or-more block of shares outstanding." Id. at 50 (citing Palmer, Separation of Ownership from Control in Large U.S. Industrial Corporations, 12 Q. REV. ECON. & BUS. 55 (1972)). Two studies of the control of large publicly held firms are reviewed in Reeder, Corporate Ownership and Control: A Synthesis of Recent Findings, 3 INDUS. ORG. REV. 18 (1975). Summarizing the findings of one of the studies, Reeder states that the researcher "studied the largest 500 nonfinancial U.S. corporations ranked by 1963 assets and found: of the top 50 firms, 42 were management-controlled; of the top 200, 167; and of all 500, 377." Id. at 22 (citing R. LARNER, MANAGEMENT CONTROL AND THE LARGE CORPORATION (1970)).

An important question not addressed by these studies or by Professor Eisenberg is the implication, if any, for the small public investor of a significant block of shares being held by a few large shareholders. This may lessen the gap between ownership and control. Whether the public shareholder is better off on that account is another matter. If there is control by a few large shareholders, the management is no longer subject to the risk of an outside takeover, and if the large shareholders are the managers, they may adopt policies in their own interest from which the outside shareholders may receive little benefit. See Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964). The small public investor may therefore be better off if there are no large shareholders.
fact attempt to maintain and raise the level of net revenues generated by their companies. This is evidenced by the extensive regulatory scheme that seeks to curb aggressive and predatory competitive practices. Indeed, the most persistent complaint about corporate management's behavior by the advocates of corporate responsibility is that in their zealous pursuit of profits corporate managers have engaged in antisocial behavior.

Shareholders are unreliable allies in efforts to control undesirable business practices by managers. Shareholders want to invest in the winner rather than the loser, and they are therefore less concerned than the government and the general public with eliminating questionable but effective business practices by the firms they own. Two good examples of this are the furor over questionable payments abroad and the issue of investment in South Africa. The Securities and Exchange Commission took the lead on the foreign-payments question, and the protests about doing busi-

3. This obvious point needs no citation. Merely by way of current illustration, see Getschow, Overdriven Execs: Some Middle Managers Cut Corners to Achieve High Corporate Goals, Wall St. J., Nov. 8, 1979, at 1, col. 6. There has been some discussion about whether the goal is to maximize net revenues or merely to make enough money to satisfy shareholders' expectations and the stockmarket, but this distinction is of little practical importance.

The conventional legal view assumes that managers have an obligation to promote the economic interest of shareholders. The law gives managers wide discretion in choosing the means for achieving this objective. See Dodge v. Ford Motor Co., 204 Mich. 459, 499-502, 170 N.W. 668, 681-82 (1919). The discretion so conferred is extremely broad: For example, nothing is said about whether short- or long-run maximization should be sought. Traditional legal theory does not throw much light on this issue either. The theory of “satisficing behavior” has been advanced as a means of analyzing how managers elect between permissible goals within the imprecise legal and economic notions of maximizing gain. See, e.g., Simon, Theories of Decision-Making in Economics and Behavioral Science, 49 AM. ECON. REV. 253, 253-64 (1959).


6. Though shareholders do not condone unlawful behavior by management, it is contrary to their economic interest to have their firm incur a disadvantage by not engaging in business practices employed by competitors. Since the economic interests of the shareholders are directly affected, they have a higher tolerance for dubious or ethically questionable behavior than the public in general or governmental regulatory agencies in particular.

7. The history of the improper payments scandal is briefly summarized in Cof-
ness in the Republic of South Africa have been led by students, church groups, and other "nonprofit" investors. Private shareholders, whose personal assets are invested in stock, have been indifferent to these issues. The most convincing evidence of this is the unbroken record of defeats of public interest proposals at shareholders' meetings.

From the shareholders' perspective, the mechanism that greatly reduces or eliminates the significance of the separation of ownership and control is the stockmarket. The market price of a security conveys to management the investment community's view of management's performance. Both managers and shareholders

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9. Public-interest resolutions must obtain three percent of the vote if they are to be reintroduced the following year; six percent must then be obtained for reintroduction again; for subsequent introduction ten percent support is required. 17 C.F.R. § 240.14a-8(c)(12) (1979). The "success" of public resolutions is measured in terms of meeting these thresholds for reintroduction. Such proposals are not wholly without impact or significance. N.Y. Times, Feb. 22, 1980, at D2, col. 3. Managers have learned that such proposals are to be handled carefully as a matter of public relations, and some accommodating gestures have been made. See Stevenson, The Corporation as a Political Institution, 8 Hofstra L. Rev. 39, 45-50 (1979); Purcell, Management and the 'Ethical' Investors, Harv. Bus. Rev., Sept.-Oct. 1979, at 24, 30. For example, one large New York bank has agreed to "a policy of not making loans that will have a negative social impact," id.; accord, Rockefeller, Ethics and the Corporation, 8 Hofstra L. Rev. 135, 137-38 (1979), although there may be some question about what this means, if anything. Upon occasion, however, managers have mistakenly confused the views expressed by the press and the more vocal segments of the general public with those of the shareholding public. See, e.g., Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970) (dispute over right of shareholders to compel inclusion of public interest proposal in company's proxy statement mooted when management withdrew its objection) (proposal overwhelmingly defeated by shareholders), vacated as moot, 404 U.S. 403 (1972). The difference is that "socially responsible" behavior, however defined, is a free good as far as the general public is concerned; the shareholders for whom such behavior is not free, can generally be counted upon to prefer their own economic interests. In the end, shareholders overwhelmingly favor policies likely to increase profitability and tend to favor any proposed transaction that increases, or is likely to increase, the market price of their shares.

10. The accuracy of the market price is vital to the market's performance of this function and to its ability to provide investors with a fair price for their shares. Evidence supporting the efficient-market hypothesis indicates that the market price of a given security at any given time is an accurate assessment of its value in relation to other available investments of comparable riskiness. Studies also indicate that the market anticipates announcements of material information to establish the value of a security. See J. Lorke & M. Hamilton, The Stock Market 70-110 (1973).

Legal scholars have tended to think that the mere fluctuation of market prices
benefit from rising market prices for the firm's shares: shareholders through the increased value of their investment and managers through a reduced exposure to takeover attempts. The capital market bridges the gap between ownership and control by evaluating management's record and by providing management with a continuing incentive to improve its performance. As long as management maintains and increases the firm's profitability, shareholders are likely to feel that they are getting what they came for. This attitude is surely the primary reason why, during the forty-seven years that the separation of ownership and control has been a byword in the literature, there has been no serious protest by those whose interests are directly involved. Thus, apart from occasional management frauds, which probably cannot be prevented at acceptable cost under any scheme of corporate governance, the behavior of corporate management generally conforms with investor expectations. Advocates of reform have been unable to prove the existence of systemic deficiencies in the present arrangements for governance of publicly held firms.

With these general observations in mind we can now address suggestions that have been made for restructuring publicly held

over short intervals of time demonstrates the unfairness of market prices and leaves dissenting shareholders in mergers to the market for a remedy. M. Eisenberg, supra note 2, at 80-83. Eisenberg suggests that it is unfair to leave dissenters to market prices when market prices are influenced by factors other than the firm's performance. Id. at 82. In fact, external factors are every bit as relevant to value as internal ones, and this intuitive argument against market valuation amounts to saying that the property is worth more than anyone will pay for it at the time, which is plainly not so. Swings in market prices are changes in value: Their apparently erratic nature reflects the firm's performance, capital structure, and external events. It is, therefore, not "arbitrary" to leave the dissenter to the market remedy, but the converse. See Saari, The Efficient Capital Markets Hypothesis, Economic Theory, and Securities Regulation, 29 STAN. L. REV. 1031 (1977).

The Fall 1977 issue of the Journal of Portfolio Management is devoted to articles discussing the implications of the efficient-market hypothesis for managers of institutional investors. Investment managers have a substantial stake in securities analysis and, therefore, have a skeptical disposition concerning this hypothesis. The leading article in the issue strongly attacks the efficient-market hypothesis in its extreme form (that stock prices reflect not only corporate information that is generally available, but also information that is not generally available) and contends that it is possible through securities analysis to out perform the market. Murphy, Efficient Markets, Index Funds, Illusion, and Reality, J. PORTFOLIO MANAGEMENT, Fall 1977, at 5. See Kripke, Where Are We on Securities Disclosures After the Advisory Committee Report?, 6 SEC. REG. L.J. 99, 109 (1978).

firms and changing their goals. These are primarily reflected in two areas: Corporate social responsibility and corporate democracy.

**Corporate Social Responsibility**

Anyone who has examined the extensive literature on corporate responsibility and good citizenship is likely to conclude that little if anything remains unsaid on the subject. The purpose of the present discussion is merely to interject a comment on the relationship between the demands that corporations undertake socially responsible behavior and the separation of ownership and control in publicly held companies.

There has been some difficulty in determining precisely what is socially responsible behavior by business firms. Presumably it means more than compliance with laws regulating corporate conduct. To have any independent meaning, socially responsible activity must refer to actions that management has both the legal right and the power to take. Social responsibility only becomes an issue and a constraint upon management behavior when those actions that would provide the greatest economic benefits to the firm are likely to have adverse effects on some specific external constituency.

The preference of public shareholders that managers not forego lawful profitmaking opportunities because of such external consequences is plainly reflected in both stockmarket responses to changes in corporate earnings and in the consistent lack of sup-

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12. There is no shortage of social goals and interests that might be placed on the corporate agenda. The list includes consumer interests, environmental protection, plant-community interests, and special programs for the benefit of minorities and women. It is also interesting to note the conservative nature of some recent proposals, including resolutions to block all trade with communist dictatorships and to support tax-cutting campaigns. N.Y. Times, Feb. 22, 1980, at D2, col. 2. The difficulty of precisely identifying nonprofit maximizing expenditures is that many expenditures that appear to fall in this category can easily be justified in the name of public relations. Expenditures that help to create or maintain a favorable public image of the firm can be justified in long-term profitmaking terms, although the results are not immediately visible on the income statement. The extent to which firms are likely to engage in such image-building activity depends upon their visibility to the public as members of the business community and their vulnerability to public criticism. For example, oil companies are currently engaged in such image-building advertising. In general, nationally known firms that are publicly identified with consumer products are under greater pressure to engage in such behavior than those with less visibility because of their smaller size or the nature of their business.

port for public-interest shareholder proposals.\textsuperscript{14} It would appear, then, that if management adopts policies that reduce profits but promote what management considers to be socially responsible goals, there must be some separation between ownership and control. Since managers are not residual claimants, except as they may be shareholders or are compensated under arrangements directly tied to earnings, they theoretically have less reason than shareholders to resist demands for socially responsible corporate conduct. To the extent that shareholders tolerate reduced earnings that result from corporate social responsibility decisions,\textsuperscript{15} managers may be expected to engage in a limited amount of such activity because it provides some psychic income to them. The notion of business statesmanship has considerable psychological appeal to managers, in part because of the prestige associated with being a philanthropist. In addition, the high cost of takeovers provides management with additional security, allowing them to engage in socially responsible conduct.\textsuperscript{16}

Experience suggests that management's discretion and disposition to sacrifice profits for social responsibility is extremely limited.\textsuperscript{17} There is no separation of ownership and control in publicly held firms on this issue. It seems as though public shareholders' conservative views about corporate social responsibility have prevailed without their participation in the great debate about the social responsibilities of business: Corporate managers, unlike the trustees of the Sleeper's property, have behaved in a manner entirely consistent with the views and wishes of the overwhelming majority of the beneficiaries of their trust. It follows that any

\begin{itemize}
  \item \textsuperscript{14} See, e.g., D. Vogel, \textit{supra} note 8, at 203-06; Schwartz & Weiss, \textit{An Assessment of the SEC Shareholder Proposal Rule}, 65 Geo. L.J. 635, 642-48 (1977); Purcell, \textit{supra} note 9, at 24, 30.
  \item \textsuperscript{15} This tolerance can be the product of a number of factors: (1) The deminimus amount of the reduction; (2) the attractiveness of the investment even with the reduction in earnings; and (3) the costs of changing management behavior.
  \item \textsuperscript{17} The leading study of the performance of owner-controlled and management-controlled firms concluded:
    On the basis of the evidence presently available, I conclude that, although control is separated from ownership in most of America's largest corporations, the effects on the profit orientation of firms and on stockholders' welfare have been minor. The magnitude of the effects appears to be too small to justify the considerable attention they have received in the literature for the past 38 years.
\end{itemize}
changes in the agenda or priorities of corporate managers for the purposes of creating affirmative obligations to engage in socially responsible conduct would be contrary to the interests and wishes of shareholders and investors.

Corporate Democracy

Although the stockmarket largely succeeds in providing managers with strong personal incentives to promote the shareholders' interests, there are important areas in which the preferences of the managers and the interests of the owners conflict. Managers generally prefer arrangements giving themselves flexibility in reorganizations and limiting the shareholders' ability to make trouble. They therefore have favored provisions that limit appraisal rights in reorganizations, restrict the shareholders' ability to bring derivative suits, and restrict access to company books and records. Although the efforts of the corporate bar have undoubtedly facilitated management's accomplishment of these objectives, it is equally clear

18. Serious conflicts exist concerning direct and indirect compensation, a subject that attracts continuing investor and regulatory attention. Since most managers are self-selected and self-perpetuating, managers have some latitude in pushing their compensation toward or even beyond the high side of reasonableness. Although publicity and criticism are not wholly adequate remedies for such abuse, it is difficult to show that investors have been exploited by this behavior. Talented, innovative managers are often worth their hire and more. That less capable managers appear to get remuneration that exceeds their individual merit is due in part to firm size and the practical reality that the person at the top must earn considerably more than those in lower level positions. In smaller companies salaries that appear to be excessive probably reflect some degree of voting control by management. Professor Folk has described eight characteristics of "pro-management" statutes, as distinguished from "merely enabling" statutes. See note 27 infra. Two of those relate to compensation: "excessively liberal provisions for loans to directors and officers" and "provisions for excessive compensation for executives, especially through stock options ... more recent surrogates." A third characteristic concerns compensation indirectly: allowing "overly broad" indemnification for expenses incurred in litigation arising out of the defendant's corporate office. Folk, State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct, 31 Bus. Law. 1031, 1078 (1976).

19. See, e.g., ABA-ALI MODEL BUS. CORP. ACT § 5 (1974) (increasing protection of managers against personal liability arising from their conduct on behalf of firm); id. § 41 (relaxing rules concerning director conflicts of interest); id. § 49 (requiring contemporaneous ownership of shares for commencement of derivative suits (requiring security for costs before commencement of derivative suit if shareholder holds shares having market value of less than $25,000 or less than 5% of an outstanding class of shares); id. § 52 (allowing shareholder access to corporate records only for "proper purpose"); id. §§ 59(c), 73, 79(c), 84(c) (reducing required percentage of favorable votes for amendment of articles of incorporation, merger, sale of assets, and dissolution to majority of outstanding shares); id. § 80(b) (denying appraisal rights on mergers of publicly held companies).
that both individually and collectively these changes have been greeted with total unconcern by the shareholding public. While academic commentators have viewed them with alarm, there is no convincing evidence that these changes have in fact been detrimental to the interests of public shareholders.

The agitation over corporate democracy has been largely concerned with the separation of ownership and control. Reformers have sought to protect shareholders from management abuses by changing the composition of boards of directors. Boards composed substantially of the firm's executives have now been replaced by boards where a majority of the members are outsiders selected on the basis of their acceptability to the firm's chief executive. In addition, the SEC has strongly advocated outsider-con-
trolled audit and nominating committees for some time. While academic critics strongly favor outsider-dominated boards, the investing public has manifested no interest in this change. This indifference is undoubtedly due to the absence of any evidence to indicate that outsider-dominated boards perform better than boards dominated by insiders.

It has been suggested that more management irresponsibility, fraud, and incompetence would be ferreted out if outside directors were supplied with independent sources of information and were subjected to liability for failure to police management conduct. In addition, requiring inside directors to justify their proposals before an outsider-dominated board may cause management to consider its recommendations more carefully, and some unwise or ill-advised ventures may be avoided as a result. But if management is required to justify its proposals to a board that is concerned with its own liability exposure and that is less familiar with the business than is management, there may be an appreciable cost in management time and some reduction in management aggressiveness, creativity, and flexibility. The importance of these consequences would vary greatly among firms.

For example, investors in innovative and high-technology companies may be better served by boards composed of the firm's scientific, manufacturing, and marketing people than one dominated by outsiders on whom the law casts oversight obligations. The reader will undoubtedly know of highly successful firms that were totally dominated by innovative, autocratic, eccentric, and talented individuals. It takes a wholly unwarranted degree of paternalism to say that public investors, for their own protection, should be prevented from investing their money in such firms. This is not the only instance in which arguments for limiting investor choice are based on speculations by corporate theorists about what other people should do with their money.

24. E.g., Hearings on Corporate Rights and Responsibilities Before the Senate Comm. on Commerce, 94th Cong., 2d Sess. 241, 246 (statement of Harvey Goldschmid, Prof. of Law, Columbia Univ.); id. at 338, 339 (statement Detlev Vagts, Prof. of Law, Harvard Univ.); A. CONRAD, supra note 11, at 367-71; M. MACE, DIRECTORS: MYTH AND REALITY 127 (1971) ("the seemingly plausible reasons given for having insiders on boards of directors are essentially fallacious and specious").
25. C. STONE, supra note 21, at 150-209; Coffee, supra note 7, at 1150.
26. See Part III infra.
REFLECTIONS ON GOVERNANCE AND RIGHTS

The reason why so much attention has focused on management-dominated, self-perpetuating boards of directors is that such boards are the visible manifestations of the separation of ownership and control, which in turn violates the conventional assumptions about the roles of shareholders and managers. Shareholders are assumed to be the firm’s owners, and the board of directors and all subordinate employees are their servants. It follows, therefore, that statutes that confer upon the board power to control amendments to the articles of incorporation, mergers and other forms of reorganization, sales of the business, and changes in the firm’s activities are unsound since these are matters properly reserved to the owners.

A scholarly, perceptive, and systematic elaboration of this model and its implications for the relationship between shareholders and directors is presented by Professor Eisenberg in his book The Structure of the Corporation, published in 1976. Professor Eisenberg finds that by adopting permissive and enabling corporate statutes the states have abandoned the normative model, and in so doing have “defaulted on their responsibilities.” He concludes that if reform “is not forthcoming, a response must be sought at the national level.” It seems to me that this analysis views publicly held corporations “in a light that never was on land or sea.”

27. The philosophy of “enabling” corporate statutes has been described by Dean Wilber G. Katz:

Under this theory, the privilege of incorporation with “limited liability” should be made freely available, and promoters should have freedom in defining the scope of the enterprise and in allocating risk, control, and profit through the corporation’s security structure. This theory prescribes also that relatively unhampered procedures should be available to meet changing conditions by effecting changes in corporate purposes and security structures.

Katz, The Philosophy of Midcentury Corporation Statutes, 23 LAW & CONTEMP. PROB. 177, 179 (1958). As Dean Katz points out, almost all modern corporate statutes follow the enabling model. Id. at 187. There has been no trend away from this model since his article was written. Enabling acts do not impose any serious barriers for the protection of creditors against the withdrawal of surplus and even capital by shareholders. Id. at 181. More restrictive models, which now have been generally abandoned, impose restrictions on capital structure “to make it less likely that agreements as to division of risk, control, and profit may be inadvisedly made or ineffectually implemented,” or even more restrictively, may “prescribe a specified margin of safety for creditors, or require more than a simple majority vote for various corporate readjustments.” Id. at 180. Enabling statutes do not attempt to perform these functions.


29. Id. at 320.

30. W. WORDSWORTH, Elegiac Stanzas Suggested by a Picture of Peele Castle
The investing public has never had active control of publicly held companies. Since the nineteenth century, when industry giants were building fortunes by selling watered stock to the public, industrial entrepreneurs have been hiring capital, it has never been the other way around. For shareholders, voting power has always been a second line of defense to corporate inefficiency and management incompetence. Therefore, there can be no question of “restoring” active control to the shareholding public.

This does not answer the question of whether present arrangements adequately protect shareholder interests and expectations. That question must be kept continuously open. It does suggest, however, that before major changes in the control structure of publicly held companies are undertaken, there should be clear evidence of the defects in present arrangements and the need for changes. Professor Eisenberg does not attempt to establish how departures from his normative corporate model have injured the shareholding public. He also fails to elaborate on what changes would be necessary or appropriate to implement the model. Some of these changes are outlined by Professor Cary, who proposes federal legislation to remedy the lapses from the normative model identified by Professor Eisenberg.

The activity generated by Professors Eisenberg and Cary has indeed been remarkable. There is no doubt that Eisenberg’s general thesis and Cary’s more specific version is correct: State statutes


32. Gardiner Means concluded from his study of early 20th century American capitalism that where ownership and control are completely separated and profits are destined only for the “owners” they cannot perform their customary role of inducing the efficient management of enterprise, though they can perform the role of inducing the taking of risk. It is suggested that if the logic of traditional profit theory were to be followed, any profits over and above enough given to the “owners” to induce the continued supply of new capital should be received by control as a prize to induce the efficient management of enterprise.


33. Cary, supra note 20, at 700-05.
have become permissive and enabling, and they have abandoned any attempt to regulate and restrict corporate conduct. In addition, they have greatly broadened the prerogatives of management in a manner inconsistent with the notion that the primary responsibility over all fundamental changes in the firm and its principal business ought to be reserved to the shareholders. Cary argues that this trend in state legislation, especially in Delaware, has been accompanied by a decline in fiduciary standards and that consequently investors' interests have suffered. The difficulty arises when one attempts to do a body count to support this proposition. The fatal difficulties with the "reformist" position are carefully and fully elaborated on by Professor Winter. I will not attempt to summarize Winter's illuminating discussion. The point is that there is no convincing reason to believe that the present state of corporate law, even in Delaware, has consequences that are demonstrably adverse to the interests or expectations of the investing public.

In considering Eisenberg's proposal to restructure the director-shareholder relationship, a case study of a corporate structure completely at variance with the normative model is useful. Prior to a reorganization effected in 1967, the entire voting power of the Green Giant Company was vested in forty-four voting common shares held by management; the public held over four-hundred thousand nonvoting common shares. The public investors in Green Giant resembled shareholders in a business trust whose management was self-perpetuating, holders of certificates of a beneficial interest under a voting trust, or limited partners in a partnership. The corporate structure removed even the possibility of a challenge to management's tenure. The nonvoting common shares were a riskier investment than a voting issue, and the market price reflected that increased risk. When the company was reorganized under a plan that replaced the two classes of shares with a single class of voting shares, management received shares of new voting common representing 9.3% of the company for its forty-four shares of old voting common, which once represented .01% of the company's equity. After the reorganization, the market price of

37. Id.
the new voting common was thirty-three percent higher than that of the old nonvoting common that the public had held. 38
The question posed by this case is whether the law should have permitted the Green Giant Company to offer nonvoting shares to the public while the management retained control through its ownership of a class of shares representing a minute fraction of the company's net worth. Green Giant nonvoting common had been sold to employees of the company and others over a period of time. Since their purchases must have reflected their confidence in the management, it is not certain that these buyers were concerned about the absence of voting rights. Subsequent events plainly show that the securities markets took this factor into account in valuing the shares. 39 If the company had been organized under the prescriptive model that prohibited the issuance of nonvoting shares, 40 it is likely that management would have taken enough cheap shares to assure themselves of control. 41 The result would have been an immediate dilution of any shares sold to outsiders at higher prices to obtain capital. As it was, the public shareholders paid less than ten percent of book value—after the success of the firm was assured to the organizers, whose skill had built the firm into a major international enterprise. Because management's tenure was secure, it may have settled for a smaller percentage of the firm's equity than it would have otherwise demanded.

The point is that, even in this extreme departure from the prescriptive model, one cannot be certain that public shareholders would have benefited from any protections against the investment opportunity offered by Green Giant. With all respect, academic lawyers are not qualified by training or experience to act as investment counselors. Absent systemic deficiencies that inflict injuries on public investors, it is difficult to justify limiting investor choices.

38. V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 533 (1972).
39. See id.
40. It has been suggested that nonvoting common shares should be outlawed. E.g., Cary, supra note 20, at 702. But there may be positive values in distributing nonvoting shares both for the corporation and for shareholders. See Alchian & Demsetz, Production, Information Costs, and Economic Organization, 62 AM. ECON. REV. 777, 787-89 (1972). For a discussion of this and other proposals in an earlier period, see Loomis & Rubman, Corporate Governance in Historical Perspective, 8 HOFSTRA L. REV. 141 (1979).
41. Cheap shares simply refers to management's ability to purchase shares at a price that is lower than the initial public offering price. Management would undoubtedly take advantage of the price reduction to secure enough shares to ensure control.
on the basis of academic opinions on the soundness of corporate structures. Proposals for limiting the types of securities that corporations may offer the public ought to be responsive to demonstrable defects in the protection of investor interests that do in fact result in failure to meet reasonable investor expectations. A policy that permits diversity in corporate structures is in investors' best interests because it provides the flexibility necessary for developing new investment forms. The only prerequisite should be full disclosure and the imposition of fiduciary duties on managers to compel fair dealing. Despite suggestions to the contrary, we do not have any evidence of a decline in fiduciary standards. On the other hand, legislation such as the Williams Act and state takeover statutes have increased the difficulty of displacing managements through the stockmarket. Unlike structures such as Green Giant,

42. E.g., Cary, supra note 20, at 702.

43. For example, the original conflict-of-interest rule, which voided contracts in which directors had an adverse interest to that of the corporation, see, e.g., Wardell v. Railroad Co., 103 U.S. 651 (1880), was successively replaced by rules making such contracts voidable, see, e.g., CAL. CIV. CODE §§ 2230, 2234, 2322(3) (West 1954) (applied to corporate directors in Graves v. Mono Lake Hydraulic Mining Co., 81 Cal. 303, 22 P. 665 (1889)), then voidable if unfair, see, e.g., Kaufman v. Schoenberg, 33 Del. Ch. 211, 91 A.2d 786 (Ch. 1952); Ross Transp., Inc. v. Crothers, 185 Md. 573, 45 A.2d 287 (1946), and finally by statutes under which such contracts are not voidable if they are approved by a disinterested majority of the board of directors or by the shareholders or if "fair and reasonable to the corporation," ABA-ALI MODEL BUS. CORP. ACT § 41(c) (1974). The effect of these statutes is unclear, however, since courts have on occasion scrutinized transactions for fairness despite approval by disinterested shareholders. E.g., Gottlieb v. Heyden Chemical Corp., 33 Del. Ch. 82, 90 A.2d 660 (Sup. Ct. 1952); See E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 83 (1972). See generally Arsh, supra note 34. The progressive relaxation of the rule is traced in Marsh, Are Directors Trustees?, 22 BUS. LAW. 35, 36-43 (1966). Professor Marsh observes that any evaluation of these rules "must be largely speculative, since there can be no proof of how many frauds were prevented or discouraged by one rule or the other." Id. at 53. As he states, the strict-prohibition rule existed briefly at a time when "corporate morality... probably reached its all time low." Id. He nevertheless concludes his analysis by proposing a prohibition of transactions by publicly held companies in which directors have an adverse interest, subject to certain exceptions unless approved by the SEC. Id. at 74-75. Professor Marsh makes his administrative-approval proposal in part to deprive overreaching transactions of the cover they presently receive from legitimate transactions. Id. at 53. As is the case with many other proposals to "protect" shareholders, it is impossible to demonstrate that investors would be better off under such a system. The difficulty with the proposal is the impossibility of knowing, given the presently available information, whether investors would in fact be any better off if it were adopted.

44. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1976).

in which the position of management is clear, these statutes indirectly undercut the shareholders’ existing voting power. The value of the voting rights of all shares in companies that could be the subject of a takeover attempt is reduced by legislation that increases the costs of takeovers and thereby diminishes the chances that any attempt will be made, or if made will succeed. The emerging literature that argues that managers have a duty to present all tender offers made by outsiders to the shareholders recognizes that these protective statutes cut against investors’ interests.

The case for massive reform of state corporate laws is

46. In its argument as amicus before the Supreme Court in Leroy v. Great West. United Corp., 443 U.S. 173 (1979), the SEC contended that the Idaho anti-takeover statute was preempted by the Williams Act. 500 SEC REG. & L. REP. (BNA) A-15, A-19 (1979). Counsel for the Commission contended that state tender-offer legislation makes tender offers, which benefit target shareholders, economically unfeasible. He stated:

Only if a person is persuaded that the target company’s shares are going to be worth more in his hands than in the hands of current management will he make an offer... The closer any rule drives the price to what the shares are worth to the offeror, the less likely it is that there will be an offer.

Id. at A-19.

47. For a recent review of cases on this subject, see Lynch & Steinberg, The Legitimacy of Defensive Tactics in Tender Offers, 64 CORNELL L. REV. 901 (1979). The authors, both SEC staff members, discuss the “primary purpose” and the “business purpose” tests, which have been devised by the courts to determine the legitimacy of defensive tactics employed by managements of target companies. They conclude that “[t]he business purpose test poses a nearly insurmountable obstacle for the plaintiffs,” id. at 926, because management can readily invent a plausible business purpose for its opposition, and the the “primary purpose” test is more in keeping with the spirit of the Williams Act but does not “allocate the burden of persuasion in the most rational and flexible manner.” Id. The authors argue that the test of the legality of the target management’s behavior ought to be whether it “preclude[s] or materially impede[s] the shareholders’ consideration of the offer.” Id. at 927. They conclude that tactics that are undertaken for this purpose “are illegitimate no matter how complete the disclosure may be surrounding the use of the tactic,” id. at 939, and that tactics that do not interfere with shareholder consideration of the offer ought to be permitted even if the purpose is to defeat the offer, provided that full disclosure is made, id. This seems to be a sensible approach because it implicitly recognizes that where management’s self-interest is strongly involved and potentially conflicts with shareholder interests, no management interference with the shareholders’ right to make their own investment decision should be tolerated. See Cohen, A Note on Takeover Bids and Corporate Purchases of Stock, 22 BUS. LAW. 149, 149-50 (1966); Fleischer & Mundheim, Corporate Acquisition by Tender Offer, 115 U. PA. L. REV. 317, 353-59 (1967); Krasik, Tender Offers: The Target Company’s Duty of Disclosure, 25 BUS. LAW. 495, 473-74 (1969); Swanson, S. 310 and the Regulation of Cash Tender Offers: Distinguishing St. George from the Dragon, 5 HARV. J. LEGIS. 431, 505 (1968). But see E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 219-76 (1973); Comment, A Proposal for Affirmative Disclosure by Target Management During Tender Offers, 75 COLUM. L. REV. 190, 217 (1975).
unconvincing. Professor Winter points out that if professional or informed investors believed that the protections sought by advocates of corporate law reform were in the shareholders' interest, it would be to the benefit of some firms to offer such protections voluntarily because they would be able to attract capital at lower cost.\textsuperscript{48} If such protections were worth anything to investors, they would pay for them, and it would be in the interest of some firms to supply that demand. Similarly, if investors were injured by the lack of protection under enabling-type statutes, it would be to the advantage of some companies to move from permissive to more restrictive states. Ultimately, a state interested in increasing its revenues from the incorporation of business would have an incentive to adopt a restrictive statute because firms organized under its laws would have an advantage in the capital market. None of this has happened. The identity of a firm's state of incorporation remains a matter of total indifference to investors. Ignorance cannot explain the investment community's conduct. When restrictions on management behavior are in investors' interest, they demand and get them.\textsuperscript{49} There is little doubt that sophisticated equity investors would recognize the desirability of restrictions on management behavior if they thought that such restrictions were in their best interests or would enhance the value of their investments. The market would quickly reflect their views.

II

If not to the investing public, to whom does the existence of the separation of ownership and control and the permissiveness of state corporate laws make a difference? An examination of the interests and perspectives of three interest groups whose concern for the present state of corporate law and investors' rights indicate that the separation of ownership and control is of great importance to them. Investors' indifference has provided the occasion for these interest groups, like the Sleeper's trustees, to define the rights and

\textsuperscript{48} Winter, \textit{supra} note 35, at 256.

\textsuperscript{49} A brief look at the bond market and the indentures under which corporate bonds are issued makes this abundantly clear. The contractual rights of senior security holders to both interest and the return of their capital are a major part of the law of corporate reorganizations. \textit{See generally} W. BLUM & S. KAPLAN, \textit{CORPORATE RE-ADJUSTMENTS AND REORGANIZATIONS} 354-479 (1976). For a general description of trust indentures and the often elaborate and complex restrictions imposed on corporate management to protect bond and debenture holders, see J. KENNEDY & R. LANDAU, \textit{CORPORATE TRUST ADMINISTRATION AND MANAGEMENT}, 19-44, 228-44 (2d ed. 1975).
needs of investors in terms congenial to their own perspectives and interests. But unlike those trustees, none of these interest groups have succeeded in fully implementing their views.

The Academicians

The response to Professor Cary’s proposal\(^50\) provides a clear answer to the question of who is interested in corporate law reform: corporation law professors are interested.\(^51\) For years, academic lawyers who have labored in vain to build meaningful restrictions and controls into state corporate laws have come away from the experience not with the realization that theirs was a mistaken ambition, but with feelings of frustration because their “sound” and disinterested views died in the hands of the irreverent representatives of the corporate bar on the drafting committees. Academic lawyers were brought up on the separation of ownership and control and are the true believers in Eisenberg’s model. It is not gratifying to them to be told that the idol they have loved so long consists of “towering skyscrapers of rusted girders, internally welded together and containing nothing but wind.”\(^52\) Consequently, it is not surprising that many academic lawyers look favorably upon suggestions for revitalizing the shareholders’ franchise and bridging the control-ownership gap. Another reason why this constituency rallies to the reformist proposals is the nature of the evidence showing that investors have not suffered from the present state of affairs. Both the SEC and the law-teaching fraternity have consistently overlooked or underestimated the importance of the market as a vehicle for controlling management behavior. The reasons for this in the case of academic lawyers is in part their general lack of familiarity with economics.\(^53\) An economic analysis would show

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50. See text accompanying notes 33 & 34 supra.
52. Manning, The Shareholder’s Appraisal Remedy: An Essay for Frank Coker, 72 YALE L.J. 223, 245 n.37 (1962). Professor Manning went on to say that, as a result, corporate law scholars “face technological unemployment.” Id.
53. Academic lawyers, indeed lawyers generally, are unlikely to look favorably upon any evidence or body of knowledge that appears to reduce the importance of their area of expertise. This understandable response is part of the larger problem of social science’s role in the teaching of law. As it becomes unacceptable to analyze cases and problems in commercial areas without considering economic implications, academic lawyers will feel that they are becoming strangers in their own house. The criticism that lawyers are too little concerned with the empirical research and too content with “manipulating legal concepts in certain approved ways” is not new. See Cohen, Transcendental Nonsense and the Functional Approach, 35 COLUM. L. REV. 809, 820 (1935). The reviewer of a recent effort to bridge the law-real world gap, J.
that because of the operations of the stockmarket, investors have not been injured by the lack of control over corporate management.

The importance of the market to the average investor is not inconsistent with traditional vehicles of shareholder democracy. When investors buy into a public company they buy a package that includes the present management. If performance is disappointing, they leave as quickly and silently as they came, and by the same route. For investors this is the only rational course: The market is the only remedy for managerial default to which the investor has direct, certain, and immediate access. Investors buy an investment package, not a lawsuit or a proxy fight. This does not mean that there is no reason to follow Professor Eisenberg's suggestion and open up the proxy machinery to permit shareholder nominees to appear in the company proxy materials. Such an increase in the value of shareholders' voting rights could well supplement and strengthen the "exit" option. The indifference of the financial and investment community to proposals for further federalization of corporate law does not mean that no changes can be made in the interests of investors, but that the existing arrangements largely satisfy investor expectations. Therefore the changes called for in

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54. M. Eisenberg, supra note 2, at 113.
55. Shareholders who are disappointed in management's performance, like dissatisfied customers, have an option: they can take their money elsewhere, or they can attempt to bring about an improvement in management's performance in the future. These choices, which have been labelled "exit" and "voice" respectively, are to some extent mutually exclusive. The interaction of these alternative remedies for inferior performance by firms, and the affect on each of loyalty to a firm by customers (and shareholders) has been explored in an original and insightful book by Professor Albert Hirschman entitled Exit, Voice, and Loyalty (1970). Hirschman points out that where the exit option is readily available, as in the case of shareholders of publicly held firms, "voice" is less likely to be utilized and weak management may be perpetuated as the best informed investors sell out. Id. at 46. Ultimately management may be displaced as the market price drops low enough to make a takeover profitable.
the interests of investors do not involve rolling the calendar back
to restrictive prescriptive statutes; rather they are incremental
changes, such as strengthening shareholder participation in the
election process and limiting the barriers erected in state and fed-
eral law against takeovers.

Public-Interest Reformers

The position taken by academic critics has been warmly em-
braced by the professional critics of big business, of whom Ralph
Nader is the most prominent and persistent. A primary focus of his
activities has been on the outrages perpetrated on consumers,
shareholders, and the general public by corporate managers in
their overzealous pursuit of profit. Since most if not all of the
exploits of corporate managers in the name of gain have been ap-
proved by investors in the firms involved, there is some reason to
question the depth of Mr. Nader's commitment to the profitmaking
interests of investors. He and his associates appear willing to join
in any challenge to the legitimacy and activities of the managers of
business.56 In this particular crusade he seems to be playing a
character part.

There is an obvious difference, however, between the works of
academicians and that of professional reformers. The tone of the
discussion changes: The rhetoric of the reformers has an intensity
and urgency born of the conviction that the present situation is
outrageous and that the public, consumers, and shareholders (that
is, all of us) are being victimized and exploited by the big business
establishment. As one reads through the works of Mr. Nader and
his associates on the behavior of business enterprise and the gov-
ernance of publicly held firms,57 one can discern an antagonism to
the materialistic, consumption-oriented values of the 1970's, which
the business establishment both fosters and serves. There are many
grounds upon which one might strongly object to the values of a
society that has so single-mindedly and successfully devoted its en-

56. Nader-led coalition groups have drafted a "Corporate Democracy Act of
1980" which is intended to make corporations more accountable to employees, con-
sumers, and others. See Wall St. J., Apr. 9, 1980, at 1, col. 4, at 37, col. 2; N.Y. Times,
Apr. 10, 1980, at D1, col. 3.
57. See, e.g., CENTER FOR THE STUDY OF RESPONSIVE LAW, THE CONSUMER
AND CORPORATE ACCOUNTABILITY (R. Nader ed. 1973); D. LEINSDORF & D. ETRA,
CITIBANK (1973) (Ralph Nader's Study Group Report on First National City Bank); J.
PHELAN & R. POZEN, THE COMPANY STATE (1973) (Ralph Nader's Study Group Re-
port on Du Pont in Delaware).
ergies to the production of goods and services for mass consumption. A Puritan in Babylon would disapprove of much of what she sees going on around her. It is entirely appropriate as well as useful for social critics to attempt to persuade their fellow citizens to change their values. Criticism of the means, however, from one whose real objection is to the ends loses a certain amount of credibility.

Corporate social responsibility critics have a somewhat different set of values and priorities than the great majority of those in whose interests and welfare they purport to speak. There is a tendency for reformers, who know what the right choices are, to place a low value on the right of others to make different choices. In both the consumer and corporate governance areas, those seeking to bring about change would eliminate choices that most of the constituency for whom they presume to speak do not find objectionable. Thus, Mr. Nader chastises shareholders for not being interested in corporate affairs and undertakes to devise a scheme to enable "thousands of dispersed shareholders" to oversee the behavior of the firm. He attributes shareholders' past lack of interest to the futility of attempting to exercise their rights under the present state of the law. The fatal flaw is that investors in publicly held firms do not share his enlightened view about what they should want. Their behavior strongly suggests approval of managerial priorities and confidence in present arrangements to monitor its performance. One could easily conclude that Mr. Nader's aim is to reform the shareholders as well as the corporation.

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58. See F. Knight, Risk, Uncertainty & Profit 182 (1921); R. Winter, The Consumer Advocate Versus the Consumer (1972). Professor Knight further observed:

[No clear line can be drawn between being tricked and gratifying a perverted taste. The difficulty is the ultimate impossibility of saying what one “really” wants.... The man who sells whiskey, patent medicine, corrupt literature or art, etc., to people who want them and are willing to pay for them is productive; but one who sells gilded chunks of lead to unsuspecting rustics for gold bricks clearly is not.

F. Knight, supra, at 183 n.1. There is little question about the category in which Mr. Nader would include American consumers. See generally Nader, A Citizen's Guide to the American Economy, N.Y. Rev. Books, Sept. 2, 1971, at 14. The general opinion that emerges from Mr. Nader's work is of a basically dispeptic view of society, which regards the economy as a dark conspiracy by everybody against everybody.


60. Id. at 88-91.

61. That his interest in the economic welfare of shareholders is rather different from shareholder views of their own interests is indicated by proposals that would
Unlike the academicians and the corporate reformers, the third major interest group influencing the development of corporate law has posed as neither a friend nor a representative of the American shareholder. The corporate bar is and has consistently been the confidant, advocate, and friend of corporate management. It has also been the most influential force in shaping the development of state corporate law, and it is almost singlehandedly responsible for the modern permissive enabling-type state corporate laws.

The views of the corporate bar are plainly revealed in the Model Corporation Act, which is the work product of the ABA Corporate Law Committee. Professor Eisenberg has argued that corporate law drafting committees ought to include practitioners with a management practice, practitioners with a “shareholders’ action” practice, and academics.62 Reviewing the ABA committee composition in 1974, he found that the committee’s membership has never included a shareholder’s lawyer. He noted that “management lawyers apparently filled every one of the Committee’s seats during the twenty-year period ending in 1969; filled all but one seat from 1969 through 1972, and still fill virtually all the Committee’s seats even today.”63

The committee’s overwhelming dominance by management-oriented lawyers does not, however, entirely account for the present condition of state corporate law. Of equal significance is the

alter the structure of publicly held companies to reduce the emphasis on profit maximization. Id. at 123-25. Reordering managerial priorities is the central idea behind the public responsibility school of criticism of the behavior of corporate enterprise. In this respect his position differs substantially from that of the academic critics. His proposals stem from a set of values and priorities that differs from those of both the investing public and the law professors.

Others have argued that similar obligations are owed by shareholders. See, e.g., Bayne, The Basic Rationale of Proper Subject, 34 U. DET. L.J. 575, 579 (1957):

[The shareholder] has not only the clear right, but more to the point, perhaps, he has the stringent duty to exercise control over [the use of his capital by management] for which he must keep care, guard, guide, and in general be held seriously responsible. [The shareholder] never can shirk a supervisory and secondary duty (not just a right) to make sure these goods are used justly, morally and beneficially.


63. Id. at 1410. Professor Eisenberg is also severely critical of the committee’s procedures and scholarship. Id. at 1410-27. It appears that academic representation on the committee has recently increased. Currently the 24 member Committee on Corporate Laws includes four academics, a former member of the SEC, and the head of the FBI. 35 Bus. Law. at xlii (1979).
absence of other interest groups taking opposing and diverse positions. Present conditions do not result from the corporate bar overcoming all opposition; instead, opposition has been absent for over four decades. The primary reason for the absence of opposition is that the investing public believes that managers of publicly held firms do strive to increase earnings, and hence stock prices. The lack of investor objection to these changes results from their perception that these changes were not adverse to their interests. Therefore, not surprisingly, the statutory changes that have been made have overwhelmingly favored management: Their cumulative effect has been to increase management's flexibility in reorganizing and redirecting the enterprise and to confer upon management the power to influence and control decisions that are traditionally viewed as the prerogatives of the owners.

Because permissive and enabling state legislation has not been perceived as adverse to shareholder interests, the corporate bar has been able to procure the adoption of some highly partisan pro-management provisions that are arguably adverse to shareholder interests. These changes could only be accomplished because they are of relatively little importance to each individual shareholder, while they are of great significance to each individual corporate manager. The most important provisions of this type are those dealing with derivative suits and the indemnification of manage-

64. There have been some exceptions. For example, the revisers of the Virginia statute in 1973 were unable to reduce the two-thirds voting requirement for approval of amendments to articles of incorporation and mergers to a simple majority. In 1973, the Virginia House of Delegates Committee on Corporations, Insurance and Banking deleted from proposed amendments to the Virginia Corporation Code a proposal to reduce the required shareholder vote for various corporate transactions from "more than two-thirds" to a majority of the shares entitled to vote. Statement by Richard G. Joynt to Author (Apr. 7, 1980). See VA. CODE §§ 13.1-56(c)-70 (1978). Occasionally other interest groups have succeeded in preserving unusual provisions of importance to them. For example, in New York and Wisconsin shareholders may be liable for unpaid wage claims if a corporation becomes insolvent. N.Y. BUS. CORP. LAW § 630 (McKinney Supp. 1979-1980) (liability limited to largest shareholders in close corporations); WIS. STAT. ANN. § 180.40(6) (West 1957) (liability limited to par value or consideration paid for no par stock).

65. See notes 18 & 19 supra and accompanying text.

66. ABA-ALI MODEL BUS. CORP. ACT § 49 (1974). The statute limits such actions to persons who were shareholders at the time of the complained of wrong and subjects plaintiffs to burdensome security-for-costs provisions unless they hold five percent of an outstanding class of shares or shares having a market value in excess of $25,000. Professor Eisenberg concludes a review of the committee's brief and evasive comments on the amendments to § 49 by saying: "What on earth is going on here? Did the committee fail to see the many problems raised by the [statute]. Or did it see the problems and decide to avoid dealing openly with them? Which is
Managers view the possibility of unwarranted liability and crippling defense costs with great alarm, which on the basis of the record to date seems to be grossly exaggerated. We are living in a period of increasing litigiousness in which the business establishment is subjected to continuous criticism from a variety of sources for a variety of reasons—ranging from environmental matters to insensitivity and irresponsibility about questions of social justice. In this climate, the apprehensiveness of managers about possible personal liability cannot be rejected as wholly unreasonable. The efforts of the corporate bar to protect clients from what they view as an unjustified attack are therefore entirely understandable. These efforts are encouraged by the generally accurate perception that most shareholders support management efforts to maximize revenues and that opportunities to intervene in management policies and practices are taken advantage of by individuals whose interests and objectives are not supported by the great majority of the shareholding public.

worse?" Eisenberg, supra note 62, at 1425.

The committee's view on derivative suits is reflected in an amicus brief filed on behalf of the American Bar Association in Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970). The brief argued that communications between corporate management and its counsel should be absolutely privileged, even in a suit brought by shareholders to redress an injury by management to the corporation and its owners. Id. at 1102. (Two of the four signers of the ABA brief were members of the Committee on Corporate Laws).


68. Both managers and shareholders are likely to perceive that derivative litigation is brought by irresponsible "strike suiters," whose purpose is to profit personally from the nuisance value of harassing managers who have attempted in good faith to serve the interests of the corporation and not by honest shareholders acting in good faith to remedy a real wrong to the corporation.

69. These considerations also account for the present law concerning dissenters' rights on mergers and sales of assets. The feasibility of mergers and reorganizations may well require that as little cash as possible be paid to dissenters. ABA-ALI MODEL BUS. CORP. ACT § 81 (1974). See generally A. FREY, J. CHOPER, N. LEECH & C. MORRIS, CASES AND MATERIALS ON CORPORATIONS 1143-59 (2d ed. 1977). The right of dissenters from these transactions to be paid the fair value of their shares is enveloped in complexity, and a shareholder can lose her dissent and appraisal right by a small misstep at any stage along the way. Under the Model Act, the dissenters' demand must be submitted no later than the meeting at which the vote is taken. ABA-ALI MODEL BUS. CORP. ACT § 81 (1974); accord, VA. CODE § 13.1-75(c)(1)(A) (1975). The justification for this requirement is to provide for "abandonment of the proposal if it appears that dissenters' demands will cause an excessive cash drain." A. FREY, J. CHOPER, N. LEECH & C. MORRIS, supra, at 1145. In fact this burdensome requirement is wholly unnecessary for this purpose, since the board of directors can abandon the transaction after its approval by the shareholders, ABA-ALI MODEL BUS. CORP. ACT § 79(d) (1974), or pursuant to a provision to that effect in the agree-
Regulation of takeover bids presents a more difficult problem for the corporate bar because management interests are divided. The issue is of greater urgency to managers who consider themselves the potential victims of takeovers than it is to those whose primary interest is using takeovers as a mechanism for advancing the firm's interests. The legislation that has emerged reflects these conflicting interests.\(^0\)

Corporate participants in these transactions can be divided into three broad categories: (1) Large companies that are unlikely to be targets because of their size or because a takeover is likely to involve anticompetitive possibilities that would greatly complicate the attempt, (2) smaller companies vulnerable to takeovers because management's stock position is weak, (3) small firms in which management's position is impregnable because of its stock position. There are fewer firms in the first category than in the second, and fewer in the second than in the third. Companies in the first category are more likely to be the aggressors in any takeover battle, although they are not immune from takeover attempts.\(^1\)

The basis for this rule is plausible: Having elected not to go along with the merger or sale of assets and to retain their equity positions in the new firm and bear their share of the risks of failure, the dissenters are not entitled to any benefit flowing from it. Arguably, however, the opportunity to enter into an advantageous merger is itself a product of the firm's past performance, which belongs to all of the firm's owners, and each shareholder should have the right either to stay in or to sell out at its current value. Even if this position is rejected, as it has been in mergers where shareholders have been offered shares in the surviving entity, it is plain that in a cash-out merger where minority shareholders are being forced to take cash for their stock, synergistic values should be considered in valuing dissenters' stock. In revising the Model Act, the Corporate Law Committee nevertheless declined to take this position. The farthest that the committee would go was recently to amend § 81 to provide that the valuation of dissenters' shares should exclude "any appreciation or depreciation in anticipation of such corporate action unless such exclusion would be inequitable." \(^0\)ABA-ALI MODEL BUS. CORP. ACT § 81(a)(3) (1979) (emphasis added).

Dissent and appraisal rights are frequently denied to holders of publicly traded shares. \(^0\)Id. § 80. Since market prices take into account all publicly available information, including any anticipated effects of a merger, the market has some advantages as a remedy for dissenters, provided there is an adequate volume of trading. See Note, A Reconsideration of the Stock Market Exception to the Dissenting Shareholder's Appraisal Right, 74 MICHL. L. REV. 1023, 1033 (1976).


\(^1\)One study of tender offers concludes that size does not immunize firms...
the third category have no need for protection, but as they grow they are likely to migrate into the second category. Their managements are likely to identify with the concerns of medium-sized potential target firms, and since they are not likely to be aggressors themselves, they are likely to identify with the views of managers of firms that are vulnerable to takeovers. Firms in the first category are often incorporated in Delaware,\textsuperscript{72} which for this reason has some interest in not adopting legislation biased against tender offerors. Firms in the second and third categories, especially the latter, are therefore more likely to be locally incorporated, gaining the protection of local antitakeover statutes.\textsuperscript{73}

The first state antitakeover legislation was adopted in Virginia in 1968.\textsuperscript{74} It applies only to locally incorporated firms and was intended to protect them from hostile takeovers.\textsuperscript{75} It has been entirely successful: Since it was adopted no hostile takeover attempt has succeeded in Virginia.\textsuperscript{76} More ambitious statutes have been widely adopted, covering businesses with substantial local operations, regardless of where they are incorporated.\textsuperscript{77} Unlike the Del-

\textsuperscript{72} In 1976, 655 of the 1542 corporations that have shares listed on the New York Stock Exchange were incorporated in Delaware. \textit{NEW YORK STOCK EXCHANGE, GUIDE 701} (1976).

\textsuperscript{73} \textit{E.g., N.Y. BUS. CORP. LAW §§ 1600-1612 ( McKinney Supp. 1979); OHIO REV. CODE ANN. § 1707.041 (Page 1979); WIS. STAT. ANN. § 552 (West 1979).}


\textsuperscript{75} The statute was intended in part to encourage firms incorporated in Virginia not to reincorporate elsewhere, and to interest Virginia firms not incorporated in Virginia to consider reincorporating there to obtain the protection afforded by the statute. The immediate occasion for the adoption of the Virginia statute was an attempt by a conglomerate (ultimately successful) to take over a Virginia shipbuilding firm. \textit{See Buford, The Virginia Takeover Statute, 32 BUS. LAW. 1469 (1977). See also W. Clingman, State Tender Offer Regulation and the Virginia Experience (Jan. 8, 1978) (unpublished seminar paper on file in office of the Hofstra Law Review).}

\textsuperscript{76} Two takeover attempts were made, W. Clingman, \textit{supra} note 75, at 50-57, and a third is reportedly in progress. In both attempts, proceedings were commenced under the statute. \textit{Id.} at 50. The proceedings were prolonged, and in both cases the tender offers were withdrawn before a final order was issued under the statute by the State Corporation Commission. In the second case the target company paid the tender offeror $1.2 million as partial compensation for expenses incurred in making the offer. \textit{Id.} at 54; Richmond News Leader, June 10, 1977, at 9, col. 1.

\textsuperscript{77} \textit{See E. Aranow, H. Einhorn & G. Berlstein, DEVELOPMENTS IN TEN-
aware statute, which merely requires disclosure of information concerning the offeror,78 these statutes permit target management to obtain a hearing on the adequacy of the disclosure and prohibit the offer from proceeding while a determination that the tender offeror has fully complied with the requirements of the statute is pending.

There is little reason to doubt that the various state statutes were adopted at the behest of the local corporate bar to protect clients from hostile takeovers, as was the case in Virginia. Even though the shareholders' interests are quite different, the protection of these same shareholders is advanced as an argument in favor of such legislation.79 It is difficult to quarrel with the requirement that the shareholder offerees be given adequate information to enable them to make an informed decision. The asserted purpose of the Williams Act was to accomplish this objective and not to tilt the balance against tender offerors.80 However, it is uncertain whether the alleged benefits to shareholders under the Williams Act have been worth the substantial costs, while the benefits to target management because of the increased difficulty and expense of takeovers are obvious and substantial.81 The story of anti-

78. The Delaware statute requires only that specified information be given to the target company before the offer can be made. It does not provide for filing with a state agency, nor does it authorize the target company to obtain a judicial or administrative hearing. The statute merely confers jurisdiction on the court of chancery in the event of violation of the Act. DEL. CODE ANN. tit. 8, § 203 (Supp. 1978).

79. Some states not only give the commissioner the discretion to call a hearing, but also require a hearing at the target company's request. See, e.g., HAW. REV. STAT. § 417E-3(F) (Supp. 1975); IDAHO CODE § 30-1503(4) (Supp. 1979); IND. CODE ANN. § 23-2-3-2(e) (Burns Supp. 1978). Other states only provide a hearing at the state official's discretion. See, e.g., N.Y. BUS. CORP. LAW § 1604 (McKinney Supp. 1979). For a comparison of the various state takeover statutes, see the chart in E. ARANOW, H. EINHORN & G. BERLSTEIN, supra note 77, at 240-42.

80. See H.R. REP. NO. 1711, 90th Cong., 2d Sess. 1, 2 (1968), reprinted in [1968] U.S. CODE CONG. & AD. NEWS 2811, 2811; Address by Chairman Manuel F. Cohen, Proposed Legislation to Regulate Tender Offers, before the Am. Soc'y of Corp. Secretaries, in Colorado Springs, Colo. (June 28, 1966), reprinted in V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 720, 720-24 (2d ed. 1979). Some concessions were made: "While the bill may discourage tender offers or other attempts to acquire control by some who are unwilling to expose themselves to the light of disclosure, the committee believes this is a small price to pay for adequate investor protection." H.R. REP. NO. 1711, supra, at 4, reprinted in [1968] U.S. CODE CONG. & AD. NEWS at 2813.

81. An empirical study of 80 tender offers between 1956 and 1970 concluded:
takeover legislation illustrates the power of the corporate bar in the various states and the consequences to shareholders of the exercise of that power in an area where management interests differ significantly from those of public investors.

The dominance of the corporate bar in state corporate law reform and its allegiance to management interests has also been of greater significance for minority shareholders of closely held companies than for shareholders of publicly held firms. In the latter, the congruence of management and shareholder interests and the monitoring function of the market have served to protect the interests of investors. For shareholders in closely held firms, whose shares have no outside market, the corporate bar's allegiance to management and the bar's control over state corporate laws have had different consequences. There is no effective constraint on management exploitation of the minority investors trapped in the firm by the illiquidity of their investment. Statutory reforms have all been "enabling": They permit departures from the statutory norm. No statutory provisions compel fair treatment of the minority or enable the minority to withdraw its investment from the firm. Shareholders in closely held corporations must rely on voluntary arrangements adopted by the majority. Legislative reforms have failed to address directly the central problems in the area, reflecting the management and controlling shareholder oriented views of the corporate bar.

The uninterrupted success of the corporate bar in expanding

The most striking finding in this study is that the Williams Amendment has had a substantial impact on costs in tender offers, increasing them by between 13 percent and 27 percent . . . . [T]his impact should be considered the next time a legislative body begins consideration of a market mechanism which could (if left alone or encouraged) be instrumental in providing market imposed discipline on managers of U.S. firms . . . . Our findings indicate that one effect [of repealing the Williams Act] would be to decrease costs in tender offers substantially with resultant effects on the efficiency of firms in the U.S. economy.

Smiley, supra note 71, at 145.

82. See generally Hetherington & Dooley, Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem, 63 Va. L. Rev. 1 (1977) (advocates statutory sellout right for minority shareholders in close corporations subject to judicial supervision to prevent price unfairness and to protect corporation against excessive cash drain).

83. Although enabling-type statutes, see note 27 supra, authorizing special internal arrangements for close corporations have been widely adopted, special close-corporation legislation has been resisted in part because of the concern of some corporate lawyers that recognition of close corporations as a separate class would expose publicly held corporations to more onerous regulation.
management perogatives and in reducing the difficulty of procuring shareholder approval of actions favored by management has had at least one unintended consequence. Although much, if not most, of what has been accomplished has not been demonstrably adverse to shareholders' interests in publicly held companies, it has undoubtedly contributed substantially to the support among academic lawyers for federal standards for publicly held companies.84

The Role of the Securities and Exchange Commission

Each foregoing interest group has sought to speak for the American shareholder. However, theirs are not the most powerful or influential voices to be heard in the continuing debate about corporate governance. That distinction is reserved for the SEC, the official governmental voice for the interests of the American shareholder and our first national consumer protection agency. The Commission is highly regarded in Congress, has a favorable public image, and is generally considered by the business community to be a well-run agency. From the outset it has been able to attract a talented staff, and throughout its existence it has generally been regarded as the most prestigious federal regulatory agency.

The most important reason for the Commission's remarkable success has been the nature of its regulatory activities. From its inception, the Commission's principal function has been to ensure that adequate information is available about companies offering securities to the public. As a regulatory device, disclosure has some unique characteristics that distinguish it from substantive regulation of business activities. In the first place, disclosure is intuitively "right." It suggests openness, candor, and fair dealing; secrecy, on the other hand, suggests unfairness and an interest in obtaining an unfair advantage over another party. Because it is difficult to determine how much disclosure is enough, the Commission is likely to favor requiring more rather than less information. The Commission is unlikely to be criticized by Congress or by investors for requiring too much disclosure. On the other hand, the failure to require the disclosure of information that in retrospect appears to have been relevant could result in criticism. This tendency to require greater disclosure is enhanced by the absence of any cost-

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84. See, e.g., M. Eisenberg, supra note 2, at 319-20; Cary, supra note 20, at 701-05; cf. Folk, supra note 18, at 1080 (indicating some degree of approval for Professor Cary's suggestions).
benefit analysis of disclosure. The Commission occasionally expresses an interest in such an analysis, but it is not serious and has never followed through. The absence of data does not expose the Commission to damaging criticism because virtually its only critics are a few academicians and groups within the securities industry whose opinions are heavily contaminated by self-interest. Hard data about the costs and effects of disclosure can only result in limiting the Commission's discretion and would provide a sound basis, which is presently lacking, for evaluating its policies.

85. Professor Nicholas Wolfson, a Commission staff member for six years, has written:

In the main, federal securities laws are based on unproven assumptions that they achieve their purposes, rather than on empirical proof that they do. A securities law or a regulation promulgated by the Securities and Exchange Commission typically is founded on untested beliefs about its effectiveness. Although it is possible to state with some confidence that our securities markets operate better with the present regulatory scheme than they would without any regulatory law at all, the comparative effectiveness of one particular formulation of a rule over another remains almost a pure guess. Wolfson, The Need for Empirical Research in Securities Law, 49 S. Cal. L. Rev. 286, 286 (1976).

86. The Commission's most recent feint in this direction was the appointment of an advisory committee on disclosure. See STAFF OF ADVISORY COMM. TO THE SECURITIES AND EXCHANGE COMM'N REPORT ON CORPORATE DISCLOSURE (submitted to the House Comm. on Interstate and Foreign Commerce, 95th Cong., 1st Sess. (Comm. Print 1977)). Dean Kripke, a member of the committee, has stated that while the committee's charter required it "to pass on cost/benefit considerations, the Committee sloughed off the problem, saying that it was generally unable to make the analysis." Kripke, supra note 10, at 101. He also observed that although the committee received a lecture on "the efficient market hypothesis . . . at an early meeting the Committee never discussed the new economic concepts in depth." Id. at 100.


Professor Benston's views are severely criticized in Fiflis, Economic Analysis as One Phase of Utilitarianism, in CORPORATIONS AT THE CROSSROADS 62 (De Mott ed. 1980). Professor Fiflis argues that critics of required disclosure have been unable to show conclusively that there are no benefits from required disclosure or to accurately demonstrate the costs of required disclosure. Id. 73-96. Hence he concludes that those who would substantially reduce, if not eliminate, required disclosure have not made their case. Id. As a critique of the challenge to the orthodox wisdom on the value of required disclosure, Professor Fiflis' comments are extremely useful. If the case for required disclosure rests on speculative arguments and suggested weaknesses in the case presented against it, then the benefits of required disclosure and the justification for its retention are dubious at best. If the merits of the argument are so evenly divided that whoever bears the burden of persuasion loses, then one ought seriously to consider the possibility of removing or at least substantially reducing, disclosure requirements.
Investors are no more aware of what disclosure requirements cost them than they are of the benefits that they are said to receive. The only groups to take a position before the Commission are representatives of management and the securities industry and public-interest advocates. These groups all have some special interest to promote. Their views are reliably predictable and may safely be discounted by the Commission in reaching its conclusions. Since investors themselves say nothing and the Commission is charged by statute with promoting their interests, it decides what their interests require. Thus, the American shareholder remains a nonparticipant in the on-going process by which the Commission gradually and selectively extends the scope of disclosure requirements in the shareholder's name over the opposition of the special interests in the industry.

The same thing is true in the area of corporate democracy. The proxy rules concerning shareholder proposals and the election of directors are determined by the Commission on the basis of its own judgments about what is good for the public shareholders. Any proposals for increasing the scope of shareholder sufferage or making board elections meaningful contests are resisted by management, largely on the basis of costs and shareholder indifference. Their argument against expanding shareholder sufferage is that any changes would be taken advantage of by social responsibility activists whose purpose is to obtain a platform for advancing their particular interests toward which most shareholders are hostile or indifferent. The Commission has generally adopted this view in its

88. A shareholder-relations firm, which claims that in any year it handles “500 security holder solicitation campaigns” and that it acts as a consultant “to over 200 publicly held companies in all phases of shareholder relations,” offered the following comments on the Commission’s recently proposed changes in shareholder proposal and board of director election procedures:

[We believe the Commission’s current concern with matters broadly covered in the phrase “corporate governance” is not based on any empirical evidence that the millions of individual security holders and indirect beneficiaries believe the current corporate system and procedures are fundamentally inadequate. While there may be recognition that some portions of the system and practices can be improved, we have never discerned during our extensive contacts with shareholders any sense of disquietude.]

Nor do we perceive from the Commission’s release that it has uncovered any broad objections from shareholder/investors. The source of interest in the proposals seems to be restricted to “certain commentators,” whose numbers, while vocal, are insignificant in comparison to the millions of investors.

regulation both of shareholder proposals and of elections of directors under the proxy rules. For decades the Commission narrowly limited the subject matter of shareholder proposals and successfully resisted judicial review of its actions despite a record of unexplained substantive inconsistency and procedural irregularities. The screening of shareholder proposals was only relaxed after severe judicial criticism of the Commission's high-handed behavior. Shareholders' interest in profits and indifference to social causes is hardly a reason for denying them the opportunity to consider such questions if appropriate restrictions are created to control duplicative and repetitious presentations.

In 1943 the Commission rejected the suggestion that shareholder nominees to the board of directors should be given space in the company proxy statement. The principal reasons given for this decision were that unqualified persons might be nominated, that too many candidates might be nominated, and that the shareholders would become confused and improperly mark their proxies. The notion that workable procedures could not be devised to limit the number of candidates and to handle the nomination and voting processes is absurd. Similarly, the suggestion that investors cannot be trusted with a meaningful vote is arrogant and condescending as well as untenable. If investors cannot be trusted to make intelligent choices on their own behalf given adequate information, then the disclosure philosophy of the securities laws was mistaken from the start.

91. See note 9 supra.
93. Professor Eisenberg has argued that, subject to reasonable restrictions, shareholders should have the right to nominate candidates. M. Eisenberg, supra note 2, at 117-18; accord, Caplin, Shareholder Nominations of Directors: A Program for Fair Corporate Suffrage, 39 VA. L. REV. 141, 151-54, 159-61 (1953); Note, A Proposal for the Designation of Shareholder Nominees for Director in the Corporate Proxy Statement, 74 COLUM. L. REV. 1139, 1148-57 (1974).
The Commission has had the power for decades to make the boards of directors more independent of management if it seriously desired to do so. While the Commission has recently moved to change election procedures, it has not given shareholder nominees access to the company proxy statement. Instead, it has required that management nominees be identified by status,94 and suggested that shareholders be permitted to vote on each candidate individually rather than for or against the entire slate.95

The Commission's discretion is further enhanced by permissive and enabling state corporate laws. As these state laws have been condemned by academics who called for some degree of federal regulation in the name of investors, the Commission has been encouraged to expand the frontiers of its authority and to seek new authority where plausible arguments can be made "in the interests of investors."

The foreign-payments affair illustrates this process. The subject provided the Commission with the same kind of irresistible opportunity that pornography prosecutions offer to elected district attorneys: a chance to take the moral high ground and attract favorable public attention and publicity, regardless of the outcome. The issue also offered the Commission the possibility of obtaining substantive authority to regulate business conduct along the lines

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94. 17 C.F.R. § 240.14(a)-101 (1979). The Commission stated that at its 1977 hearings on the proposed amendments to 17 C.F.R. § 240.14(a)-101 over 300 individuals and organizations testified or submitted written comments, Securities Exchange Act Release No. 34-15384, 43 Fed. Reg. 58,522, 58,522 (1978), and that the publication of the rule proposals generated communications from almost 600 individuals and organizations, Id. at 58,523. It is clear from the Commission's release discussing the input it received that most of the persons who communicated with it were representatives of interest groups within the industry, mostly managements and their lawyers, plus some public interest professionals and a few professional shareholders. It is also likely that the 300 and 600 figures overlap to a considerable extent. Let us put these figures in context: Georgeson & Co., a firm specializing in shareholder relations, stated in a submission to the Commission concerning the proposed revisions of the proxy rules that "[a]n estimated 25,000,000 individuals are direct owners of shares of stock in public companies." Letter from Georgeson & Co. to the SEC, supra note 88, at 2.

95. Securities Act Release No. 34-16104, 44 Fed. Reg. 48,938 (1979) (to be codified, if adopted, in 17 C.F.R. § 240.14a-4(b)(2)). These new rules flow from the Commission's campaign to have outsiders compose a majority of the board of directors. Although it is unclear whether outside boards perform better than management-selected boards, the latter are clearly inconsistent with the academicians' theoretical model. Thus the recent SEC changes can expect substantial support from that quarter. Once again, the initiative is from the Commission acting in its loco parentis role on behalf of investors on the basis of its unverified and self-serving perceptions of investors' interests.
proposed by the academic critics who decry the decline of moral and fiduciary standards in corporate management.\textsuperscript{96} It was far from clear that disclosure of foreign payments would have any significant benefit for investors, and the scope of the Commission's authority in the matter was uncertain.\textsuperscript{97} There was never any question that the challenged payments were intended to, and did in fact, preserve the corporation's business interests. Further, in some cases at least, it was clear that the payments conformed to widespread commercial practice and were not unlawful where made.\textsuperscript{98} The legislation ultimately adopted by Congress at the Commission's urging did not rest on any showing that such payments were contrary to investors' interests,\textsuperscript{99} because no such showing could be made.\textsuperscript{100}

What has been achieved? It appears that some payments that were the subject of criticism are now lawful under the legislation.\textsuperscript{101} Since corporations now have a right to make political con-

\textsuperscript{96} For a review of events leading up to the enactment of federal legislation on questionable payments abroad and a description of the SEC's role therein, see Coffee, \textit{supra} note 7, at 1115-25.


\textsuperscript{98} \textit{E.g.}, Gall v. Exxon Corp., 418 F. Supp. 508, 518 (S.D.N.Y. 1976) (payments by Exxon in Italy lawful under Italian law). The payments are intended to promote the business interests of the donor and therefore plausibly fall within the purposes prohibited by the statute. If they are not for this purpose, however, they are waste and unlawful under state law. \textit{See e.g.}, CAL. CORP. CODE § 309(a) (West 1977); N.Y. BUS. CORP. LAW § 720(a) (McKinney 1963 & Supp. 1979). Under the federal statute these contributions are no different from any other expenses incurred to obtain goodwill, and they are not "corruptly in furtherance" of that purpose.

\textsuperscript{99} The prospects for obtaining legislation were enhanced by congressional sensitivity to the issues. Political contributions and bribery are politically sensitive subjects. It behooves politicians to take strong and uncompromising stands against all improprieties and to resolve any doubts in questionable cases with a position against. Hence there was no serious opposition to the adoption of the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (to be codified in scattered sections of 15 U.S.C.), which prohibits United States firms from making payments abroad "corruptly in furtherance of . . . obtaining or retaining business," \textit{id.} § 103(a) (to be codified in 15 U.S.C. § 78dd-1).

\textsuperscript{100} Most studies that have been done (though none claim to be conclusive or of definitive depth) would indicate that disclosures of improper activity abroad or at home have not had a lasting effect on either the prices or volume of trading of a company's securities. Anecdotal evidence of the relative indifference of shareholders to confessions of corporate misconduct is common.


\textsuperscript{101} \textit{See} Gall v. Exxon Corp., 418 F. Supp. 508, 518 (S.D.N.Y. 1976) (payments
tributions in this country, it is unlikely that the legislation can reasonably be interpreted to make such payments abroad unlawful. The Department of Justice recently announced that in the future prosecutions under the Act will not be based on so-called "grease payments," and that it will issue guidelines concerning them. The principal result of the whole exercise seems to be that the SEC has been given authority to police management behavior in an area no more directly related to securities regulation than any other type of management activity. The Commission has been given roving authority to inquire into allegedly unlawful payments, an activity that enhances the SEC's power and produces favorable publicity for the agency.

The usual means by which the Commission's jurisdiction is extended is not by the acquisition of new authority, but by the reinterpretation of old. The most remarkable example of this development occurred in the insider trading area. Eleven years after the promulgation of rule 10b-5 and seven years after Kardon v. National Gypsum Co. held that there could be a private cause of action for damages if the rule were violated, it had not occurred to the Commission to use the rule to regulate insider trading on inside information. Twenty-seven years later, not only is trading on inside information by insiders considered a violation of the rule, but such trading by just about anyone may also violate rule 10b-5.

by Exxon in Italy lawful under Italian law).


103. The Department of Justice plans next year to begin advising "businessmen how far they can go [in paying bribes] without risking prosecution." TIME, Nov. 26, 1979, at 61. According to the report, United States firms have complained that their inability to make routine payments that are needed to facilitate and expedite business transactions abroad is proving to be a competitive handicap. Id. Such payments have been called "grease" payments. Coffee, supra note 7, at 1120. The SEC is also studying how the Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (to be codified in scattered sections of 15 U.S.C.), affects American business operations abroad. N.Y. Times, Feb. 22, 1980, at D3, col. 1.


107. A 1953 article, co-authored by the then-Chairman of the Commission, extensively reviewed the law applicable to insider trading, but did not mention the possibility of liability under rule 10b-5. Cook & Feldman, Insider Trading Under the Securities Exchange Act (pts. 1 & 2), 66 HARV. L. REV. 385, 612 (1953).

108. Although rule 10b-5 is violated by noninsiders trading on information received from insiders, see Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495
The SEC's ability to exercise discretionary power is unique among agencies regulating the behavior of specific industries. The total indifference of the investing public to its conduct enables the Commission to define investors' interests, to implement rules dealing with problems that it has discovered, and to conclude that it has been successful in protecting the shareholders' interests because the contrary can rarely be proved.109 The Commission's decisions are subjected to less intense counterbalancing pressures from the constituencies with which it deals than are the decisions of such agencies as the National Labor Relations Board, the Federal


109. In contrast consider the experience of the National Labor Relations Board, an agency that, like the SEC, was created to protect the interests of an unorganized client group in its dealings with powerful economic organizations. National Labor Relations Act, Pub. L. No. 74-198, §§ 1, 3, 49 Stat. 449 (1935) (current version at 29 U.S.C. §§ 151, 153 (1976)). Unlike the SEC, whose activities were largely confined to implementing disclosure laws, the NLRB was charged with developing a body of substantive law to protect the interests of industrial labor. Although the Board's constituency was initially in need of protection, labor rapidly became powerful, well organized, and able to speak effectively for itself. When labor had become an effective force in its own right, the Board's mandate was changed in 1947 to an essentially judicial role. Labor Management Relations (Taft-Hartley) Act, Pub. L. No. 80-101, 61 Stat. 136 (1947) (current version at 29 U.S.C. §§ 141-197 (1976)). The Board is now charged with developing a body of law that regulates the interaction of two powerful interest groups. The result is that the Board's decisionmaking practices have become highly defensive: Its opinions have been criticized by academics and practitioners for consisting of elaborate factual descriptions followed by delphic pronouncements of results without any legal analysis or argument. E.g., Bernstein, The NLRB's Adjudication-Rule-Making Dilemma Under the Administrative Procedure Act, 79 YALE L.J. 571, 576 (1970). The Board's defensive position between these powerful constituencies is further illustrated by its persistent refusal to engage in rulemaking. Id. at 573-74. In this way, the agency seeks to limit its exposure to criticism.

In two respects the Board is very much like the SEC. It has consistently shied away from an empirical study of the effects of its activities.

The assumption that the Board has the ability to assess the actual impact of employer- or union-conduct is a fiction. Although it has been administering the National Labor Relations Act for over thirty-five years, the Board has never engaged in an effort to determine empirically whether a particular type of conduct [by parties to labor disputes] has a coercive impact.

Getman & Goldberg, The Myth of Labor Board Expertise, 39 U. CHI. L. REV. 681, 682 (1972) (footnote omitted). The Board has also succeeded in developing an unwarranted reputation with the courts for expertise in its field. Uncritical judicial acceptance of the myth of Board expertise is fostered by "its usefulness in allocating institutional responsibility" and in justifying "a fairly limited scope of judicial review." Id. at 683.
Trade Commission, and agencies that regulate prices, such as the Interstate Commerce Commission and the Civil Aeronautics Board. The decisions of these agencies have immense importance for the firms affected. For this reason, decisions are usually made only after elaborate proceedings, and if they are adverse to the firms involved, they are likely to be challenged in court. SEC enforcement of its disclosure requirements for prospectuses, proxy statements, and reports filed with the Commission do not have comparable continuing impact on particular firms. Increased disclosure is often troublesome and more costly to the firms affected, but the matter is unlikely to be of substantial importance to them. In cases of disclosure requirement violations, the Commission frequently obtains consent decrees in which firms, often without conceding any wrongdoing, agree not to repeat the violation. The mildness of both the burden of compliance and the sanction means that resistance to Commission decisions is not cost-justified for most firms. The costs of complying with disclosure requirements can be borne by established firms or passed on to investors. For smaller firms compliance costs may be more serious and one of the costs of regulation may be the investment opportunities that these costs prevent from coming to the public markets. Such lost opportunities are not visible to the investing public, however, and do not expose the Commission to serious criticism. For present purposes it is important to recognize that the nature of the Commission's principal regulatory activity, requiring disclosure, largely insulates it from serious challenges and sustained criticism from both the firms whose activities it regulates and the investing public.  

110. Only occasional massive securities frauds or those involving public figures attract public attention to the Commission's activities. The Commission is obviously not responsible for the activities of crooks, and cannot be expected to police the honesty of the entire business community. These events do, however, give the Commission an opportunity to attract favorable publicity and create an atmosphere in which it is politically feasible and publicly acceptable to expand its authority. In a number of cases, serious and deliberate managerial improprieties have enabled the Commission to obtain orders restructuring the boards of publicly held companies. Mathews, A.L.I. Proposed Federal Securities Code: Part XV—Administration and Enforcement, 30 Vand. L. Rev. 465, 534-41 (1977). Mathews notes that "[t]he 1933 and 1934 Acts have never authorized specifically the Commission's seeking or obtaining ancillary relief in civil injunctive decrees." Id. at 538. He then enumerates 13 different types of such relief that the Commission has obtained by consent. Id. at 538-41. The separation of ownership and control provides the necessary theoretical justification for the replacement of elected directors by court appointees. Since the conduct that leads to the intervention is detrimental to the interests of investors and adversely affects stock prices, the intervention gives rise to little serious criticism.
A regulatory agency can be expected to attempt to broaden the scope of its authority. Problems in administering a statute are often experienced at the margin of its coverage. Administrators often perceive that the difficulties of their task will be diminished and the effectiveness of their performance increased if the frontiers of their mandate can be broadened. Hence, it is not surprising that the SEC has sought to narrow the scope of the statutory exemptions to its regulatory authority and to expand the disclosure requirements for security offerings.

Narrow construction of the exemptions is said to be justified by the broad remedial purposes of the Securities Act of 1933. Thus, the regulations concerning the private-offering exemption currently provide that, to ensure its availability, issuers claiming the exemption must ascertain that the offerees are sufficiently wealthy to withstand the possible loss if the venture should fail and sophisticated enough to assess the investment without SEC-mandated disclosures. It is a long jump from the statutory language, which merely exempts "transactions by an issuer not involving any public offering," to the conclusion that Congress contemplated that investors could be required to disclose their own financial affairs before they could be eligible to participate in an investment exempt from the statute. Issuers claiming the exemption can be relied upon to enforce compliance by offerees because of the severe consequences if the exemption is lost. When the legitimacy of the regulation is challenged, the Commission may respond that its mandate has not been exceeded because compliance

Instances of massive fraud and activities that are contrary to investors interests can also be used to support the case for federal standards generally. If federal intervention after the fact is useful to protect investor interests, might it not be desirable to anticipate and forestall such crises by preventive action by the Commission? The issue comes down to the significance of these occasional headline-catching management failures. If one looks primarily at such instances, the case seems clear; if one considers them as isolated and inevitable occurrences, their significance is greatly reduced. For present purposes, the point is that such events are opportunities for the Commission to broaden its authority in the area of corporate governance.

111. 17 C.F.R. § 230.146(d) (1979).
113. The landmark Supreme Court decision in the area emphasized the offeree's need for information in determining the scope of the private offering exemption. SEC v. Ralston Purina Co., 346 U.S. 119 (1953). This does not suggest that disclosure of the offeree's wealth is a factor to be weighed in determining the availability of the exemption. The Commission has, however, exempted offerings partly on the ground that the offerees were extremely wealthy. Mulford, Private Placements and Intrastate Offerings of Securities, 13 Bus. Law. 297, 301 (1958).
The regulation is not the only way in which the exemption may be obtained.\footnote{114}{The regulation's burden is not great and there is only a slight intrusion into the privacy of the prospective purchaser. The result may protect some potential purchasers from ill-advised investments, a function not previously known to have been assigned to the Commission. Investors may also be excluded from a profitable investment opportunity, in effect because the drafters of the suitability language in the regulation thought these investors should not run the risk. Curiously, this protection against risky investments is not provided to potential purchasers of investments that are subject to the SEC's jurisdiction.}

The Commission has subtly extended its own authority. It has done so, not because of the felt or expressed needs of investors, but sua sponte because of its views about what investors should have and because of its own institutional interest in extending the reach of its jurisdiction. The statute's broad remedial purposes become the means by which the agency rewrites the letter of its statutory mandate. Exemptions from the statute's coverage are often not justified by policy; they are arbitrary limitations likely to be based upon the political power of particular interest groups and on practical enforcement considerations. Easing them out of the statute by constricting regulations nevertheless amounts to rewriting the law. By such limitations on exemptions and through expansive interpretations of its regulations, occasionally with powerful judicial assistance,\footnote{115}{See, e.g., Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).} the area within which the SEC exercises largely unreviewed discretion over the course of developments of the law is expanded.\footnote{116}{The performance of the Commission in shaping the development of securities law through its dominance over the other forces that have helped to shape the growth of this body of law is testified to by the proposed Federal Securities Code ALI FEDERAL SECURITIES CODE (Mar. 1978 proposed official draft). The Code is the product of a major effort by the American Law Institute and the American Bar Association's Business Law Section. It attempts to give a coherent and intelligible structure to the complex combination of statutes, regulations, and court decisions that have been accumulated over the last 35 years and now comprises the federal securities law. The principal objection to the Code is its codification of rules developed by the SEC and courts on the basis of rigid misperceptions concerning the interests of investors without regard to the empirical research and data on the relationship between securities markets and the securities law. See Benston, Required Periodic Disclosure Under the Securities Acts and the Proposed Federal Securities Code, 33 U. MIAMI L. REV. 1471 (1979); Kripke, Securities Law Reform and the ALI Federal Securities Code, 33 U. MIAMI L. REV. 1453 (1979); West, The Federal Securities Code: Some Comments on Process and Outcome, 33 U. MIAMI L. REV. 1485 (1979). Realistically, the drafters of the Code could not have been expected to reexamine critically the theology of securities law: there was no point in drafting a Code that had no chance of passage, and no Code can be passed that is not approved by the SEC. See Loss, Keynote Address: The Federal Securities Code, 33 U. MIAMI L. REV. 1431.
III

It is to be expected that the body of law built under the guidance of a powerful and competent regulatory agency, based on its perceptions of investors' interests, would differ from a body of law built by accretion under the common law through cases brought by private parties to vindicate what they perceive to be their rights. Private litigation is initiated because plaintiffs perceive that the defendants' conduct has inflicted an injury on their interests. The issue is always whether the plaintiff had the rights she thought she had, and if so, whether the conduct of the defendant in fact interfered with those rights. The final issue is whether the defendant was entitled to behave as she did so that the plaintiff must bear the loss. When rules are developed in this manner, the legal process focuses directly on the factual connection between the conduct of the defendant and the loss sustained by the plaintiff.

Administrative rulemaking, however, does not occur in the context of a particular case and is wholly prospective in effect. The agency need not, and in fact often cannot, demonstrate conclusively that the rule being promulgated will actually have the beneficial effects intended. This inescapable uncertainty enables the rulemaker to advance regulations in the name of investor protection that do not demonstrably benefit investors, but clearly do benefit the agency's power, prestige, and institutional interests.

The following section discusses two areas, insider trading and going private transactions, in which changes in the law initiated by the SEC illustrate this process. In both, the Commission has brought about major changes in the law at great expense to taxpayers and investors in the name of investor welfare. These changes have extended the Commission's authority, but have been of little if any benefit to investors. In both areas the Commission's efforts have been assisted by the academic critics' perception that the conduct sought to be controlled or prohibited is unethical or unfair to investors. In the terms of the story with which this Article began, the principal representative of the Sleeper's interests is the SEC, and the current scheme of things is more the handiwork of this powerful custodian of the Sleeper's presumed interests and desires than of any other factor.

**Insider Trading**

When nonpublic information exists that would affect the market price of a security, investors who lack the information are exposed to a risk from the resulting inaccuracy of the market price. If the undisclosed information is favorable, all sellers receive too little for the shares, and all buyers pay too low a price, irrespective of whether they possess the undisclosed information. Conversely, if the unrevealed information is bad news, all sellers receive and all buyers pay too much. The “losses” sustained by those who sold at too low a price in the case of undisclosed good news or who bought at too high a price in the case of undisclosed bad news equals the gains of those who bought in the first case or sold in the second. Because the market does not have information that would affect the price, wealth transfer between all sellers and all buyers results that would not have occurred if the information had been public. The amount of the wealth transfer is the difference between the market price and what the market price would have been if the information had been disclosed.

The wealth transfer occurs whenever there is undisclosed information regardless of whether those who know of the undisclosed information are trading in the market, and indeed regardless of whether anyone knows the information. Hence under conventional principles of civil law, there is no basis for imposing liability on those who possess undisclosed information and trade in the market in favor of those who lack the information and trade in the market.\(^1\) One might with equal logic impose liability on everyone who possesses the information, whether they trade on it or not.\(^2\) Trading by those who possess the nonpublic information may well benefit the uninformed traders if their activities are sufficient to affect the market price. For example, suppose that the market price is thirty dollars and there is undisclosed information that would

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\(^1\) See Goodwin v. Agassiz, 283 Mass. 358, 363, 186 N.E. 659, 661 (1933) (directors of mining company, on learning of geologist’s theory on possible existence of copper deposits, are under no duty to disclose theory to shareholders). After stating that the “law in its sanctions is not coextensive with morality,” the Goodwin court commented that “the applicable legal principles ‘have almost always been the fundamental ethical rules of right and wrong.’” Id. (emphasis added) (quoting Robinson v. Mollet, L.R. 7 E. & I. App. 802, 817 (1875)).

\(^2\) Since any losses sustained by the uninformed traders result from their lack of knowledge, anyone who has the information can prevent these losses by releasing it. There is no reason why the duty to disclose should rest more heavily on those who trade than on those who do not. For a discussion of the disclose-or-abstain rule, see note 136 infra.
cause the price to increase to forty dollars. If the knowledgeable traders’ buying causes the price to rise to thirty-three dollars, then uninformed sellers who would have sold at thirty dollars and who now receive thirty-three dollars have benefited from the trading of those who had nonpublic information. However, any shareholders who sold at thirty-three dollars but who would not have sold at thirty dollars may have been injured by the effects of the insider trading, assuming that if the price had not moved these investors would have continued to hold their shares until the price went to forty dollars on publication of the news.

This analysis was developed in Professor Manne’s controversial book *Insider Trading and the Stock Market*, in which he demonstrated that insider trading was not injurious to uninformed traders and defended it as a form of management compensation.119 In the discussion that has raged in legal literature since the publication of his book, Professor Manne’s views have generally been rejected, and the correctness of his damage argument has been given little weight.120

For many years the SEC exhibited little interest in insider trading. Rule 10b-5 was adopted in 1942 because a corporate official was fraudulently disseminating misleading information so he could purchase shares at depressed prices.121 Civil liability under the rule for an apparently fraudulent nondisclosure of material information in a face-to-face transaction involving the shares of a closely held firm was established in 1947.122 In 1953 the Commission still did not believe that rule 10b-5 covered trading on nonpublic information in the securities markets.123 In 1961 the

119. H. MANNE, INSIDER TRADING AND THE STOCK MARKET 93-110 (1966). One need only examine Professor Manne’s book and the spate of articles that followed it to conclude that the battle lines between the moral arguments and economic analysis were drawn then, and have not changed since.

120. Professor Manne responded to his reviewers in *Insider Trading and the Law Professors*, 23 VAND. L. REV. 547 (1970). The numerous reviews, numbering at least 13 and including one by this author, are cited in that article. *Id.* at 547 n.2. Manne fairly characterizes much of the criticism of his book as “emotional and almost hostile.” *Id.*


122. Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947). It is interesting to note that although liability was imposed under rule 10b-5 in this case, *id.* at 802, the Securities Exchange Act of 1934, 15 U.S.C. § 78a-111 (1976), was invoked to obtain extraterritorial jurisdiction over the defendants, 73 F. Supp. at 800, and the theory of liability was one that the court correctly considered to have been well established at common law, *id.* at 803. In the court’s view rule 10b-5 added nothing to the substantive law involved.
Commission disciplined a brokerage firm for advising clients to trade on the basis of information acquired by a member of the firm as a director of a publicly held company. The Commission condemned the "inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." In 1968 the civil liability of insiders for their profits and those of persons whom they had advised to trade on the basis of nonpublic information was established in SEC v. Texas Gulf Sulphur Co. The old problem of the absence of injury to traders who lacked the confidential information was not dealt with by the court, which awarded a windfall recovery to the company. The Commission’s crusade against insider trading recently suffered a setback when the criminal conviction of an employee of a financial printing firm for trading on information obtained through his employment was reversed by the Supreme Court in Chiarella v. United States. The principal ground for the reversal was that the defendant was not a fiduciary upon whom a duty to disclose or refrain from trading could be imposed under rule 10b-5.

Given the absence of injury or loss to the shareholding public from insider trading, one could well ask why the Commission has undertaken and the courts have so enthusiastically supported this great crusade. Congress had, after all, provided a limited and specific remedy to control the more flagrant uses of confidential information by company officials. The Commission

123. See note 107 supra.
125. Id. at 912.
126. 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).
127. SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307-08 (2d Cir.), cert. denied, 404 U.S. 1005 (1971). In response to the contention that since the corporation had sustained no loss ordering "restitution" of trading gains to it was a penalty, the court observed that the corporation "may well suffer harm" because of the damage to investor confidence in its securities as a result of the insiders' activities. Id. at 1308.
128. 48 U.S.L.W. 4250 (U.S. Mar. 18, 1980). The issue of criminal liability under the securities laws will be before the Supreme Court again as certiorari has been granted to consider the conviction of an individual who pledged worthless shares as collateral for loans. Rubin v. United States, 48 U.S.L.W. 3655 (U.S. Apr. 14, 1980) (No. 79-1013). The issue is whether a pledge of shares is a "sale" of securities within the meaning of § 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a) (1976).
129. 48 U.S.L.W. at 4252-53.
was not under any mandate to supplement this remedy, and there was no demand from the investing public. The answer, it seems, is the "inherent unfairness" of insider trading to which Chairman Cary referred in the Cady Roberts case.\textsuperscript{131} The unfairness of trading on confidential information is, in this egalitarian age, enough not only to justify its condemnation but to sustain efforts to supplement the plain statutory remedy.

The absence of harm to uninformed traders has been disregarded by the courts, which, with few exceptions,\textsuperscript{132} have embraced the "inherent unfairness" concept. In Texas Gulf Sulphur, the Second Circuit stated that there is "a justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."\textsuperscript{133} Judge Waterman's opinion in Texas Gulf Sulphur\textsuperscript{134} and Chief Judge Kaufman's opinion for the court of appeals in Chiarella\textsuperscript{135} sought to protect this expectation by requiring "anyone who regularly receives material nonpublic information" to disclose it or to stay out of the market.\textsuperscript{136} The securities


\textsuperscript{132} E.g., Freeman v. Decio, 584 F.2d 186 (7th Cir. 1978). In Freeman, the court considered whether as a matter of Indiana law it should follow the rule of Diamond v. Oreamuno, 24 N.Y.2d 494, 248 N.E.2d 910 (1969) (corporation has right to recover profits made by insiders who traded on confidential information). The Freeman court noted that "[t]here is a good deal of ambiguity as to who should be considered a direct victim of insider trading," id. at 191 n.20, and observed that a "growing body of commentary suggests 'that pursuit of this goal of 'market egalitarianism' may be costly,'" id. at 190 (footnote omitted).

\textsuperscript{133} 401 F.2d at 848.

\textsuperscript{134} Id.

\textsuperscript{135} 588 F.2d 1358, 1365 (2d Cir. 1978), rev'd, 48 U.S.L.W. 4250 (U.S. Mar. 18, 1980).

\textsuperscript{136} Neither judge argued that the rule protects traders lacking the information from loss or diminishes the risk of loss to which they are exposed, because it does not. Subsequent defenses of the rule similarly have spoken of "fulfillment of investors' anticipations regarding the fairness of their treatment in the marketplace." Insider Trading: Some Questions and Some Answers, 1 Sec. Reg. L.J. 323, 331 (1974) (quoting Comment Letter from the Subcomm. on Broker-Dealer Matters and the Subcomm. on Rule 10b-5, of the Comm. on Federal Regulation of Securities of the Section of Corp. Banking and Business Law of the Am. Bar Ass'n (Oct. 15, 1973)), quoted with approval in Brudney, Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws, 93 Harv. L. Rev. 322, 353 (1979). It is difficult to argue that although insider trading does not injure uninformed traders individually, it nevertheless injures them collectively. The accurate point is that the existence of undisclosed information makes buying and selling riskier for all uninformed traders. It makes little difference to buy-and-hold investors, since they will not be affected unless there happens to be undisclosed information when they decide to buy or sell. What is left of the rule's justification advanced by Judge Water-
marketplace—whoever that may be—has no such expectation, however. Individual traders know that information continuously makes its way to the market in thousands of diverse, uncontrolled, and largely uncontrollable ways. No trader can be sure that she has all the relevant information or that new information is not about to reach the market. Speculators and brokers watch for unusual trading activity and buy or sell on the basis of price movements and rumors. If undisclosed material information exists, it would not be in the interest of other traders to exclude those who possess the information from the market. Their exclusion, to the extent that their trading would have made a difference in the price, increases the volatility of prices and the riskiness of the market for all other traders. The unavoidable conclusion is that in expanding the war against insider trading the courts and the SEC are not benefiting investors. Instead, their efforts may be having the opposite effect.

It is impossible to determine how much unlawful trading on public information occurs. In a recent article, Professor Dooley suggests that because executives appear to experience better than average trading results, a considerable amount of trading on nonpublic information occurs. Its significance, however, is ques-

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137. The point can be simply demonstrated. Suppose that insider trading were lawful and that only two common stocks are available to investors. Assume further that the two companies are in all important respects identical, and that each publicly reports all potentially price-relevant information as promptly as required and permitted by law. Finally, assume that the only difference between the two is that in one management never trades on inside information and in the other it does so freely. Which of the stocks should an outsider buy? The shares of the company whose management trades are bound to be more accurately priced in the market; they are therefore a less risky investment. Hence cautious investors should buy those shares, while speculators should buy the shares of the firm in which no inside trading occurs.

138. Dooley, Enforcement of Insider Trading Restrictions, 66 Va. L. Rev. (forthcoming 1980). It is not clear that this is the only possible factor involved. The intimate familiarity of insiders with the business may enable them to make trading profits legitimately. Because they live in the environment, they can be sure, for ex-
tionable. In view of its actual effects, or perhaps the lack of them, the American shareholder, with her customary insight, has viewed the whole exercise with almost complete indifference. In his study of insider trading, Professor Dooley found only thirty-seven Commission-initiated reported decisions since 1966; moreover, virtually all private enforcement efforts were based upon proceedings brought by the Commission. There can be little ample, that the firm is effectively managed or that management has achieved effective control of prior problems (or the opposite). Trading on insights based on such intimate knowledge is not unlawful.

139. Professors Lorie and Hamilton have observed that there is a possibility of occasionally superior profits from the very prompt scrutiny of information on insider trading. Certain patterns of trading by insiders, if noticed very promptly, can produce a small margin of superiority in trading in those stocks. The opportunities are not glittering since the patterns with predictive power occur only rarely, but profits on those occasions can make the effort worthwhile.

J. LORIE & M. HAMILTON, supra note 10, at 103-04 (footnote omitted).

140. Texas Gulf Sulphur is illustrative. This case offered a unique opportunity for insider profitmaking because of the immense importance of the information (the discovery of a rich nonferrous metals mine) and the long period of time (five months) that elapsed between the first indication of the magnitude of the discovery and the final confirmation and published public announcement. When drilling began in November 1963, the market price was around $17; after the final announcement in April 1964, the price went to $37. In mid-May it was over $58. 401 F.2d at 847. On December 1, 1964, the stock closed at $51; the closing price on December 31, 1965 was $91. The insiders and their tippees bought a total of 10,810 shares and calls for 11,000 shares prior to the final release of the information. Id. at 840-41. During the period from December 1, 1963, through April 10, 1964 (just prior to the announcement confirming the discovery), over two million shares were traded on the exchange, 1963 NEW YORK STOCK EXCHANGE DAILY STOCK PRICE INDEX Vol. 4, at 279; 1964 id. Vol. 1, at 279; id. Vol. 2, at 283. That is, over two million shares were bought by investors who were not privy to inside information. The market's efficiency in disseminating information could hardly be more dramatically illustrated. The insiders' activities in this most extraordinary and prolonged opportunity for insider profitmaking were trifling in relation to the total trading activity.

141. Dooley, supra note 138. Dooley notes that it is easier to measure the incident of enforcement than violation. He states that “the number of reported insider trading decisions is a reasonable proxy for the frequency with which legal claims are asserted and, by extension, the rate at which violations are detected and punished.” In determining the number of reported insider trading cases, Dooley limits his figure to “classic” insider trading cases—trading by a limited number of persons in a position to acquire and act on specific information before that information can be widely disseminated. Therefore cases involving face-to-face transactions were eliminated as were cases in which the insider trading claim seemed to be secondary or peripheral because factors peculiar to those cases produce a probability of detection and incentive to bring suit that are different from the typical insider trading case.

142. Id. Dooley cites five cases that have been initiated by private parties without any prior SEC action: Dolgow v. Anderson, 464 F.2d 437 (2d Cir. 1972); Lilly v. Guardian Mortgage Investors, Inc., [1978 Transfer Binder] FED. SEC. L. REP. (CCH)
question that the behavior of the investing public once again reflects an accurate perception of its interests. As Professor Dooley points out, if insider trading were a cause for concern among investors, it would be in the interest of some issuers to attract investors by taking special precautions against the possibility of illegitimate use of confidential information by their executives. The price of such companies’ shares would command a premium reflecting the value that investors place upon this assurance. In this, as in other matters, the behavior of the public has been entirely consistent with an accurate and rational view of the economics, if not the morals, of insider trading.

Since the Commission perceives trading on nonpublic information as a moral issue, the absence of private enforcement can be seen as proof of the need for stronger Commission action. Not to act is to tolerate, if not to condone, unethical behavior. Even if there were a significant amount of private enforcement, the miscreants usually lose only their profits if they are caught. These considerations and the general approval the Commission gains in its role as white knight call for further action, with little regard to balancing costs and benefits. An agency that has not displayed a serious concern about cost-benefit analysis of its activities from the standpoint of investor interests has even less incentive to take such considerations into account when unethical or immoral conduct is involved.

The Supreme Court’s recent reversal in Chiarella v. United States of the conviction of a financial printing company em-

143. Professor Dooley found no evidence of manipulation of the release of information to facilitate trading by insiders. Of the 33 incidents of insider trading investigated by the SEC since 1966, only six involved officers and directors—those having the best opportunity to manipulate the release of information. Dooley, supra note 138.

144. Two types of firms have made special efforts to prevent trading on inside information: law firms and financial printers. Id. The behavior of both is the result of competitive pressure and reflects their respective tradition about clients’ confidences. In both instances the clients’ ability to carry out the transaction may depend on secrecy. In Texas Gulf Sulphur, for example, the company’s land-acquisition program required that reports of the mining strike not be revealed. 401 F.2d at 843.


146. 48 U.S.L.W. 4250 (U.S. Mar. 18, 1980).
ployee for trading on information procured through his employment will necessarily limit the Commission's effort to expand liability for trading on nonpublic information. Neither the defendant nor his employer had a business relationship with the company whose shares were traded by the defendant. The Court concluded that under these circumstances the defendant could not be considered a fiduciary of the issuer whose shares he traded. For this reason it noted that affirmation of the conviction would have required "recognizing a general duty between all participants in market transactions to forego actions based on material, nonpublic information." Finding no intention on the part of Congress to create such a duty, the Court held that it could not be read into rule 10b-5, which was described "as a catchall provision, but what it catches must be fraud." The decision is thus a clear holding that the act of trading on nonpublic information is itself not fraud. The Court cited and apparently approved the decisions in Cady Roberts and Texas Gulf Sulphur, both of which found violations of the rule in trading on nonpublic information by insiders and their tippees. If it is still true that an obligation to disclose or refrain from trading can be imposed under rule 10b-5 on insiders (who are not named in the rule), a person in this class could possibly be criminally convicted for deliberate violation of rule 10b-5. After Chiarella it seems likely that the attempt will be made to obtain such a precedent when the proper case arises. If, as the Court observed, rule 10b-5 catches only fraud, and if fraud requires that someone be defrauded in consequence of the defendant's conduct, there would be serious question whether a conviction would be warranted.

The value of a criminal sanction to the Commission in the insider trading area would be significant. The possibility of criminal prosecution would greatly assist the Commission in threatening individuals whose behavior is within the scope of the insider trading

147. Id. at 4253.
148. Id. at 4252.
149. Id. at 4253.
150. Id. at 4251.
prohibition and in obtaining both disgorgement and consent agreements. While it is unethical for an attorney to use the threat of criminal prosecution in an effort to settle a civil matter, the two cannot be separated where the same party has control over both types of proceeding. The Commission regularly uses its broad regulatory authority over persons and firms in the securities business and over attorneys practicing law before it for coercive purposes. The converse is also true: Civil procedures may be improperly used to aid the criminal process, a possibility that has caused considerable difficulty in the tax field. The possibility of coercive use of the threat of criminal prosecutions of insiders seems particularly objectionable because the crime of insider trading was

152. ABA Code of Professional Responsibility DR 7-105(A).
153. The ultimate control of criminal prosecutions under the securities laws is in the Department of Justice, which acts upon referral by the Commission. 15 U.S.C. §§ 77t(b), 78u(d), 79r (1976).
154. The Commission has the ability to make the activities of those who regularly deal with it easier or more difficult merely by granting or withholding small courtesies. Within this author’s limited experience, Commission staff members would accept oral assurances, for example, concerning changes in language in a prospectus, while emphasizing that such courtesies were extended to the firm because it was “reliable.” On one occasion this author innocently declined to make a small change in a mutual fund prospectus which the staff had stated they would require as a condition of acceleration. (There was no immediate rush since the prior prospectus had not expired.) Shortly thereafter the staff member called back to state that in view of our refusal, a general inquiry would be made into the completeness and accuracy of the registration statement. The change was made. This trivial example illustrates a pattern of behavior that securities lawyers can confirm from their own experience. No law firm or registrant can therefore afford to defy the Commission or to incur the displeasure of its staff.

Professor Monroe Freedman concludes a short article reviewing instances of the SEC’s coercive tactics and the attitudes of members of its staff in dealing with registrants and their lawyers with the following observation:

In sum, therefore, securities regulation is characterized by denial of the right to counsel, corruption of the independence of the Bar and of the traditional professional standards of attorneys’ obligations to their clients, a police-state system of investigation, and denial of a variety of other basic due process rights.


155. The difficulty arises in the discovery process. In civil proceedings the IRS has extensive discovery powers. See I.R.C. § 7602. It may not, however, use these powers to search for facts on which to base a referral to the Department of Justice for criminal prosecution. See United States v. La Salle Nat’l Bank, 437 U.S. 298 (1978) (civil discovery power limited by good faith use). This rule invites the IRS to delay a criminal referral to enjoy the advantages of the broad civil discovery powers. For protection against this, the taxpayer depends upon what the Court has called the “institutional good faith” of the agency. Id. at 317 n.19. The problem was recently reviewed in United States v. Garden State Bank, 607 F.2d 61 (3d Cir. 1979).
not created by Congress, but was invented by the courts and the Commission in the absence of any showing that the prohibited conduct was intended to be embraced by the statute under which it was invented.\(^{156}\)

The institutional incentive for the SEC to pursue the insider trading issue is great. A crusade against immoral conduct is riskless from the prosecutor's perspective regardless of the outcome. The prosecutor has the double satisfaction of both believing that she is doing what is right and basking in the warm glow of public approval. It is to be expected that issues of this kind would attract the efforts of an agency that has substantial discretion in selecting its own goals. In the Commission's case, this has led to the remarkably successful insider trading campaign. This may have occurred at the expense of some responsibilities the Commission has to the private sector, for which it is explicitly responsible under its statutory mandate.\(^{157}\) These responsibilities are arguably of far greater importance to investors. Pursuing moral turpitude is much more gratifying, however, particularly when it broadens the agency's jurisdiction.

The conclusion seems inescapable that the efforts of the Commission to create and enforce sanctions against insider trading in addition to those provided in the statute are of little or no importance to investors. On the record there can be little doubt that the

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156. See Dooley, supra note 138.
157. Dean Kripke has charged that the Commission has improperly abdicated its clear statutory responsibility concerning accounting standards. Kripke, supra note 10, at 124-29. A prominent academic accountant recently commented:

As to cost accounting data, as an accountant, I believe I am capable of proving anything I want with cost accounting data. If I can't, I will turn in my CPA. Because I have available to me a whole set of arbitrary allocation rules, any one of which is acceptable by authorities, I can make the numbers come out the way I want them to come out within some range. And anyone who looks at my data and thinks he knows something is a fool.

**BUSINESS DISCLOSURE: GOVERNMENT'S NEED TO KNOW** 124, 130 (H. Goldschmid ed. 1979) (remarks of George Benston in symposium on FTC's segmental financial reporting proposal). The nonexpert may well be somewhat disconcerted by such statements, which seem to be confirmed by other sources. See, e.g., Uttal, _The Lease Is Up on Itel's Lavish Living_, FORTUNE, Oct. 8, 1979, at 106. The author, speaking of Itel's reporting of first-quarter results from a recent fiscal year, stated:

The first-quarter report showed that computer operations as a whole had lost $4.4 million. Profits for the entire corporation were reported up to 37 percent, to $10.1 million, but this result owed much to three changes in accounting principles. Without those and a decision to discontinue some losing computer operations, net income would have declined 40 percent.

_Id._ at 109 (emphasis in original).
Commission's activity in this area, like its recent efforts to extend disclosure requirements, are demonstrably unrelated to the needs and interests of the investing public. The absence of a cost-benefit analysis makes a sensible policy on disclosure impossible, and the absence of benefit to investors means that the Commission's commitment to extend the sanctions against insider trading is a misallocation of its resources. This type of regulatory frolic and detour is facilitated because the client group whose interests are entrusted to the agency is never heard from. The agency writes messages to itself. The result is a discretionary allocation of resources focused on areas likely to enhance the agency's institutional interests.

**Going Private**

Another area in which the Commission has undertaken to reform securities law in the interest of investors is going private transactions. This general term embraces any transaction or series of planned transactions that results in a corporation's shares being withdrawn from the securities markets. Such transactions usually occur in two stages. The first is a tender offer for the shares held by public shareholders; the second is a merger in which the public shareholders who did not accept the offer are compelled to take cash or debt securities for their shares. In some ways, going private is a moving target that is harder to hit than insider trading because not all going private transactions are "bad" or contrary to shareholder interests, while all trading on nonpublic information, including trading by persons who may not be subject to rule 10b-5 after Chiarella, can be condemned as unfair and unethical. In at least one respect, however, going private transactions are easier to attack because, unlike trading on nonpublic information, they do have a demonstrable impact on some public shareholders. Criticism of going private transactions has focused on the fiduciary obligations owed by management to the public investors who own shares in the firm. In the following

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159. See Borden, supra note 158, at 1006-20, 1040.

160. See text accompanying notes 146-151 supra.

161. The prototypical situation is one in which management and a few large shareholders have de facto control because of a combination of the strategic advantages of the management and ownership of a large block of shares in relation to the widely dispersed public holdings.

162. See, e.g., Brudney, A Note on "Going Private," 61 VA. L. Rev. 1019, 1040
section this issue is discussed in connection with repurchase tender offers; next, aspects of the cash-out merger are discussed; and the last section presents a brief commentary on the regulation of going private transactions under the Williams Act. Once again the theme is the discrepancy between the interests of the shareholding public and the positions taken on its behalf by the SEC and others.

Repurchase Tender Offers.—A cash repurchase by a corporation of its publicly held shares differs from a similar offer by an outsider in that it immediately reduces the assets of the firm by the amount paid. A purchase by an outsider has no effect on the firm’s assets. From the standpoint of the shareholders to whom the offer is made, the initial question in each case is the same: whether the price is adequate in relation to the offeree’s estimate of probable future value in light of all available information. If the tender offeror is another corporation, it is merely required to comply with the applicable disclosure requirements. If this is done, there are no further securities or corporate law problems in making an offer.

Where the tender offeror is the issuer, however, special concern has been expressed over three aspects of the transaction: Price unfairness, coercion of the public shareholders, and the purchaser’s identity. The basis of the objection to the tender offer price is that although it is above current market, it is frequently lower than the price at which the shares were sold to the public. Repurchase tender offers are timed to occur when the market price of the shares has fallen, perhaps as a result of a general decline in stock prices. Hence it is argued that because management and controlling shareholders have de facto control of the corporation and the timing of the tender offer, the repurchase proposal is exploitative of the public shareholders, particularly if the public offering at a higher price occurred only a few years previously. Although it has been strongly emphasized in criticisms of going private transactions, the basis of this unfairness has never been adequately explained by the critics or the courts. This argument

(1975); Sommer, “Going Private”: A Lesson in Corporate Responsibility, 278 SEC. REG. & L. REP. (BNA) D-1 (Nov. 20, 1974); Note, supra note 158, at 919.


165. E.g., Brudney, supra note 162, at 1051-53. Professor Brudney regards the unfairness risk as so serious that he would deny public shareholders the opportunity
must assume that the current market price is in some sense unfair. This can only be true if one assumes that information material to the value of the shares is being withheld from the market. If there is no material undisclosed information, then the market price is the current value of the company’s shares and an offer to purchase the corporation’s shares at a higher price after full disclosure cannot be unfair. In other words, one cannot object to a repurchase tender offer price under these conditions without asserting that the market price itself is generally unfair and oppressive to investors.

When a corporation makes a tender offer for its own shares, it can provide more complete and accurate information concerning all aspects of its affairs than can an outsider making a tender offer for those shares. The tender offerors in a repurchase situation therefore have information that cannot be made available to them by a third-party tender offeror on which to base their decision whether or not to accept the offer. This combination of more complete and reliable information means that management is less likely to err in valuing the shares. In addition, outsiders may have incurred substantial search costs and must allow for substantial expenses in responding to legal challenges to the takeover by the incumbent management. They will also incur substantial interest charges if they have borrowed to finance the acquisition. Whether or not it ultimately succeeds in blocking the offer, the target’s management can usually delay it, causing the outside tender offeror to incur substantial interest costs for which it will get nothing if the attempt ultimately fails. The only one of these obstacles encountered by the repurchase tender offeror are borrowing costs, which are likely to be limited. This suggests that theoretically the company should be able to offer a higher price.

On the other hand, there is a theoretical objection to the price offered by insiders, as opposed to third-party purchasers. Third-party purchasers are supposedly able to pay a premium because of the efficiencies that they will introduce when they oust the incum-

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1 The cost of borrowing is likely to be more serious to the outsider if the target management succeeds in delaying the takeover. During this period, the tender offeror receives no income from the shares it is seeking to buy and loan commitment and interest costs mount. The repurchasers usually experience no opposition and a much shorter period of delay. After the transaction is concluded, both can defray acquisition costs from the earnings of the firm.
Some of this expected gain, although as little as possible, is reflected in the tender price. The higher the price presumably the greater the anticipated efficiencies. Not so with repurchase offers. Since the buyers do not plan to replace themselves they cannot anticipate any efficiency gains. Hence the greater the discrepancy between the repurchase price and the market price, the more reason there is to be suspicious of the proposal. Of course, in practice no offeror will offer a higher price than is necessary to get the shares it seeks to buy.

The answer to these analytical conundrums is that they are not useful guides for legal rulemaking or for investors. The only course that seems warranted is to give the shareholders the facts, and then let them decide. Price is price. Shareholders should be given the chance to evaluate the offer and decide whether to accept it or hold out in the hope of obtaining a better price. If the suspicious shareholder, having experienced a price decline under present management, believes that no future efficiency gains are forthcoming, she should happily take the premium.

The hostility with which repurchase offers are regarded has led some courts to make truly remarkable statements, which have been endorsed by the commentators. One court observed, "[The] argument that stockholders should not be frozen out of their corporations is not weightless. Money damages will not thaw shareholders thus afflicted." Why not? We are not talking about a grand

167. "Takeovers by outsiders must be assumed to have a commercial goal that suffices by itself to justify the transaction." Brudney & Chirelstein, supra note 165, at 1362 (emphasis in original).

168. "[G]oing private . . . promises no economic gains to the enterprise that can be regarded as significant." Id. at 1367 (emphasis in original) (footnote omitted).

169. It is interesting to note that this is the correct conclusion to be drawn by investors about repurchase offers that are not part of a going private plan. A study of 96 repurchase tender offers of New York Stock Exchange firms found that after the offer the price performance of the stock was significantly inferior to the Standard & Poor's Stock Index. Rosenberg & Young, The Performance of Common Stocks Subsequent to Repurchase by Recent Tender Offers, Q. Rev. Econ. & Bus., Spring 1976, at 109-13. See also Take the Money and Run, Barron's, Dec. 8, 1975, at 11, col. 1. The authors suggest that the repurchasing firms were cash heavy and had no better investment prospects. Usually the market price rose at the time of the repurchase, but fell again as the factors contributing to the decline reasserted themselves. Id. at 19-20.

piano or the loss of affections, but about widely scattered publicly held shares that have no control value. They can have no value other than as an investment, for which monetary payment can be full compensation. This is not an area in which the law need recognize any idiosyncratic values.

Other elements of price unfairness include the income tax liability to which sellers may be exposed and the transaction costs of finding a new home for their money. Since the critics have urged that prices are too low in repurchase transactions, thereby minimizing any gain by sellers, the tax-liability contention seems a bit strained.\textsuperscript{171} The concern over the cost of finding alternative investments is theoretically valid but probably has little real world importance for public investors.\textsuperscript{172}

For present purposes, there are two points that need to be made on the question of price. First, concern over possible price inadequacy is based primarily, if not solely, on the tender offeror being the issuer of the shares. This special concern about the adequacy of the tender offer price in going private transactions rests on the theoretical speculation that the issuer will offer an unfairly low price, even though the price is above market. Second, from the public shareholders' perspective, the more numerous the potential tender offerors, the better. All regulation reduces the number of tender offers that will occur. The presumed benefits to shareholders of each additional disclosure or other regulatory requirement must be balanced against the loss of some opportunities to sell shares at a premium over market price. The interests of investors dictate that the cost of compliance with disclosure requirements should be kept to a minimum, so that as few offers as possible are screened out by the burden of regulation. Policies or regulations that deliberately attempt to screen out repurchase tender offers reject the basic disclosure philosophy on which the federal securities legislation is based: They assume that investors cannot be trusted to evaluate repurchase offers for their shares at prices above that at which the shares are currently being traded, even if they are given information that in other contexts—including tender offers by third parties—would be considered sufficient to

\textsuperscript{171}. Professor Brudney concedes that since going private tends to occur when stock prices are low, tax problems for shareholders are not likely to be a serious problem. Brudney, supra note 162, at 1024 n.20.

\textsuperscript{172}. No empirical data has indicated that investors find search costs a serious burden, and there is no basis for concluding that finding a new investment is a problem from which investors need protection.
enable them to make an informed decision. No plausible reason has been advanced to suggest why in this single situation investors should be denied the freedom to choose on the basis of full disclosure of all pertinent information.

The second objection to going private tender offers is their inherently coercive nature. If a sufficiently large number of the publicly held shares are tendered, there will no longer be an active market for the remaining shares. If the tender offeror announces its intention to use a cash merger to acquire the remaining shares at a price no higher than the tender price, this announcement, in the opinion of one commentator, "would understandably induce the stockholder to sell." It is questionable whether such an announcement would lead a shareholder who believed that the shares were worth more than the tendered price to feel that the only course open was to sell. If the tender offeror stated in advance that the merger price would or might be higher than the tender price, it would receive very few shares. In fact, the possibility of the merger price being lower is remote, since the affected shareholders would likely challenge it by litigation or by demanding an appraisal. The safest course for the tender offeror is to offer the same price in both transactions if the interval between the two transactions is short. As the period between the repurchase tender offer and the merger becomes longer, the merger price would have to be adjusted to reflect intervening developments.

Coercion is also seen as a significant factor in repurchase cases because going private tender offer prices have often been substantially lower than the original public offering price. It initially seems unfair that a shareholder should be pressured to accept a price that is much lower than the price she initially paid. There is, however, a certain lack of realism in all the discussions about the presumed coercion of public shareholders in going private tender offers. The obvious fact that is often not mentioned is that the shares have been trading at a market price lower than the tender offer. At least some shareholders were willing to sell for less, and at least some investors will profit from the transaction. Clearly there must be

173. Brudney, supra note 162, at 1040.
174. The writer is aware of no such cases. Nor did an empirical study of tender offers find any. Borden & Weiner, An Investment Decision Analysis of Cash Tender Offer Disclosure, 23 N.Y.L.S. L. Rev. 553, 570 (1978). Yet Professor Brudney, without authority or example, suggests that the intention to go private "creates the possibility of a lower price for the stock." Brudney, supra note 162, at 1045. He overlooks the possibility of a higher price for the shares being created.
some shareholders glad to receive a price higher than market. If a shareholder feels that she must accept because others may, any "coercion" is the cumulative result of the individual decisions of the other shareholders. It takes a considerable leap of faith to assume that most shareholders who accept the offer feel that they are being coerced.

The coercion element is equally present in third-party and repurchase tender offers. The most influential critics have now agreed that coercion in third-party takeovers is acceptable because of the expected economic efficiency benefits. In their view a third party that has acquired control of a target company by a tender offer ought to be able to eliminate the nontendering shareholders, despite the possible infringement on the fiduciary duties owed by management to the shareholders being cashed out. The implication is that there are no compensating economic benefits from going private transactions to justify the possible detriment suffered by the shareholders who are being forced out (after full disclosure at a price above market). However, this may not be so. At least one study of corporate share repurchases concluded that these transactions permit the reallocation of capital resources from firms with limited growth prospects to those that have available "high-yielding" capital investment projects, and these transactions may therefore be justified in terms of allocative efficiency. The point

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175. See, e.g., Brudney & Chirelstein, supra note 165, at 1357-59. Accordingly, Professors Brudney and Chirelstein disapprove of the holding in Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977). Brudney & Chirelstein, supra, at 1356. In Singer, a parent merged with a subsidiary. Minority shareholders of the subsidiary received cash for their shares and were thus eliminated from participation after the merger. The court held that the majority could not meet its fiduciary duty to the minority unless a corporate purpose for the merger, other than freezing out the minority, was supported by the evidence. 380 A.2d at 980. Professors Brudney and Chirelstein believe, however, that "[t]akeovers by outsiders must be assumed to have a commercial goal that suffices by itself to justify the transaction." Brudney & Chirelstein, supra, at 1362 (emphasis in original).

176. Brudney & Chirelstein, supra note 165, at 1363.


178. The same allocative benefits are unlikely to be achieved through prorata repurchases or distribution in partial liquidation, because the result is that the same gross amount of money is divided among a larger number of recipients, each of whom receives a smaller amount and is less likely to make a new purchase than are the smaller number of shareholders who receive larger sums on a non-prorata repurchase, because their entire stock holding is sold. Managers of cash-heavy firms have a tendency to prefer non-prorata repurchase quite apart from any control implications because of its tendency to increase earnings per share and hopefully market price (although experience indicates that this does not occur).
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is that unsubstantiated and speculative a priori opinions about economic utility are an unsatisfactory and inappropriate basis for regulatory discrimination between market transactions that have exactly the same impact on the investors involved.

All transactions that may result in the withdrawal of a firm's securities from the public markets present the same question: To protect those shareholders who would rather not sell from feeling that they are being coerced into selling because others are selling, should we adopt a rule that not merely coerces but actually denies an opportunity to sell at a price above market to those who want to take advantage of it? Without empirical data, one has no idea how many shareholders are in each group. We do not even know whether the first group has any members. In any event, it is a novel and dubious proposition that the owners of an investment security who wish to sell it at what they consider to be a favorable price should be denied the opportunity to do so because of the effect, real or presumed, on other shareholders in deciding what to do with their shares. The shareholder who wants to sell may well say, "If they want the right to prevent me from selling my shares when I think the price is right, let them buy it!"

The third objection to repurchase offers is the identity of the tender offeror. Simply because it may have originally offered its shares to the public at prices greatly in excess of the repurchase price, the understandable but mistaken impression arises that the repurchase offer is for that reason exploitative. This impression is intensified if the principal beneficiaries and instigators of the transaction are management and the controlling shareholders, who may themselves have sold shares to the public in previous public offerings. In addition, since insiders, who know more about the business than anyone else, are the authors of the offer, the offerees may question the adequacy of disclosure. The owners of a firm have reason to be uneasy when the party who has been managing their business and who knows more about it than they do suddenly appears in the role of a buyer. One intuitively feels that under these circumstances the company's repurchase of public shares, in contrast to an offer at the same price by outsiders, is oppressive and exploitative.

Finally, from the standpoint of the academic model, there is no reason why management should have the power to use corpo-

179. Because the shares have been trading at a lower price, some shareholders welcome the opportunity to sell at the offering price.
rate assets to manipulate the firm’s ownership. This is not a management function. Non-prorata purchases are inconsistent with the principle that all shares of the same class should be accorded the same treatment.\textsuperscript{180} Going private repurchase tender offers, therefore, can easily be regarded as a self-serving use of a dubious power that managers ought not to have in the first place.

Are there any reasons for requiring more disclosure or substantive restrictions because of the buyer’s identity? It has been suggested that the buyer should be required to justify the offer by showing that any advantage expected to be obtained by operating as a private firm could not be achieved by a publicly held one.\textsuperscript{181} Since such a restriction would prevent some offers from being made, it violates our general principle that shareholders’ interests benefit from rules that increase rather than decrease the number of offers likely to be made for their shares. Why should the best informed potential buyers be limited to making offers for the shares held by public shareholders only under special or limited circumstances? One authority who favors such a restriction has written:

Until evidence rebuts the presumptive likelihood that insiders will yield to the temptation to pay an undetectably unfair price, the case cannot plausibly be made that a larger net advantage will accrue generally to public investors by a test of fairness administered on a case by case basis than by a categorical prohibition against employing corporate assets and facilities to “go private” or to “go almost private.”\textsuperscript{182}

Surely a rule that prohibits going private tender offers in such broad terms should be adopted only on a clear showing that investors’ interests require it, and the suggestion that the price may be “undetectably unfair” hardly seems a sufficient justification for depriving shareholders of the choice. The price that shareholders would pay for the protection they receive is the difference between the current market price and the tender offer price. It is impossible to demonstrate that the policy is worth the premium, since the

\textsuperscript{180} Commentators have generally viewed non-prorata stock repurchases with skepticism. E.g., Cary, supra note 20, at 673-75. The favorite horrible example is Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964). Professor Eisenberg suggests that shareholders be required to vote on prorata distributions in partial liquidation. M. EISENBERG, supra note 2, at 264-65.

\textsuperscript{181} E.g., Borden, supra note 158, at 1022-23; Brudney, supra note 162, at 1026-39.

\textsuperscript{182} Brudney, supra note 162, at 1052-53.
unfairness in the offered price is undetectable despite full disclosure.\textsuperscript{183}

The proposal is influenced by concern for the public shareholders' expectation of equal treatment "in the distribution of corporate assets"; protecting this expectation requires that "no inequality on repurchase should be forced" or "accepted unless done freely and knowledgeably."\textsuperscript{184} Such a proposal, however, would require all shareholders to forego the opportunity to sell above market even after receiving full disclosure. Professor

\textsuperscript{183}. Cases allowing cash-out transactions in which there was no showing of nondisclosure or unfairness (except on the basis of a comparison with historical values, which are irrelevant) are apparently to be considered examples of undetectable unfairness. See Brudney, \textit{supra} note 162, at 1021-23 \& n.18 (citing Marcus \textit{v. AFW Fabric Corp.}, 398 F. Supp. 734 (S.D.N.Y. 1975), \textit{rev'd}, 533 F.2d 1277 (2d Cir.), \textit{vacated}, 429 U.S. 881 (1976); Green \textit{v. Santa Fe Indus., Inc.}, 391 F. Supp. 849 (S.D.N.Y. 1975), \textit{rev'd}, 533 F.2d 1283 (2d Cir. 1976), \textit{rev'd}, 430 U.S. 462 (1977); Dreier \textit{v. The Music Makers Group, Inc.}, [1973-1974 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) \textsection 94,406 (S.D.N.Y. 1974)). Some cases cited as examples of majority exploitation in support of the proposed prohibition of going private transactions appear to be instances in which the courts detected unfairness and prevented the minority from being forced to accept an "inadequate" price. \textit{E.g.}, Berkowitz \textit{v. Power/Mate Corp.}, 135 N.J. Super. 36, 342 A.2d 566 (1975). In Berkowitz, controlling shareholders holding 69% of the company's shares attempted to force a going private transaction to eliminate the public shareholders. The controlling shareholders had paid themselves $100,000 each three months prior to the proposed merger "so as to significantly reduce the company's earnings." \textit{Id.} at 48, 342 A.2d at 573. The court found that the "undisputed facts" raised serious questions concerning misconduct by the defendants and fairness of the price. \textit{Id.} A case for a preliminary injunction seems to have been clearly made out. Accord, Bryan \textit{v. Brock & Blevins, Inc.}, 343 F. Supp. 1062 (N.D. Ga. 1972), \textit{aff'd on other grounds}, 490 F.2d 563 (5th Cir. 1974). To induce plaintiff to sell prior to merger, defendants had engaged in deceptive conduct to artificially reduce the price of the shares. Professor Brudney observes that experience with "the more or less porous constraints resulting from the exposure of the merger terms to public inspection and possible challenge for inadequate description \ldots does not suggest that any of them is wholly adequate to assure to the excluded stockholders distribution of values equivalent to those obtained by the insiders." Brudney, \textit{supra}, at 1023 (footnotes omitted).

For this proposition two cases are cited by Brudney, \textit{id.}, at 1023 n.19, in which the elimination of the minority shareholders was prevented. In the first case, the transaction was found not to be permissible under the applicable statute. Myerhoff \textit{v. Bankers Sec., Inc.}, 147 A. 105 (N.J. Ch. 1929). In the second, a corporation's principal asset had been transferred to a company that was wholly owned by its majority shareholders at a price which the purchaser failed to prove was fair. Cathedral Estates, Inc. \textit{v. Taft Realty Corp.}, 157 F. Supp. 895 (D. Conn.), \textit{aff'd}, 251 F.2d 340 (2d Cir. 1957). A transaction of this kind could be attacked on a variety of grounds, including self-dealing and waste. These cases do not seem to demonstrate the need for a prohibitory rule in going private transactions where the price offered to the public shareholders appears fair on the facts.

\textsuperscript{184}. Brudney, \textit{supra} note 162, at 1052.
Brudney believes that adequate assurances of full disclosure cannot be given because of the unique, ineluctable advantages enjoyed by those making the offer, and the element of compulsion surrounding the making of a repurchase tender offer.\(^{185}\)

Ultimately one's conclusion is determined by one's perspective: Absent evidence of detectable harm from undetectable unfairness, the better choice is not to make rules that deprive public shareholders of the opportunity to receive cash. Admittedly, this solution makes some allowance, though not enough in the view of some observers, for the presence of an element of compulsion.\(^{186}\) Those shareholders who are suspicious can refuse to sell, and when a cash-out merger is subsequently attempted, they can fight for a higher price through appraisal. If subsequently it appears that there was an undisclosed asset, rule 10b-5 can provide relief.\(^{187}\) Damages are recoverable for actual fraud, and opportunities for advantageous sales should not be sacrificed because of theoretical suspicions. The record in going private transactions does not warrant imposing upon investors protection against a possible unfair price. That protection only can be purchased by depriving all shareholders of an opportunity to sell at a price that is better than market and possibly the best price they will ever get.

Shareholders are concerned about market values.\(^{188}\) The issue to them is whether limiting or prohibiting repurchase takeovers is in their interest. It is highly unlikely that if investors were given a voice in the matter, they would decide in favor of a rule denying them the opportunity to sell at a higher than market price to protect them against the possibility that even after full disclosure, the price might be in some measure unfair. The issue has neither been presented to nor decided by the investing public,\(^{189}\) instead it is

\(^{185}\) Id. at 1040-44.

\(^{186}\) E.g., id. at 1042.

\(^{187}\) See id. at 1044-45 (citing Speed v. Transamerica Corp., 99 F. Supp. 808, 828-31 (D. Del.), opinion supplementing opinion, 100 F. Supp. 461 (D. Del. 1951); In re Ward La France Truck Corp., 13 S.E.C. 373 (1943)).

\(^{188}\) Borden, supra note 158, at 1015.

\(^{189}\) Recently, however, public shareholders of Congoleum Corporation were given an opportunity to vote on a going private transaction. On January 29, 1980, the shareholders of Congoleum overwhelmingly approved the sale of the corporation's assets to a company organized by its management for the purpose of purchasing them. The earnings of Congoleum had risen from $.05 per share in 1974 to $3.22 in 1979, and the market price of the shares, which had reached a high of $30 per share in 1973, fell to less than $3 in 1974, and then rose to more than $27 per share in the first half of 1979. Immediately prior to the announcement of the proposed going pri-
discussed by the academic legal profession and ultimately decided by the SEC. Their views, values, and perspectives are noticeably different.

Cash-out Merger.—The second stage of going private, the cash-out merger, presents more acutely some of the same questions that were raised at the tender offer stage. The compulsion element now becomes explicit. Once the corporation has reacquired most of the shares previously held by public investors, may the controlling shareholders force the remaining shareholders to sell-out?

As previously discussed, the analysis must begin with the question of price. A price exists that fully and fairly compensates the selling shareholders for their shares. While the exact point of full compensation can perhaps not be conclusively determined, an appraisal based on full disclosure, in which a conscious attempt is made to err on the high side, produces a price that will adequately compensate remaining shareholders.

The fairness or adequacy or the price cannot be made dependent upon the purchaser’s identity. Outside offerors have no access to nonpublic information in evaluating the shares, and therefore are at a disadvantage compared with inside tender offerors. This is not true at the cash-out merger stage. Whether the transaction is initiated by the parent of a partially owned subsidiary, by an outsider who has acquired control through a tender offer, or by the management that has reacquired most of its publicly held shares, the party initiating the transaction has control of all available information. Thus there is no reason to be more or less suspicious of the adequacy or fairness of the price in any one of these three situations.

In the Congoleum transaction in July 1979, the market price was $25.375. Congoleum Corporation Proxy Statement 8, 37 (Jan. 8, 1980). Book value of the stock in September 1979 was $18.45. Id. at 6. There were over 11 million shares outstanding held by 5,612 shareholders of record. Id. at 2. Management controlled 300,000 shares, which were voted in favor of the transaction; 824,500 shares were held by institutions, and according to the proxy statement management was not aware how such shares would be voted. Id. at 3. At the shareholders’ meeting, 8,485,982 shares, or 72.1% of the outstanding stock, were voted. 8,267,382 shares were voted in favor of the transaction, and 218,600 were voted against. Letter from counsel to the Author (Mar. 26, 1980) (copy on file in office of the Hofstra Law Review).

One empirical study of tender offers found that the market provides no assurance that shareholders will receive a price that fully represents the intrinsic value of the firms. The author concluded that there is “no assurance that firms will be valued at more than 86% of their true potential market value.” Smiley, Tender Of-
There is nevertheless an understandable tendency to be more disapproving of the force-out merger following a repurchase tender offer than of such a merger designed to eliminate the minority shareholders of a partially owned subsidiary. For a number of reasons, eliminating the minority shareholders of a partially owned subsidiary seems the least questionable of the squeeze-out transactions. The presence of a minority in a subsidiary that does business or competes with its parent greatly complicates the task of the management of both companies. As a practical matter it is nearly impossible to tell whether the subsidiary and its minority shareholders are being treated fairly.  

The situation has great potential for abuse, and it may therefore be difficult to make the most efficient allocation of the resources of the total enterprise. The capital supplied by the minority is likely to be insignificant relative to that supplied by the majority, and the cost of complying with legal standards of fairness in intercompany transactions and maintaining the separateness of the subsidiary may be substantial. The relationship has produced a considerable amount of litigation. In the parent-subsidiary context, there are therefore persuasive reasons for permitting firms to eliminate such minority interests at a fair price.

Different arguments support the same result in outside takeover cases, such as Singer v. Magnavox. Where a third party seeks to purchase the entire firm by means of a tender offer, there is no impropriety in allowing it to complete its purchase by a cash-out merger of the minority shareholders who do not accept the offer. By accepting the tender offer, shareholders have accepted the transaction individually, just as they could have done as a body if the transaction had been presented to them as a merger or sale of...
assets. In those cases, the minority would have been forced to go along, subject to any right they may have under state law to receive the appraisal value of their shares. The majority's acceptance of the tender offer does not alter the nature of the transaction. When the minority is offered what the majority has accepted, and where there is no detectable reason to believe that the price was unfair, there is no injustice in limiting the minority to its appraisal rights. The result in Singer, where the minority was able to block the cash-out merger, sets up a strategic bargaining situation in which the minority may be able to collect a toll payment for permitting the acquisition to be consummated. This led to the abandonment of the unanimity rule for corporate reorganizations by preventing the last shareholder whose approval is necessary for the transaction from exacting a benefit payment exceeding the value of her investment.

There remains something different in pure going private mergers, where insiders oust the public shareholders, that distinguishes them from both the partially owned subsidiary cases and the outsider takeover cases. There is a faint but unmistakeable smell of impropriety about a transaction in which one owner or group of owners forces the other owners to sell their investment. It is argued that these cash-out transactions should only be permitted when there are demonstrable advantages to be gained from operating as a private firm. The difficulty in attempting to distinguish the pure going private cases is that a forced sale is a forced sale, and whether it is fair is a matter of price. If there is full dis-
closure, and if all uncertainties are resolved in favor of the minority, it is unreasonable to insist that the sale is exploitative and oppressive merely because of the purchaser's identity. Professor Brudney has nevertheless argued that going private transactions will occur only when the insiders know that the business of the firm is about to improve. This means the repurchase offer price may not fairly and fully reflect the intrinsic value of the firm at the time. Hence, "the danger that the public stockholders will be undercompensated is too great to tolerate." \footnote{199} In addition, the correctness of the price paid cannot be confirmed after the fact because the firm will then be privately held. \footnote{200}

The case for prohibiting going private mergers depends on the synergism that results from combining a number of arguments, each of which, taken alone, is speculative and inconclusive. The first assumption is that neither disclosure nor scrutiny can adequately assure the price's fairness. The second is that the risk of unfairness may be unacceptable in going private transactions, but acceptable in takeovers by outsiders, because only the latter potentially improves the firm's efficiency. Similarly, the element of coercion present in third-party takeovers at the merger stage is acceptable because of the efficiency gains and is unacceptable in going private transactions, where no such gains are said (incorrectly) to be present and no justification exists for allowing an exemption from the general requirement that all members of a given class of owners receive equal treatment.

There is no conclusively valid way to balance these considerations against the tangible benefits to the public shareholders of being offered an amount in excess of market for their shares. A few things are clear: The offer is a benefit, the public may never receive a better offer, disclosure must be made, limiting the insider's opportunity to take advantage of the public, and disclosure and appraisal can lead to a valuation of shares that is reasonable and that protects the public. In the end, the arguments against permitting such transactions to occur depend upon speculative assumptions about the ineffectuality of the means by which investments are valued.

Reading through the literature on going private is like taking a walk on Halloween: One has the distinct impression that there is much less to what one sees than meets the eye. Empirical evi-
vidence of actual disadvantages to shareholders is wholly lacking; the case for prohibition is supported solely by the theoretical mis-
givings of academic analysts, who in effect concede that they can-
not prove the injury to shareholders from these transactions.

The public shareholder in a company controlled by a few large

201. A much-cited going private case, Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974), aff'd per curiam, 514 F.2d 283 (2d Cir. 1975), illustrates what has
disturbed critics about going private: Insiders apparently reap huge profits at the ex-
pense of innocent investors. An examination of Kaufmann, however, reveals that this
interpretation of the case is incomplete and wrong.

Kaufmann involved an advertising firm that owed a great deal of its success to
the “flamboyant style of its founder and chief executive.” D. VAGTS, BASIC CORPO-
RATION LAW 712 (2d ed. 1979). The company first went public in 1968, at $17.50 per
share; a second offering at $21.75 was made in 1971. In all, 742,639 shares were sold
to the public, of which 50,000 were newly issued shares sold on behalf of the com-
pany, and 693,639 were previously issued shares offered by directors and officers.
The officers received $12,718,019, or about $17.50 per share, for stock which appar-
ently, according to the district court, had cost them a little less than $.38 per share
on or prior to June 1968. 386 F. Supp. at 13. Such a statement is highly misleading:
Given the nature of the business and the identity of the purchasers, the principal
contribution to the firm for their shares was not money, but prior and future services.
An accurate assessment of what the full consideration given for the shares was does
not appear to have been made.

Undoubtedly it was clear from the prospectuses in the public offerings that most
of the shares offered were being sold for the accounts of insiders. It was therefore in-
correct for the court to state that the money paid for such shares was invested by the
public in the company. 386 F. Supp. at 13. The public invested only $875,000 in the
company: The balance purchased by the public was owned by insiders whose past
performance led the public to have confidence in their future performance. The pur-
chasers of the shares were buying participation in the future performance of a tal-
eted group of people in a very risky, mercurial business in which almost all of the
assets go down in the elevator every night. Such a business by conventional
standards would probably be valued at one times annual earnings.

The company’s performance justified investors’ confidence, as earnings doubled
in four years, but the market price of the stock dropped to $5.50 as a result of a gen-
eral market decline. A repurchase was made for cash and debt securities having a
value of $11, and a “current value” of $9. Id. at 14-15.

Can it be fairly said under these circumstances that the offer was so clearly ex-
ploitative of the public investors that it should have been prohibited, or indeed that
it was disadvantageous at all? An affirmative answer to these questions could only be
made by noninvestors; it would never have been made by the actual investors who
were offered an opportunity to receive almost double the market price for their
shares.

202. This is apparently the real meaning of the “undetectable unfairness” argu-
ment. The critics conclusively presume that there can be no efficiency justification
for going private. See note 168 supra and accompanying text. This is a useful pre-
sumption because it suggests that if a business prospers after going private there
must have been undiscovered unfairness in the repurchase transaction as the subse-
quent prosperity can otherwise not be accounted for. Since financial reports of the
operations of privately held companies are not published, the argument that there is
a hidden unfairness in the repurchase can always be made.
shareholders is the true passive investor; the voting element of her investment does not have any potential market value. There is a fair and adequate price, which represents the investment value of these shares. A sale at that price cannot be unfair to the investors' interests, regardless of the purchaser's identity or motives. The basic problem remains: Should the law permit the majority shareholders who dominate publicly held firms to expel the minority even at a fair price? There is some precedent for the expulsion of co-owners. Partners may expel each other at any time by exercising their right to terminate the firm.\textsuperscript{203} A new partnership can then be formed to take over the assets at their fair value, and the former partner is left with her prorata share of the business. In close corporations the most frequently litigated problem is the converse of the cash-out transactions: the majority's ability to deny the minority access to the earnings of the enterprise while refusing to pay the minority a price for its shares that represents its prorata share of the going-concern value of the firm.\textsuperscript{204} The majority therefore typically has little incentive to want the minority's shares and none to buy them out at a price that represents the minority's prorata share of the going-concern value of the firm.\textsuperscript{205} When the majority does attempt to buy out the minority, there is bound to be a wide difference of opinion as to their value. A rational minority shareholder has little reason to resist being bought out at a fair price because of the continuing and unavoidable vulnerability of her position once she and the majority are at cross purposes.

In the relatively few cases in which the majority has tried to force the minority out,\textsuperscript{206} and in the large number of cases in

\begin{itemize}
\item \textsuperscript{203} \textit{Uniform Partnership Act} § 31(1)(c).
\item \textsuperscript{204} The value of the minority's stock to the majority or to an outside purchaser can be determined by capitalizing the portion of the earnings of the minority's investment that the majority cannot lawfully capture through its control position.\textsuperscript{82} & \textsuperscript{83} supra. Portfolio theory would suggest that the insiders diversify their holdings. This suggests that the insiders should not be willing to pay to the public shareholders their prorata share of the going concern value of the firm, and therefore that the public shareholders should welcome a price premium offer.
\item \textsuperscript{205} See text accompanying notes \textsuperscript{82} & \textsuperscript{83} supra. A widely cited example of outrageous majority behavior is Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), \textit{cert. denied},
\end{itemize}
which the minority has tried to force a sale of its interest to the
majority, the basic issue is the same—price. In contrast to the
relatively small number of going private cases, there has been vo-
luminous litigation initiated by minorities trying to force the liq-
uidation of their investment in closely held firms. The actual experi-
ence of those minority investors for whose shares there is no
outside market clearly indicates that a rule that would limit the op-
portunities of minority public shareholders in closely controlled
firms to sell their shares is contrary to their interests.

One certainly cannot assume that shareholders eliminated by
merger would have been better off remaining as minority share-
holders in a company where the vast majority of shares are held by
a few persons associated with management. Once the number of
shares held by the public is reduced below the level necessary to
sustain an active market, buying the shares of the remaining public
shareholders is not contrary to their interests. Their position now
approaches, if it is not identical to, that of minority shareholders in
closely held firms. Quite apart from the vulnerability of minority
interests to deliberate exploitation by the majority, the lack of mar-
ket pressure on management to perform and the understandable
tendency of the controlling faction to be generous with itself at the
expense of the minority exposes the minority’s investment to risks
that over time are likely to become serious despite the most honor-
able intentions of the majority.

SEC Proposed Regulations.—In 1977 the SEC presented its
proposed regulations of going private transactions for comment. While the Commission’s release cited the voluminous legal litera-

316 U.S. 675 (1942). Lebold involved the dissolution of a partially owned subsidiary
by the parent company, which had a perfect right to do so. The only issue was
whether, in valuing the subsidiary’s assets for the purpose of paying off the minority,
the going-concern value of the subsidiary’s shipping business had to be taken into
account. Id. at 374. Since the parent had not, in fact, taken its business away from
the subsidiary, the minority was held entitled to participate in the going-concern
value. Id. The case best illustrates the fiduciary tangle that can arise when partially
owned subsidiaries do business with their parents and a reason for permitting the
termination of such situations.

207. See Hetherington & Dooley, supra note 82, at 63 app. (summary of cases).
208. This is the function served by involuntary dissolution litigation. See also
Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975). This was
the basic issue in the celebrated case of Jones v. Ahmanson & Co., 1 Cal. 3d 93, 460

tecture that elaborates at great length on the possible unfairness to public investors inherent in such transactions, it did not seriously review the issues. There can be no doubt that this body of speculative, theoretical writing in the law reviews provided the basic justification for the Commission's proposals. The law review literature discusses the few decided cases and constructs theoretical models of corporate structure on which the postulates concerning shareholder rights are predicated. In reading this literature and the SEC's prospectus describing the need for its proposed regulations to protect investors, it is difficult to keep in mind that the proposed subject of regulation had not then, nor has not since, been shown to have caused any loss to any shareholder. Following the commentators' views, the Commission noted that going private transactions are coercive, and then stated: "The issuer... may choose a period of depressed market prices to propose the transactions. Thus, the investor is faced with an investment decision which he may not have anticipated and which may result in loss to him." However, the loss has already been incurred as a result of the decline in market prices, and, as previously observed, the offer to purchase the shares at a somewhat higher price represents an opportunity to recoup some of the loss.

In the preamble to its proposed regulations, the Commission observed:

Among other things, these transactions may frustrate the reasonable expectations of investors. When an investor purchases equity securities in a public company, he reasonably expects that the issuer has the burden of justifying any actions which would result in depriving him of the characteristics inherent in his investment in publicly traded securities.

This presumably means that the investor did not expect the company to go private. The significance of this is unclear. The investor also did not anticipate that the price would decline, that any offer would be made to purchase her shares at a price above market, or that, if such an offer were made, she might ultimately be forced to accept it because a majority of the public investors decided to sell...

210. See id. at 60,092 n.26. The work of the commentators seems to have been useful only as justifying the SEC's acting on going private, not as a source of useful content or analysis. For example, in only four instances was any page of an article cited other than the first.
211. Id. at 60,091.
212. Id. at 60,100.
their shares. Certainly our hypothetical shareholder would not have assumed that if any of these events occurred, the result would be contrary to her interests. This assumption would be unreasonable, since these events could well provide her with the last good price for her shares. Nor can it be assumed that public investors would be deterred from buying the shares when they are first offered if they had been advised that, if in the future, for reasons beyond the company’s control, the market price of its shares drop below the public-offering price for a sustained period of time, the company might exercise its right under state law to offer to repurchase these shares after full disclosure, and thereafter to effect a cash-out merger for the remaining public shares. Only the commentators and the SEC would consider such a suggestion hostile to investors’ interests. Investors could well consider it valuable in reducing the risk of their investment.

As is the case with other Commission policies, the proposed regulation is based on unverified and dubious assumptions about the needs and interests of investors. On this shaky ground, the Commission’s proposed rules not only require elaborate and detailed disclosure but also that the repurchaser demonstrate the transaction’s procedural and substantive fairness.213 Perhaps because of Sante Fe v. Green’s214 implications that it does not have the power to regulate fairness, the Commission subsequently adopted new regulations requiring “only” disclosure.215 The Commission did not, however, abandon the fairness issue. Investors are required to be informed of current and past market prices, book, going-concern, and liquidation values, prior repurchase prices, appraised evaluations, and firm offers by outsiders.216 The tender offeror is also required to state whether, on the basis of this information, it considers the terms of the offer fair, to explain its reasons, and to state whether any director abstained or dissented from the proposal and why.217 It would seem somewhat superfluous to require that this evaluation be given to investors who are required to be provided with all the details of the transaction, at least if the purpose is merely disclosure. It seems likely, how-

213. Id. at 60,101 (Proposed Rule 13e-3(b)(2)).
216. Id. at 46,744-45, 46,747 (to be codified in 17 C.F.R. § 240.13e-100, Items 3, 14).
217. Id. at 46,745-46 (to be codified in 17 C.F.R. § 240.13e-100, Item 8).
ever, that this requirement has a somewhat different purpose. If it subsequently appears that the transaction was disadvantageous to shareholders, then this requirement may lay the basis for civil liability, despite full disclosure of its terms: A former shareholder could contend that the statement of opinion was false or misleading and seek to recover her damages under rule 10b-5.218 This appears to be yet another attempt to increase the difficulty of going private.

The Commission’s efforts to impose substantive regulations on going private transactions appear to have been avoided recently when the shareholders of a large publicly held corporation approved a sale of assets to a private company controlled by its management.219 The overwhelming approval of the transaction by the public shareholders, who received a premium over market, casts doubt on the academic critics’ assumptions that public shareholders in going private transactions are reluctant victims of management’s avarice. It may be that shareholders would prefer to be given the opportunity to make their own decision, rather than have their choices limited by regulations designed to implement the value preferences of the Commission and its academic supporters.

These regulations are another illustration of the enormous discretion the Commission enjoys in selecting the subjects for regulation, and its discretion in defining investors’ interests on the basis of its own a priori judgments without any empirical basis or appreciable input from those on whose behalf it purports to speak. The institutional goals and objectives that the conventional wisdom attributes to regulatory bodies appear to have played a part in the Commission’s response to the going private phenomenon. The attempt to read into its statutory authority the power to impose substantive regulation and to prevent issuers from withdrawing from the Commission’s area of regulation, like its effort to constrict the statutory exemptions, all are familiar to observers of bureaucratic behavior. It is to be expected that an aggressive and powerful

218. I am indebted to Professor Michael Dooley for this point. If the required information concerning the value of the stock is given, what is the relevance of management’s opinion? The requirement is plainly linked to the Commission’s notion that in this situation disclosure is not enough to protect shareholders, because, in Professor Brudney’s phrase, the price in going private transactions is likely to be “undetectably unfair.” See Brudney, supra note 20, at 1052-53; text accompanying note 182 supra.

agency would defend and attempt to extend its frontiers, and would perceive as serious those problems that are just beyond its regulatory reach. Furthermore, the Commission has a special interest in limiting transactions that are, or may be considered to be, implicit criticism of its own regulatory practices: in this instance, the costs of complying with reporting requirements, which are particularly burdensome to small companies.

CONCLUSION

The implications of my thesis for the growth and development of corporate and securities law are substantial. Since the SEC and the other organized groups that help to shape the legal developments in these areas perceive investors' interests almost exclusively through the perspectives of their own goals and interests, they will, and indeed do, instigate changes in the law in the name of investors' interests that do not enhance, and may even impede, these interests. Misperceptions of investor interests seriously distort the policies adopted by the SEC. Similarly, but for less obvious reasons, the traditional model of corporate function and structure leads academic lawyers to advocate changes in the law that are not demonstrably related to the interests of the investing public. The bias of the academic lawyers is in favor of traditional corporate law values and rights that may be of almost no relevance to investors in the public securities markets. The erosion of shareholders' rights under corporate law cannot be shown to have any demonstrable adverse effect on public shareholders. The persistent bias of the SEC is a distrust of both the market and investors' intelligence. While it may be that those who regulate are bound to distrust free markets, this bias is of little significance in markets where the property traded can be classified in uniform grades, such as grain and other tangibles. But where there is competition in a market, and an unlimited variety and quality of units traded, as in the securities markets, the regulating agency is likely to be unable to resist the temptation to try to protect traders by improving the quality of the products.

The nature of the investing public confers great power on those who speak for investors without their consent. Like the coma of the Sleeper, the indifference of the investor has become a mandate for those who speak for her. And like the trustees of the Sleeper, neither the SEC nor any other special interest has any incentive to awaken the American shareholder or to determine empirically what her wishes are. To make such an effort would be to
risk revocation of the Commission's apparently irrevocable proxy to pursue policies in the name of investors that are congenial to its own institutional interests and to its largely uncorroborated and self-serving view of the needs of the investing public. This state of affairs produces a wholly unrealistic impression of the importance of the Commission's activities in relation to the interests of investors, and results in a continuing misallocation of the Commission's and industry's resources, which cannot be justified in terms of the actual interests of the investing public.