Corporate Control Transactions

The preceding chapters implicitly take “the firm” as a constant. Yet the only constant feature of corporate organization is change. Firms are in motion. They build new plants and enter or retreat from markets. They also change their own structure—setting up new divisions, entering or leaving markets, buying or selling plants, acquiring or being acquired, increasing and decreasing leverage, going public or private, selling stock or buying it back (generally or from particular investors). We call these changes “corporate control transactions.”

Control transactions may make some investors rich while they leave others unaffected or poorer. For example, owners of controlling blocs may sell at a substantial premium, without any obligation to share the bounty with other shareholders. Firms may make “targeted” repurchases of shares, paying a premium to some investors while not offering the opportunity to others. Managers may arrange to take a corporate opportunity for themselves, with the consent of the directors, or may allocate an opportunity for a family of connected corporations to the firm that can make the most profitable use of it. Mergers set up in arm’s-length bargaining may distribute the lion’s share of the gain to one party, even though both parties to the merger are controlled by the same people.

Firms may alter internal structure and the structure of ownership as they please—or refuse to do so—subject only to the fiduciary standard. Managers who live up to the all-purpose duties of care and loyalty face few, if any, additional constraints. These doctrines, and the exceedingly limited judicial role they entail, have run into withering criticism from scholars demanding two kinds of change: an obligation to “share” the gains from corporate control transactions, and a prohibition against certain kinds of transactions. (Different critics put different transactions under the bans.)
Criticism has had little visible effect on the law. Well it should not, for rules requiring the sharing of gains may prevent their creation, and the transactions most vociferously attacked serve important functions (hence the profits). Courts’ laissez-faire approach to corporate control transactions is economically sound, another example of the economic structure of corporate law. Many of the arguments pro and con on this topic refer to “fiduciary duties.” Everyone believes that fiduciary duties, “properly understood,” favor his approach. Chapter 4 defined fiduciary duties as implicit contractual terms—obligations to act in shareholders’ interests, when explicit contracts are silent, in the fashion the parties would have provided by contract had they been able to negotiate without transactions costs. We apply that understanding to corporate control transactions.

**Equal Treatment, Fiduciary Duty, and Shareholders’ Welfare**

Many scholars, though few courts, conclude that one aspect of fiduciary duty is the equal treatment of investors. Their argument takes the following form: fiduciary principles require fair conduct; equal treatment is fair conduct; hence, fiduciary principles require equal treatment. The conclusion does not follow. The argument depends on an equivalence between equal and fair treatment. To say that fiduciary principles require equal treatment is to beg the question whether investors would contract for equal or even equivalent treatment.

Proper analysis of this question employs a distinction between rules that maximize value *ex ante* and actions that maximize the returns of certain investors *ex post*. A simple example illustrates the point. A corporation may choose to invest its capital in one of two ventures. Venture 1 will pay $100, and the returns can be divided equally among the firm’s investors. Thus if there are ten investors in the firm, the expected value to each investor is $10. Venture 2 will pay $150, but only if the extra returns are given wholly to five of the ten investors. Five “lucky” investors will receive $20 apiece, and the unlucky ones $10. Because each investor has a 50 percent chance of being chosen, each would think
Venture 2 worth $15. The directors of the firm should choose Venture 2 over Venture 1 because it has the higher value and because none of the investors is worse off under Venture 2.

Now consider Venture 3, in which $200 in gains are to be divided among only five of the ten investors with nothing for the rest. If investors are risk-neutral, fiduciaries should choose Venture 2 over Venture 2 (despite the fact that some investors end up worse off under Venture 3), because the expected value to each investor is $20 under Venture 3 and only $15 under Venture 2.

If the terms under which the directors obtain control of the firm call for them to maximize the wealth of the investors, they select the highest-paying venture and abide by its rules of distribution. If unequal distribution is necessary to make the stakes higher, then duty requires inequality. The firm’s managers could not easily justify a choice of Venture 2 or 3, followed by a “surprise” equal distribution of the proceeds among the ten investors. In the example we posed, the firm obtained the higher returns only by agreeing to unequal distribution. It might get away with a breach of these conditions once, but Ventures 2 and 3 or their equivalent soon would become unavailable. Besides, if the firm promises to pay some investors unequally when it undertakes the venture, the managers could not be “fair” to the unlucky investors without being unfair to the lucky ones. The ex post inequality under Ventures 2 and 3 is no more “unfair” than the ex post inequality of a lottery, in which all players invest a certain amount but only a few collect. The equal treatment of the investors going into Ventures 2 and 3, and the gains they receive from taking chances, make the ex post inequality both fair and desirable.

Our analysis of Ventures 2 and 3 should be uncontroversial. If corporate control transactions sufficiently resemble Ventures 2 and 3, this analysis supplies a guide for analyzing the fiduciary duties of corporate managers. A class of control transactions resembles Ventures 2 and 3 if: (1) control changes and financial restructurings produce gains for investors to enjoy; (2) the existence or amount of the gain depends on unequal distribution; and (3) shareholders prefer the unequal distribution to a more equal distribution of smaller gains from an alternative transaction (or no transaction). We take up these conditions in turn.
POTENTIAL GAINS FROM CONTROL TRANSACTIONS

Managers do not always maximize the wealth of investors. We have already discussed the costs of principal-agent relationships. Because managers have only a small stake in the fortunes of the firm, these costs may be quite high. Managers may not work as hard as they would if they could claim a higher share of the proceeds—they may consume excessive perquisites, and they may select inferior projects for the firm without bearing the consequences of their action. Corporate control transactions can reduce agency costs if better managers obtain control of the firm’s assets or if they alter the incentive structure facing existing managers. This means, in turn, greater wealth for all. The gains from control transactions may be exceedingly great. Going private, sales of plants, tender offers, these and more yield gains as great as doubling the market value of the firm.¹ The number of going-private transactions and spinoffs into private hands of divisions of public corporations is large and growing (see Table 1).

Why? Control transactions reflect substantial gains. Sale of a control bloc of stock, for example, allows the buyer to install his own management team, producing any gains available from the new structure. Because such a buyer believes he can manage the assets of a firm more profitably, he is willing to pay a premium over the market price to acquire control. The premium will be some percentage of the anticipated increase in value once the transfer of control is effectuated. If there were no anticipated increase in value, it would be irrational for the buyer to pay the premium.

Self-interest thus assures us that changes of corporate control, like other voluntary exchanges, move assets to higher valued uses.

Other transactions present similar opportunities for gain. The elimination of minority shareholders in a subsidiary produces gains if the combined entity can achieve economies of scale, centralized management and corporate planning, or economies of information. A parent may withhold projects from a subsidiary, for example, if the parent’s investors must guarantee loans to finance them. Under these circumstances, the parent’s investors bear a proportionally greater risk of loss than the minority shareholders in the subsidiary, but they do not receive a proportionally greater share of any gains. Eliminating the minority shareholders can increase the likelihood that profitable new ventures will be undertaken.

Other control transactions attack agency costs directly. When firms go private they eliminate—or substantially reduce—the separation of ownership and control that creates the clash of interest
between principal and agent. The effect is real when a single investor ends up with much of the equity, as in a leveraged buyout (LBO), and especially great when the managers end up owning a substantial chunk of the firm, as in a management buyout (MBO). Other things being equal, the lower agency costs mean higher returns to investors. LBOs, MBOs, and related transactions greatly increase the debt-equity ratio, which has further effects. Firms with additional debt are obliged by contract to pay out most of their profits. This compels managers to return to capital markets if they seek additional funds; lenders monitor the managers' conduct and increase the interest rate to protect themselves if things are amiss. Higher interest rates come out of shareholders' profits (and managers' income), alerting all to the problem and penalizing managers automatically. The compulsory payment obligation also puts the fear (and prospect) of bankruptcy into managers' minds, and the desire to avoid failure may be a powerful spur to success. If success is not forthcoming, the debt associated with going-private transactions precipitates bankruptcy quickly, stopping the deterioration more quickly than in firms that are capitalized principally with equity.

Extra debt introduces to the firm the specialized monitoring services of secured debtors; certain structures with assets dedicated to particular purposes may be more efficiently monitored by specialized lenders than by residual claimants. Then there are tax advantages (when the marginal rate of taxation on income falls, as it has over the last ten years, debt becomes more attractive because it is deductible at the corporate level and bears less of a penalty, compared with capital gains, at the investor's level). Finally, going-pri-


Corporate Control Transactions

Private transactions may eliminate costs attributable to public ownership, which include substantial expenditures for legal and auditing fees, stockholder relations, and compliance with the SEC's and the stock exchanges' disclosure requirements. A private firm can reduce these costs, along with the risk of liability that disclosure obligations create.4

Allocation of a "corporate opportunity" to a corporate insider may allow that opportunity to be exploited more effectively or at lower cost. The firm incurs substantial agency costs in the exploitation of the opportunity because managers, who cannot capture the gains, lack the appropriate incentives. Managers who assign opportunities to themselves can appropriate a greater portion of the marginal gains from their efforts, and thus they have a greater incentive to produce such gains. The manager can compensate the firm by taking a lower salary and bonus, and the reduction in agency costs may be mutually beneficial.

Doubtless control transactions do not always produce gains. Some, although designed to achieve gains, fail. Organizational changes come with no more guarantees than do new plants and products. Any innovation may flop. Some changes in control may be attributable to self-aggrandizement rather than to gains in the use of the acquired firms' assets. If one firm wants to squander its money by paying too much for control, managers have no duty to turn the money away; an auctioneer does not stop the auction at the "right" price in order to protect bidders from paying too much. The market penalizes buyers who pay too much money for a deal, and those losses serve as signals to future buyers. The corporate law ignores overpayments, for they are self-deterring.

Some corporate control transactions that do not produce gains, however, are not self-deterring. Looting may explain certain transfers of control. Some going-private transactions may be motivated by a desire to exploit inside information rather than to reduce

4. The costs of disclosure include not only payments to underwriters, auditors, lawyers, and printers, but also the opportunity costs of managers' time (they must provide information to the market) and the costs entailed in revealing either products or corporate strategies to market too soon. See Flann v. Eberstadt, 814 F.2d 1169, 1174-78 (7th Cir. 1987). Expected liability costs increased when the Supreme Court declined to adopt a bright-line rule governing disclosure of impending corporate control transactions. Basic, Inc. v. Levinson, 485 U.S. 224, 232-236 (1988).
agency costs. And sometimes a manager may appropriate control of a corporate opportunity even though the firm would have been able to exploit the opportunity more profitably.

At least for publicly traded firms, the market offers information that distinguishes value-increasing control transactions from others in which looting or mismanagement may be in store. The information is contained in the price of a firm's shares. If the control change is associated with an increase in price, the investors apparently do not fear looting or other harm to the firm. If a syndicate acquires a control bloc of shares, and the price of the remaining shares rises, relative to the market as a whole, then the shareholders are betting on the basis of available information that the new controller will be better for their interests than the old. Precisely the same reasoning can be used when analyzing whether a manager has appropriated a corporate opportunity that could have been used more profitably by the firm. If the firm's share prices do not fall after the taking of the corporate opportunity, investors do not believe that they have been injured.

Fewer price signals are available in going-private transactions, because such a transaction frequently eliminates public trading of the firm's shares. Even these transactions, however, leave some traces. If the price paid to frozen-out shareholders is higher than the price that the shares commanded before the transaction, the buyer anticipates that the transaction will produce gains. There is little percentage in paying $15 for shares selling at $10. If the only purpose of the transaction is to eliminate minority shareholders, it is irrational for the controlling shareholder to pay a premium over the market price. By using corporate assets to pay minority shareholders more than their shares are worth, the controlling shareholder will have decreased the value of his own holdings and therefore be worse off as a result.

All of these observations follow from the proposition that investors have no desire to give away their money. If they pay more for shares after a transaction than before, their dollar votes are a signal of gain and loss. One can obtain reliable information from the direction of price changes without believing that the prevailing price perfectly embodies the available knowledge. And price data speak clearly. Prices paid for shares acquired in control transactions exceed the market price by substantial amounts, in the range of 30 to 70 percent. The prices of the shares that are not acquired
also rise smartly, although not by so much (the range of 10 to 20
percent is more common). Other investors, such as holders of un-
secured debt, do not share in these gains—but they also do not
lose. (See note 1 above for studies demonstrating these effects.)

GAINS MAY DEPEND ON UNEQUAL DIVISION

In many cases the apportionment of the gain makes little difference
to the success of the transaction. If the gain from taking over a
corporation exceeds the cost incurred by the acquirer, it does not
matter who receives the premium that is necessary to obtain con-
tral. But the fact that apportionment may be irrelevant to the
acquirer does not mean that apportionment of gains is always im-
material—sometimes apportionment is the decisive factor. Suppose
a prospective acquirer of control concludes that, by expending $10,
it can create a 50 percent chance of producing $30 in gains. If the
prospective acquirer is risk-neutral, the transaction will go forward
because the expected gains of $15 exceed the $10 cost of the trans-
action. If the fiduciary principle is interpreted to require the pro-
spective acquirer to share the $20 gain in the event it is realized,
however, and absorb the entire loss if the gain is not realized, the
deal may become unprofitable because the costs exceed the ex-
pected gains.

In theory the law could require sharing of the $5 expected gain,
but courts could not calculate this amount because they could not
observe the ex ante risk of failure. Moreover, a large part of the
cost to the acquirer is an opportunity cost—the money the acquirer
could have made by devoting its talents to other projects. Another
cost is the premium required to compensate risk-averse acquirers
for risk bearing. Because it is difficult if not impossible to compute
opportunity costs and risk premiums in litigation, it would be
difficult or impossible to implement a sensible sharing rule. Even if
opportunity costs could be approximated, judicial errors would
arise, and beneficial control changes would be stifled.

A sharing requirement also may make an otherwise profitable
transaction unattractive to the prospective seller of control. Sup-
pose the owner of a control bloc of shares finds that his perquisites
or the other amenities of his position are worth $10. A prospective
acquirer of control concludes that, by eliminating these perquisites
and other amenities, it could produce a gain of $15. The share-
holders in the company benefit if the acquirer pays a premium of $11 to the owner of the controlling bloc, ousts the current managers, and makes the improvements. The net gains of $4 inure to each investor according to his holdings, and although the acquirer obtains the largest portion because it holds the largest bloc, no one is left out. If the owner of the control bloc must share the $11 premium with all of the existing shareholders, however, the deal collapses. The owner will not part with his bloc for less than a $10 premium. A sharing requirement would make the deal unprofitable to him, and the other investors would lose the prospective gain from the installation of better managers.

Other value-increasing transactions also would be deterred by a sharing requirement. First, as we have pointed out, sometimes a purchase of control is profitable to the purchaser only if it can prevent minority shareholders from sharing in the gains. Freezeouts after a transfer of control perform this function. Second, if the controlling shareholder in a going-private transaction or merger of a subsidiary into a parent corporation must underwrite the costs of future value-increasing transactions and thereby incur a proportionally greater risk of loss than the minority shareholders in the event expectations are not realized, then the deal may become unprofitable to the controlling shareholder if it must share the gains with minority shareholders if all goes well. Thus, a sharing principle in these transactions leads to a reduction in total wealth as shareholders desist from entering into otherwise profitable transactions.

There are other ways in which the gains from corporate control transactions may depend on unequal distribution. Because investors in the firm must cooperate to transfer control, sharing creates incentives to take a free ride. In a tender offer, for example, shareholders must tender rather than hold their shares if the bid is to succeed; in a merger (other than a short-form merger), they must vote favorably rather than abstain. If gains must be shared equally, however, each shareholder may find it worthwhile not to cooperate in the transaction. Suppose that all of the gains from a tender offer must be shared equally among the investors in the target corporation and that, if there is a follow-up merger, nontendering shareholders cannot be eliminated for less than the tender offer price. When a prospective acquirer makes a bid, the investors recognize that the acquirer can profit only to the extent it causes the value of
shares to rise. If the bidder is offering $50 per share, the reasoning runs, it cannot profit unless value eventually rises above $50. Under the legal rules assumed above, it may be rational for every shareholder to spurn the $50 offer and hope that enough other shareholders tender to make the offer succeed. If there is a follow-up merger, the "fair" price cannot be less than $50 for the un-tendered shares. If there is no follow-up merger, the shareholder expects the price to exceed $50. Each shareholder, in other words, may attempt to take a free ride on the efforts of the bidder and other shareholders. To the extent free riding prevails, it reduces the chance that the beneficial transaction will go forward.

A final reason why the gains from beneficial transactions may depend on unequal division is that sharing rules may lead to costly attempts to appropriate greater parts of the profit. The appropriation problem arises because most gain-sharing rules do not produce determinate results: it is difficult to determine the "fair" price. If all investors are entitled to a "fair" share of the bounty, each will find it advantageous to fight for as much as possible and will spend as much as a dollar, on the margin, to claim another dollar of the benefits. It is possible for a substantial part of the gain to be frittered away, therefore, as claimants attempt to make the argument that they are entitled to more. Fear of this eventuality may cause otherwise beneficial control transactions to fall through; in any event resources will be wasted in litigation or other skirmishes.

INVESTORS PREFER THE PRINCIPLE THAT MAXIMIZES AGGREGATE GAINS

Do investors prefer a legal rule creating a larger pie even if not everyone may have a larger slice? They do, for two reasons. First, their expected wealth is greatest under this interpretation of the fiduciary principle. Second, they may deal with any risk by holding diversified portfolios of investments.

If control transactions produce gains, and if the gains depend on unequal allocation, then the expected wealth of the shareholders in the aggregate is maximized by a rule allowing unequal allocation. All share prices ex ante will be highest when the probability of a value-increasing transaction in the future is the greatest. Shareholders can realize this value at any time by selling their shares, or
they can hold the shares and take the chance of gaining still more as a result of the unequal allocation of gains *ex post*.

This argument seems to disregard the fact that many investors are risk-averse; they prefer a sure $10, say, to a one in ten chance of receiving $100. On the surface, therefore, it seems that investors might benefit from equal or fair division of gains notwithstanding the loss of some gains as a result. As long as the market contains investors who are (or act as if they are) risk-neutral, however, the risk aversion of some investors is irrelevant. They can sell their (risky) stocks to the risk-neutral investors and invest in T-bills and other instruments that do not come with the possibility of unequal gain allocation. Grant the possibility of realizing the gains by sale, and every investor prefers the value-maximizing rule.

Well, not quite. We have smuggled some assumptions into this discussion. We have assumed that there are "enough" risk-neutral investors—a reasonable assumption in a world in which most stocks are in the hands of mutual funds, pension funds, insurance companies, university endowments, and other financial intermediaries that are the next best thing to the economist's hypothetical risk-neutral person. We have also assumed competitive capital markets. It is possible to show rigorously that competitive capital markets plus enough investors who are indifferent to risk leads all investors to prefer the wealth-maximizing rule. Roughly speaking, capital markets are competitive when any one firm's production and financing decisions have negligible effects on both the price of any given investment (that is, any given bundle of risk and return from one firm or many) and the menu of risk-return combinations that investors can obtain by holding portfolios of instruments issued by different firms. When there is competition, investors agree that the corporation should have the objective of maximizing wealth because greater wealth gives them the ability to consume or restructure their portfolios to yield greater returns—in either event, investors exercise greater command over resources. Given the depth and richness of the world's capital markets, and the incessant creation of new financial instruments to fill any gaps in the available

sets of risk and return, the conditions for investors' unanimity are satisfied in practice.

Let us suppose, however, that there is either too much risk aversion or too little competition to produce unanimous assent to a wealth-maximization rule. Does it follow that the risk-averse investor will want a compulsory gain-sharing rule as a means of reducing his exposure? No. Compulsory gain sharing as a result of legal rules reduces the number of options available to investors and their firms. Even risk-averse investors may prefer the wealth-maximizing result for some of their investments, while providing by contract for sharing in others. Corporations (especially close corporations, the subject of Chapter 9) contain many gain-spreading devices; legal rules giving investors the option of targeting gains allow them to tailor the degree of spreading to their taste. Risk-averse investors may wish to allow substantial inequality in distribution if these contractual remedies are cheap (they are), and if they can protect themselves by self-help the rest of the time. As it turns out, there is a ready self-help remedy: diversification.

There are two kinds of risk: systematic risk, which is common to all investments in the portfolio (for example, risk that a change in the interest rate will affect the value of all equity interests), and unsystematic or diversifiable risk. Risk is diversifiable to the extent that an investor, by investing in a portfolio containing many separate securities, can insulate himself from the risk. Suppose, for example, that ten firms bid for a single license to operate a television station. After the Federal Communications Commission makes the award, the stock of one firm will be worth $100 per share, and the stock of the other nine firms will be worthless. Each investment, standing alone, is very risky. But a shareholder can purchase one share in each of the ten firms, and this portfolio of investments will be worth $100 with certainty.

It is difficult to find firms whose fortunes are so closely intertwined. Nonetheless, diversification is highly useful in reducing risk because even an imperfectly negative correlation between the risks of different firms will dampen the volatility of the portfolio as a whole. An investor holding a diversified portfolio of New York Stock Exchange firms would barely notice the wreck of the Penn Central Railroad—not only because Penn Central stock would be a small part of the portfolio but also because bad news for the Penn Central is good news for the Chesapeake and Ohio.
Risks involved in corporate control transactions are diversifiable. Corporate control transactions are pervasive. There are mergers, takeovers, freezeouts, tender offers, going-private transactions and related events in abundance. Indeed, there is a strongly negative correlation among the risks. An investor with a reasonably diversified portfolio would be on the winning side of some transactions and the losing side of others. For example, if shareholders of one corporation obtain little of the gain from a given merger, the shareholders of the other corporation obtain more. An investor holding a diversified portfolio with stock in both corporations is concerned with the total gain from the transaction, not with how the gain is allocated. Indeed, the investor with shares of both would see any expense in allocating the gain as pure loss. To the extent an unequal allocation raises the number and amount of gain transactions, therefore, investors with diversified portfolios prefer to allow the unequal allocation to continue.

Diversification is available at remarkably low cost. In fact, it is less expensive to hold a diversified portfolio of investments than to hold an undiversified one, because diversification allows investors to avoid the expenses of investigating, picking, and trading stocks. Investors with little personal wealth can diversify by purchasing shares of mutual funds, which hold representative samples of stocks, mortgages, and many other investment vehicles. Most persons are much better diversified than they realize, because they hold wealth through their own human capital, their homes, and insurance and pension funds that are well diversified.  

The existence of diversification—not its employment—supports allowing the gains from corporate control transactions to be apportioned unequally even when investors are risk-averse and markets are not competitive. The availability of diversified investment portfolios means that investors who seek shelter from risk can find it. Others may elect to take greater risks in pursuit of larger gains, just as they may elect to hold only one risky stock. Perhaps they will become fabulously wealthy, but if they do not they will have little claim that they were treated inequitably. Any attempt to set fair

6. How much diversification is “enough” is a tough question, but gains taper off rapidly after ten stocks, and most investors are better diversified than that. Meir Statman, “How Many Stocks Make a Diversified Portfolio?” 22 J. Fin. & Quant. Anal. 353 (1987).
prices for corporate control transactions, in the name of protecting investors who choose not to diversify, penalizes other investors who eliminate risk through diversification, and in the process it reduces the number of value-increasing control transactions.

We have shown that the ex post inequality under Ventures 2 and 3, like the ex post inequality in a lottery, is not “unfair” if, ex ante, all investors have an equal chance to win and can eliminate risk through diversification. Now consider a potential objection to this reasoning. One might argue that this ex ante equality is absent in corporate control transactions because insiders systematically benefit at the expense of outsiders. Small shareholders, the argument runs, consistently will be frozen out, deprived of control premiums, and otherwise disadvantaged by insiders. Too, some investors are not diversified—shouldn’t be diversified. Think of managers’ human capital, tied up in a single firm, or the investors who, by controlling large blocs of stock, provide the monitoring services that redound to the gain of others.7

Our argument does not depend, though, on perfect or costless diversification. Recall how we got here: first we established that risk-neutral investors in competitive capital markets prefer the wealth-maximizing rule, then we drew out limits on that preference, and finally we introduced diversification to show that the limits are not serious, given possibilities for self-protection. Of course some investors will not be diversified, but by and large they are telling us that they are not the risk-averse ones. All that matters to our argument is that “enough” of the risk-averse investors be able to protect their interests—through diversification or holding low-risk instruments such as T-bills or through contractual gain-sharing provisions (as in close corporations)—that they would throw in their lot with the cause of wealth maximization as the legal norm when contracts are silent.

For what it is worth—although this is not necessary to the argu-
ment—we think that even the “little” investor does well with simple
diversification and is unlikely to opt for contractual sharing rules.
One need not be wealthy to be on the “winning side” of a control
transaction, and neither wealth nor status as an insider ensures
being a winner. If corporation A purchases from corporation B a
control block of shares in corporation C, a small (or outside) share-
holder might participate in the gains by holding shares in any of the
three firms. Similarly, if corporation D merges with corporation E
(its long-held subsidiary) and freezes out the minority shareholders
of corporation E, these shareholders may participate in the gains by
holding shares of corporation D. Small shareholders also may par-
ticipate in the gains resulting from tender offers, going-private
transactions, allocation of a corporate opportunity to a parent
rather than a subsidiary, and other types of corporate control trans-
actions by holding shares in the firm that produces the gains. There
is no need for the small shareholder to identify these situations in
advance. By holding a diversified portfolio containing the securities
of many firms, the small shareholder can ensure that he will partic-
ipate in the gains produced. All shareholders therefore have a
chance of receiving gains produced by corporate control transac-
tions—not an equal chance, because some bidders will be close
corporations, but enough of a chance to allow substantial diversi-
fication. If the chance is not “enough” given risk aversion, then
large investors who invite minority participation must pay a pre-
mium, and again the risk-averse investor comes out well.

Market Value as a Benchmark under the
Fiduciary Principle

In the circumstances we have discussed, shareholders unanimously
prefer legal rules under which the amount of gains is maximized,
regardless of how the gains are distributed. The ideal transaction is
one like Venture 2 above, in which the gains are unequally distrib-
uted but all shareholders are at least as well off as they were before
the transaction. Shareholders may also benefit from transactions in
which the distribution of gains leave some shareholders worse off
than before the transaction—as in Venture 3—but there are prob-
ably few such transactions. We cannot imagine why gains would
depend on making some investors worse off, and we have not encountered any example of such a transaction. In a world of costly information, investors will view Venture 2 transactions very differently from Venture 3 transactions, which would raise all but insuperable difficulties in determining whether the transaction produced gain. One can imagine instances, of which looting is a good example, in which the person acquiring control pays a premium to some investor(s) in order to obtain control and obliterate the remaining claims, recouping the premium without putting resources to a more productive use. A requirement that all investors receive at least the market value of their positions prior to the transactions would be a useful rule of thumb for separating beneficial deals from potentially harmful ones. If every investor receives at least what he had before, and some receive a premium, the transaction must produce gains.

The requirement that everyone receive at least the value of his investment under existing conditions serves much the same function as the rule against theft. A thief might be able to put stolen resources to a better use than his victim, but if so then he can pay for those resources. Requiring payment increases the likelihood that transactions are value-increasing. Moreover, the proscription of theft also reduces the incentive of property owners to take elaborate precautions against theft. For example, investors might resort to costly monitoring devices to reduce the chance of confiscation of their shares. When all transactions are consensual, these precautions become unnecessary. By prohibiting confiscation, therefore, the fiduciary principle reduces wasteful expenditures while simultaneously reducing the number of socially inefficient corporate control transactions.

A rule against confiscation would be created by contract even if it were not part of the law. Whoever controlled a corporation would find it advantageous to insert an anticonfiscation provision in the articles of incorporation. If he did not, the firm could not expect to receive much for its shares. New shareholders would fear confiscation and take (expensive) steps to protect their interest. Because no firm has monopoly power over investment opportunities, the expected costs of these precautions would reduce by an equal amount the price that purchasers would be willing to pay. Thus the sums that the controlling party receives would reflect the
costs created by the risk of confiscation (as Chapter 1 explained in greater detail.)

The Fiduciary Principle in Operation

A legal rule that permits unequal division of gains from corporate control changes, subject to the constraint that no investor be made worse off by the transaction, maximizes investors’ wealth. This is really nothing more than an application of the Pareto principle of welfare economics. Turning to the law, we show that the cases and statutes by and large mirror these economic principles.

Sales of Control Blocs

Sales of controlling blocs of shares provide a good example of transactions in which the movement of control is beneficial. The sale of control may lead to new offers, new plans, and new working arrangements with other firms that reduce agency costs and create gains from new business relationships. The premium price received by the seller of the control bloc amounts to an unequal distribution of the gains. Sales at a premium are lawful, and the controlling shareholder generally has no duty to spread the bounty. 8 For the reasons we have discussed, this unequal distribution may cut the costs to purchasers of control, increasing the number of beneficial control transfers by the incentive for inefficient controllers to relinquish their positions.

Numerous commentators, however, argue for compulsory sharing. Adolph Berle argued that control is a "corporate asset" so that premiums must go into the corporate treasury. A related proposal is the "equal opportunity" rule advocated by Professors Jennings and Andrews. They would entitle minority shareholders to sell their shares on the same terms as the controlling shareholder. There are many similar proposals, reflecting persistent academic dismay with the state of the law.

Sharing the control premium would stifle transfers rather than enrich minority investors. If the premium must be paid into the corporate treasury, those who hold the controlling bloc may refuse to sell; if minority shareholders may sell on the same terms as the controlling shareholder, bidders may have to purchase more shares than necessary, possibly causing the transaction to become unprofitable (or leading to a uniform but lower price, again tempting refusal to sell). Minority shareholders would suffer under either rule, as the probability of improvements in the quality of management declined. Although the mountain of academic commentary calling for some type of sharing requirement has been uninfluential, now and again a supporting voice may be heard among the chorus of judges. We look at one such case, the famous Perlman v. Feldmann.

Feldmann, president and chairman of the board of Newport (a producer of steel sheets), sold his controlling bloc of shares for $20 per share at a time when the market price was less than $12. The purchasers, a syndicate called Wilport, were end-users of steel from across the country, who were interested in a secure supply during the Korean War. During the war, price controls blocked steel producers from raising prices. The "Feldmann Plan," adopted by Newport and some other steel producers, effectively raised the price of steel to the (high) market-clearing level available during the shortage. Aspiring purchasers provided Newport with interest-free


11. 219 F.2d 173 (2d Cir. 1955).
advances in exchange for commitments for future production. Newport used those advances to replace equipment in order to expand and compete more effectively.

The Second Circuit held that the seller of the control bloc had a duty to share the control premium with other shareholders. The court's holding that Feldmann could not accept the premium was based on a belief that the shortage allowed Newport to finance needed expansion via the "plan," and that the premium represented an attempt by Wilport to divert a corporate opportunity—to secure for itself the benefits resulting from the shortage. The court stated that "[o]nly if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed."¹²

This assumes that the gain resulting from the plan was not reflected in the price of Newport's stock. Yet the stock was widely traded, and the existence of the plan was known to investors. The price of shares prior to the transaction therefore reflected the value to Newport of advances under the plan. The Wilport syndicate paid two-thirds more than the going price and thus could not profit from the deal unless (a) the sale of control resulted in an increase in the value of Newport, or (b) Wilport's control of Newport denuded it of a business advantage (the advances), the equivalent of looting.

Consider the following simplified representation of the transaction, on the assumption that Wilport "took" something of value to Newport. Newport has 100 shares, and Wilport pays $20 for each of 37 shares. The market price of shares is $12, and hence the premium over the market price is $8 × 37 = $296. Wilport must get more than $296 from Newport in order to profit; this comes at the expense of the other 63 shares, which must drop approximately $4.75 each, to $7.25. So if Wilport extracted a corporate asset, we will be able to see the effects in the market. Unless the price of Newport's outstanding shares plummeted, the Wilport syndicate could not be extracting enough to profit. In fact, however, the value of Newport's shares rose substantially after the transaction. Part of this increase may have been attributable to the rising market for steel companies at the time, but even holding this factor constant, Newport's shares appreciated.¹³ The data refute the court's propo-

¹². Ibid. at 177.

¹³. Charles Cope computed changes in the price of Newport's shares using the capital asset pricing model, under which the rate of return on a firm's shares is a function of the market rate of return, the volatility of the firm's price in the past, a
sition that Wilport appropriated a corporate opportunity of Newport. They support an inference that Wilport installed a better group of managers and, in addition, furnished Newport with a more stable market for its products. These contributions must have exceeded any loss from abolition of the Feldmann Plan.

LOOTING

Doubtless not all investors have the same good fortune as those who held Newport. A specter of “looting” haunts opinions about corporate control transactions. Cases imply (and occasionally hold) that managers may, even must, nose out and rebuff raptors. This all-weather bogeyman of corporate law provides an argument for every occasion, whether managers seek to preserve their own control (“Sorry, investors, we can’t take that bid at 50 percent over market because the buyer might denude your company”), or commentators peddle their critique of prevailing doctrines (“Profits should be shared fairly because then looting won’t be profitable”). We interrupt our tour of corporate control transactions to say a few things about looting, a concern applicable to all flavors of control transaction.

Looting—more neutrally, removing from corporate solution assets exceeding in value the consideration to the firm—may be constant, and a residual component that represents the consequences of unan-
ticipated events. Increases in this residual reflect good news for the firm. (We explain this model in detail in Chapter 7.) Cope found a significant positive residual for Newport in the month of the sale to Wilport. The raw price data are no less telling. The $12 price to which the court referred was the highest price at which shares changed hands before the sale of control. The average monthly bid prices for Newport stock during 1950 were: July, $3 3/4; August, $8 1/2; September, $10 7/8; October, $12 1/2; November, $12 3/8; December, 12. The sale to the Wilport syndicate took place on August 31, 1950. This pattern of prices certainly does not suggest that the 63 percent interest excluded from the premium perceived injury to Newport.

14. For example, Insuranshares Corp. v. Northern Financial Corp., 35 F. Supp. 22 (E.D. Pa. 1941), and Gerdes v. Reynolds, 28 N.Y.S. 2d 622 (1941), hold a controlling investor liable on account of failure to investigate a purchaser.

profitable under some circumstances. Theft sometimes pays. Existing holders of control, no less than prospective purchasers, however, have an incentive to put their hands in the till, and a proposal to ban one or another corporate control transaction as an antidote to looting is like a proposal to ban investments in common stocks as an antidote to bankruptcy.

If it were feasible to detect looters in advance—if they all wore yellow carnations and pinkie rings, and smelled of sulfur—it might make sense to forbid the sellers of control to allow shares to pass to scoundrels (or even to the honest but inept). Certainly the sellers of control can detect knavery at a lower cost than the public shareholders who are not parties to the transaction. Yet it is difficult if not impossible to detect looters early on. Looting is by nature a one-time transaction. Once looters have plundered one firm, their reputation (or their residence in jail) prevents them from doing so again. But when they first obtain control, they may appear innocuous. Any rule that blocks sales in advance is equivalent to a program of preventive detention for people who have never robbed banks but have acquisitive personalities.

Although sellers could spend substantial sums investigating buyers and investors and still more in litigating over the quality of investigation, almost all of these efforts would be wasted. If investigations blocked transfers, most of these refusals would be false positives. That is, they would be refusals that reduced the gains available from transferring control. Sometimes the best way to manage a firm is to break it up—to sell off some operations and reorganize the rest. Spinoffs and splits are no more suspect than mergers and the construction of new plants; both are efforts to obtain the optimal allocation of assets among management teams. Some managers are especially skilled in reorganizing or liquidating ailing firms. Yet the suspicion of looting falls most heavily on such people, for it is hard to say in advance whether a radical restructuring of a firm is good or bad for investors. A legal rule that has its bite when a firm is approached by a buyer with a proposal for radical (and potentially highly beneficial) surgery is unlikely to increase the value of investments.

We do not suggest that the legal system should disregard looting, but the best remedies are based on deterrence rather than prior scrutiny. Looters, when caught, may be fined or imprisoned. Penalties could be made high enough to be effective, making the transaction unprofitable ex ante. The costs of deterrence are less than
the costs of dealing with looting through a system of prior scrutiny that would scotch many valuable control shifts as a by-product.

**Changes in Control Structure**

Many practices may affect the way in which investments are pooled to obtain or hold control. Voting trusts, holding companies, and other devices allocate control as effectively as sales. These control transactions have the same sort of potential benefits and accordingly they should be evaluated the same way. By and large, corporate law does so. Shareholders may form voting trusts and holding companies without any obligation to share the gains; the only significant limitation, usually imposed by statute, is that voting trusts lapse unless periodically renewed.

One prominent case charts a different course. In *Jones v. H.F. Ahmanson & Co.* the owners of 85 percent of the stock of United Savings and Loan Association, a closely held corporation, organized a Delaware holding company. In exchange for shares of the holding company, they transferred all of their shares in the savings and loan along with several other businesses. The holding company went public, issuing stock and debentures. The original controlling shareholders of the savings and loan ended up with stock in a leveraged holding company; the position of the minority shareholders of United was unaffected. In the next few years, the profits of the savings and loan went up, while the prices of the shares of the holding company went up even faster. *After* the rise in the holding company’s price, the minority shareholders demanded admission. When offered only $2,400 per share (the United shares placed in the holding company at the outset had risen to the equivalent of $8,800), they sued.

The Supreme Court of California, citing *Perlman* and referring to the gain-sharing proposals of Berle and Jennings, held that “the controlling shareholders may not use their power to control the corporation for the purpose of promising a marketing scheme that benefits themselves alone to the detriment of the minority.” It insisted that “the minority shareholders be placed in a position at least as favorable as that the majority created for themselves.”

16. 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969). The quotations in the next paragraph appear at 1 Cal. 3d at 115, 118, 460 P.2d at 476, 478, 81 Cal. Rptr. at 604, 606.
court permitted minority shareholders to elect between the appraised value of their shares at the time of the exchange and the price of the holding company stock that they would have had at the time of the action.

At first blush the case presents a classic usurpation of a corporate opportunity (the ability to go public) by the controlling shareholders. Because the majority could have included the minority without jeopardizing the transaction, there was no need to exclude the minority. But this interpretation won’t wash. The controlling shareholders wished to consolidate their 85 percent stock ownership of the savings and loan together with several other businesses into one corporation. Such a consolidation could produce efficiencies, from sources such as centralized management. Participation by the minority in the holding company would decrease the incentive of the controlling shareholders to create the gains by incurring the costs of consolidating the related businesses. The court failed to perceive this difficulty with a sharing requirement.

More fundamentally, the court did not grasp the significance of the minority shareholders’ delay in bringing suit. The costs and risks of creating the holding company were borne by the controlling shareholders, and their expected reward was the premium resulting from the increased value of the transformed asset. The minority shareholders bore none of the costs, and allowing them to take a free ride on the benefits would reduce the number of value-increasing transactions in the future. Moreover, a substantial part of the increase in the price of the holding company’s shares was attributable to its leverage. The minority shareholders waited to see whether United’s earnings rose before demanding to participate; if United’s earnings had fallen, the minority doubtless would have held onto their United shares while those who participated in the holding company were wiped out in favor of the debenture holders. If generally accepted, the court’s *ex post* view of fairness, giving the minority a right to participate in the gains without taking the risk of loss, would go a long way toward discouraging beneficial control transactions. But *Ahmanson* has not been generally accepted.

**Sale of Office**

Managers could transfer control by selling their offices. A sale of office is unlawful in every state, however, in the absence of con-
tructual permission. 17 This application of the fiduciary principle is usually explained as resting on the belief that "[a] fiduciary endeavoring to influence the selection of a successor must do so with an eye single to the best interests of the beneficiaries. Experience has taught that, no matter how high-minded a particular fiduciary may be, the only certain way to insure full compliance with that duty is to eliminate any possibility of personal gain." 18 Doubtless the only "certain" way to prevent defalcations is to remove "any possibility of personal gain," as the only "certain" way to prevent drunk driving is to scrap every automobile in the world. No legal rule demands that there be zero possibility of evil befalling us—and corporate law does not try to answer any such demand. A principle that personal gains may not influence the transfer of control would proscribe any sale of control blocs of shares even though the law allows these sales.

It is more accurate to say that the fiduciary principle bars the sale of office, while allowing the sale of control, because control sales have built-in guarantees of the buyer's good intentions but office sales do not. One who buys a controlling bloc of shares cannot hurt the corporation without hurting himself too. Substantial investment acts as a bond for honest conduct. One who buys an office may obtain control too cheaply. The argument is fundamentally the same one we presented in Chapter 3 to show why votes may not be sold without the equity interest. Offices would sell for their value to the incumbent, including any value attributable to the incumbent's ability to extract profits and perquisites. It is possible to argue that because the incumbent would insist on full payment for value, only a buyer who could put the firm's assets to better use would be able to meet the incumbent's demands. On this view there would be no reason to prohibit the sale of office. But this would be an accurate assessment only if managers now could fully extract the value of their positions. As we have emphasized repeatedly, they cannot: markets for control and managerial services constrain them.

The law is consistent with this rationale for the ban on selling offices. Managers may agree, as part of the sale of a controlling

17. In general, an agent may not sell his position of authority. See Restatement (Second) of Agency 18 (1958) (restriction on ability of agent to delegate his authority).
block of shares, to turn over their offices. In such cases part of the premium reflects the value of the office. Managers also may accept payment for recommending that the shareholders approve a merger, when the payment is disclosed and the managers simultaneously sell their own shares. The sale of office violates the fiduciary principle only when the office is sold by itself.

**FREEZEOUTS, SQUEEZEOUTS, LBOs, AND MBOs**

Transactions eliminating public or minority shareholders (which we call “freezeouts,” although they go by many other names) serve a variety of purposes. The freezeout of minority shareholders soon after a transfer in control allows the bidder to capture a disproportionate share of the gains from the acquisition; the elimination of minority shareholders in a subsidiary corporation may facilitate various economies of operation and eliminate conflict of interest problems; going private directly reduces agency costs and the costs attributable to public ownership. We discussed earlier in this chapter some of the sources of these gains.

It used to be very difficult to force a shareholder to disinvest involuntarily, because courts viewed shares as vested rights that could not be taken without consent. Because this rule of unanimity created intolerable holdout problems and frustrated many efficient corporate transactions, it was jettisoned in favor of a rule that allowed the majority to freeze out minority shareholders. Under the modern view, the shareholders’ only entitlement is to demand an appraisal of their shares, a remedy that does not give dissenting shareholders any element of value attributable to the transaction from which they dissent.

Within the last few years, however, freezeout transactions have come under greater scrutiny by courts and increasing attack by scholars. It has been suggested that freezeouts are unfair to the shareholders and lack a business purpose. They go on all the time,


however, subject only to the constraints of the customary duties of
care and loyalty.

Our outlier is Singer v. Magnavox Co. 21 A company called De-
velopment Corp. made a tender offer for the common stock of
Magnavox. The price was $9 per share, and 84.1 percent of the
stock was tendered. Development merged Magnavox with T.M.C.
Development, its wholly owned subsidiary, paying $9 for every
outstanding share. The result of this two-step process was that
every original shareholder of Magnavox received $9, and Develop-
ment got all of the common stock. Development told the non-
tendering shareholders that they had the right to appraisal under
Delaware law. Some shareholders, however, spurned the appraisal
and sought an injunction, contending that the merger was unfair
and did not serve a valid business purpose because it allowed De-
velopment to keep "a disproportionate amount of the gain [Devel-
opment] anticipated would be recognized from consummation of
the merger."

Development argued that the shareholders' only right was to the
value of the existing investment, protected by the appraisal remedy
(see Chapter 6). The court replied that shareholders have a pro-
tected right in the form of their investment as well as in its value.
Thus the court set the case for trial to determine whether there was
a business purpose for the merger and whether $9 was a fair price.
Because the directors of Magnavox, the nominees of Development,
owed fiduciary duties to the shareholders, the price paid in the
freezeout had to satisfy "entire fairness" as well as the appraisal
standard.

Invocation of the fiduciary principle does not answer the ques-
tion whether shareholders would contract for (and fiduciaries thus
must provide) some sharing of gains, and the court begged this
question in Singer. Perhaps the price had to exceed $9 to be en-
tirely fair, but the court did not say so; indeed, it did not foreclose
the possibility that $8 or even $5 would have been entirely fair. It
left these matters to the chancellor. Courts in other states have
been hesitant to embrace Singer's holding, and the case is defunct
in Delaware. Delaware has held that a merger may be approved
when all of the gain accrues to one firm; that the appraisal standard
continues to exclude elements of value attributable to the transac-

21. 380 A.2d 969 (Del. 1977). The following quotations are from pages 978, 980.
tion that provokes the dissent; and that managers may exercise ordinary business judgment in structuring control transactions. Singer has been consigned to oblivion—so insignificant that the latest edition of the leading casebook omits it.

What has lingered in Delaware law is a belief that the market price of a firm’s stock is not (necessarily) its “real” or “intrinsic” value, a proposition that can cause much grief from time to time. This sometimes comes together with a belief that a transaction conducted at two different prices must reflect “coercion” to accept the high price (we should all be so unlucky) or that the low tier lies below the “intrinsic value” of the firm. Neither of these themes has significantly affected the ability of firms to restructure themselves as they please—provided they spend a few hundred thousand dollars to get an investment banker’s “fairness opinion” that a price higher than market is indeed at the “intrinsic” value of the stock—although both of them have been important in contests for corporate control, as we discuss in Chapter 7 in connection with tender offers. Here, we limit further comments to arguments about transactions that are initiated by the firm being restructured.

William Carney has argued that compensation of the minority at market value is inadequate because the minority may value its shares more highly than either the majority or the market. If the minority values its shares at $30 even though the market price is $10, the argument runs, they may lose more than the majority gains, and the transaction may decrease value. This argument is flawed, however, because if different shareholders place different values on the same investment, those who had the higher valuation would purchase the shares held by the remaining investors. In-


23. Carney, supra note 20, at 112–118.
vestors can make mutually beneficial trades until those holding any given firm's stock have reasonably homogeneous expectations about its performance, and there is little risk that the pessimistic investors in a firm can use freezeout transactions to exploit optimists.

Victor Brudney and Marvin Chirelstein maintain that "fairness" requires any gains from the merger of a parent corporation and a subsidiary to be calculated and shared among all investors according to the premerger ratio of the equity investments in the two firms. For the reasons we have covered above, this would deter value-increasing transactions. Moreover, the suggestion that sharing promotes "fairness" is dubious. How does the controlling shareholder know what the gains will be in order to apportion them fairly? How can "synergy gains"—the subject of the Brudney and Chirelstein sharing proposals—be separated from the ordinary return on the time, effort, and resources that the controlling firm put into accomplishing the merger, or from the opportunity costs of the controlling shareholder? What if the merger results in a loss rather than a gain? Why does fairness require sharing in proportion to equity value rather than in proportion to total asset value or some other standard? There is no accepted standard of fairness, one more reason why the cases and the fiduciary principle do not require sharing.

An argument occasionally heard from the press, though rarely from scholars, is that the freezeout price is unfair (even though above market) when it is below the price at which the shares were sold to the public. The assumption must be that insiders somehow bilked the public into paying too much—or perhaps have confused the market so that the current price is too low—and should not be permitted to profit by their chicanery. Those who make that argument both underestimate the efficiency of the stock market and misconceive the importance of yesterday's stock prices. In an efficient capital market, the informational value of prior prices is incorporated into today's price, and the fact that the firm's price was once high does not indicate that it will rise again. A freezeout price above the current market price is no less beneficial to shareholders because the price was once higher, and the person paying

the above-market price cannot hope to profit unless the transaction is value-increasing.

A related, and more plausible, argument has it that the insiders in freezeouts know more than the outsiders and use this knowledge either to depress the price of the stock just before the transaction, so that the “premium” is illusory, or to take out the public investors with knowledge that the firm’s prospects are better than outsiders believe, thus scooping up gains that the public would have enjoyed but for the freezeout. If a firm makes a valuable mineral discovery, for example, and this information is not yet reflected in the price of the firm’s shares, a controlling shareholder might be able to reap a considerable gain by freezing out the minority, even though the value of the firm is not increased. Such concerns have been expressed especially loudly concerning MBOs. But this possibility has not led to a ban on going-private transactions, for several good reasons.

First, its likelihood has been exaggerated.\textsuperscript{25} Second, the possibility of insiders’ profiting is a well-known risk for which investors can demand compensation. Third, tricking the market about current value is hard. Freezeouts usually take some time to accomplish and almost always require the shareholders to vote. During the delay the truth may come out—generally the insiders must reveal the news when they seek the needed votes—or an auction develops. If insiders attempt to go private at a price less than the firm’s future prospects indicate, the firm in all likelihood will be the subject of a higher bid.\textsuperscript{26} Auctions in response to proposed MBOs are common.

For what it is worth, data do not support a belief that insiders are

\textsuperscript{25} In the famous Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947), for example, minority shareholders alleged that the controlling shareholder unlawfully attempted a freezeout without disclosing that the value of tobacco, the firm’s principal asset, had tripled. The court held that the planned transaction was a breach of fiduciary duty. Yet it is very unlikely that an increase in the price of tobacco, a commodity with a readily ascertainable price, was inside information not reflected in the firm’s stock price. \textit{Zahn} makes sense only if the shareholders were unaware of the quantity or kind of tobacco held by the firm, which would be known to insiders, and then only if the ignorance affected their decision concerning conversion between classes of shares. Perhaps they were ignorant, but the court did not discuss the problem.

\textsuperscript{26} The American Law Institute’s \textit{Principles of Corporate Governance: Analysis and Recommendations} 5.15 (Tent. Draft No. 10, 1990), comes to this same conclusion when allowing restructurings subject only to disclosure and a market test. The reporters of this provision treat it as a restatement of current law.
trying to scoop up the shares before the market wises up. LBOs and MBOs commonly carry premiums of 30 to 50 percent over existing prices. If, on the one hand, these are based on temporary distortions (or knowledge of a brighter tomorrow), we should expect to see prices soon rise higher still when the transaction is called off; if, on the other hand, the premium is attributable to real changes made possible by the transaction, it will disappear if the transaction is called off. Harry DeAngelo, Linda DeAngelo, and Edward Rice looked at successful and unsuccessful LBOs and MBOs and discovered that when the transaction collapses, so does the price. Clifford Holderness and Dennis Sheehan found that shares not acquired in these transactions appreciate in value. Several scholars, most recently Laurentius Marais, Katherine Schipper, and Abbie Smith, have found that debt investors whose interests remain outstanding do not lose as a result of LBOs and MBOs. These conclusions (see note 1) collectively supply powerful evidence in favor of the efficiency hypothesis for corporate control transactions.

THE APPRAISAL REMEDY

Statutes and cases routinely require certain minimum payments to the investors that are affected by a corporate control transaction. These minimum payments, codified in most states by the appraisal statute, require that shareholders receive the equivalent of what they give up but do not require sharing of the gain from the change in control. The Delaware statute is most explicit, providing that the court “shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation” of the event giving rise to appraisal rights.27

The appraisal standard reflects the economic principles we have discussed. Gains need not be shared, and every investor receives at least what he had before. As a rule, the fiduciary principle is satisfied if some investors receive a premium over the market price of their shares, and other investors do not suffer a loss. Appraisal puts that floor under all investors. We return in Chapter 6 to a detailed treatment of how the appraisal procedure does so, and whether there is room for improvement in its operation.

27. 8 Del. Code 262(h).
CORPORATE OPPORTUNITIES

Corporate opportunities are business ventures of some sort, and the allocation of an opportunity within a family of affiliated corporations, or between a corporation and an officer, is a control transaction as we have used that term. Given the survey of the law to this point, it is not surprising that there is no sharing principle in the law of corporate opportunities. A parent corporation may allocate a business opportunity to itself, for example, even though public shareholders in a subsidiary believe that this is unfair. 28 A corporation also may allocate an opportunity to one of its managers. The "corporate opportunity doctrine," far from forbidding such allocations, simply requires that the opportunity be presented to and passed on by the firm’s directors or other officers. The firm is free to decline to pursue the opportunity, releasing it to a director or officer. Such releases are common when an employee of the firm has an invention or an idea for a new product that he holds in higher esteem than does the firm. The classic corporate opportunity doctrine cases deal with undisclosed conversions of opportunities; they are to corporate control transactions as theft is to salary.

A number of scholars have decried the state of the law, proposing that current rules be replaced with doctrine of equitable sharing or even absolute bans on the allocation of opportunities to parent corporations or corporate managers. Victor Brudney and Robert Clark contend, for example, that the prospect of overreaching by managers is so great that nothing save prohibition could protect the interests of shareholders. 29

One response to these proposals is that they will deter the undertaking of some value-increasing ventures or cause them to be undertaken inefficiently. Moreover, in most cases there is no agency cost problem requiring attention. When managers decide whether to allocate an opportunity to a parent or a subsidiary, the allocation decision will reflect the managers’ best judgment about which firm can best develop the opportunity because the same people effectively control both firms. The managers’ interests in allocation coin-


cide with shareholders' interests—each wants the venture to be exploited by the corporate structure that can do so best, because that result will generate the greatest profits, and thus the highest share prices for investors and the highest salaries for managers.

Much of the existing literature assumes that a parent corporation will allocate corporate opportunities to itself to avoid sharing of the gains with minority shareholders of the subsidiary corporation. Brudney and Clark, for example, argue that this danger is so great that corporate opportunities should presumptively be awarded to the subsidiary corporation. The argument is defective because it ignores the possibility of side payments. Assume that a corporate opportunity is worth $100 to a 70 percent owned subsidiary but only $80 to the parent. It might appear that the parent would allocate the opportunity to itself even though it could use the opportunity less profitably, because the $80 gain is greater than the $70 (70 percent of $100) gained if the opportunity is allocated to the subsidiary. But the parent corporation could gain more than $80 by allocating the opportunity to the subsidiary and charging it some amount between $11 and $30. The charge could be explicit or implicit. That is, the parent's other dealings with the subsidiary could be adjusted to compensate it for the release of the opportunity—transfer pricing between parents and subsidiaries is extremely flexible. Thus the opportunity would be allocated to the firm that could use it more efficiently, and all parties, including the minority shareholders of the subsidiary, would benefit as a result.

The same is true when managers take opportunities for themselves. Assigning the opportunity to the manager may reduce agency costs by enabling the manager to receive a greater part of the marginal gains produced by his efforts. The manager would view the business opportunity as just another form of compensation similar to (but more risky than) salary, bonuses, and stock options. Managers properly take opportunities for themselves when they can exploit them more profitably than the firm. The increase in the value of the opportunity creates the possibility of a mutually beneficial transaction between manager and firm: the manager takes the venture, and the firm reduces the manager's other compensation.

Such a transaction is the equivalent of a decision to hire the manager only part-time, leaving him free to pursue other things during the rest of his time. Part-time employment is common in
labor markets. Sometimes firms want to hire only 1 or 2 percent of a person’s time, and they obtain such labor inputs from independent contractors (among them law firms and architects). Sometimes firms want 100 percent of the agent’s time. But figures in between are sensible, too. Law schools typically hire approximately 50 percent of professors’ time, giving them four months in the summer and some time off during the year to do as they please (consulting, travel, teaching elsewhere, even writing). Part-time employment arises when, at the margin, a person’s time is more valuable to some other employer or to the agent himself (pursuing other projects or simply taking life at leisure) than to the firm. The part-time employee compensates the firm through a reduced salary.

This might appear misleading, because executives who take opportunities typically do not reduce their salaries on the spot or explicitly accept part-time employment. But managers’ time commitments are flexible; taking an opportunity may coincide with a reduction from sixty to fifty hours spent on the firm’s business each week. The salary reduction may be part of a settling up with the firm as the employee receives a lower bonus or a lower salary for the future. The adjustment also may come ex ante because employees will accept a lower salary from a firm that allows its officials to exploit business opportunities on the side. Either way, the executive will pay for what he takes.

It will not do to say that executives have “bargaining power” that they use to avoid this settling up. Although managers doubtless can exploit their positions to a degree, they are constrained by labor markets, product markets, and the market for corporate control. No matter how much bargaining power the managers have, they are better off if they do what shareholders prefer and assign the opportunity to the corporation or person that can put it to best use. Such behavior creates a bigger pie, which managers may slice in favor of both investors and themselves. A ban on the assignment of opportunities to managers would not reduce their bargaining power or facilitate monitoring.

Perhaps it is generally beneficial for managers to abjure opportunities. If so, then they can benefit by promising to allocate all new ventures to the firm. Although it should be relatively easy to reach such contracts, they appear to be rare, which suggests that shareholders’ interests coincide with the existing legal rules.
Fiduciary Duty in Related Contexts

We have shown that a legal rule allowing unequal division of the gains from corporate control transactions furthers the shareholders’ interests, provided that no shareholder be made worse off. We have also shown that existing legal rules, for the most part, are consistent with our analysis. We conclude by mentioning and distinguishing several situations where equal division of gains is the norm.

A familiar rule of partnership law is that, unless the partners otherwise agree, profits must be shared equally and no partner is entitled to a salary. The rationale for this rule is clear—because the number of partners is typically small, it is relatively easy for partners to reach contractual agreements relating to particular contributions. If unequal division is necessary to provide an incentive to create gains, the partners can accomplish this by private agreement. Moreover, because partners generally invest much of their human capital in the partnership, they are unable to diversify this part of their investment “portfolio.” Partners who are risk-averse therefore benefit from a rule of equal division.

Another rule of law is that dividends must be distributed pro rata to each shareholder of the same class in a corporation. There is no tension between this rule and the fiduciary principle in corporate control transactions. Firms may and do create different classes of stock with different entitlements, just as they may agree to unequal division of other elements of value. Unequal division of the gains resulting from corporate control transactions increases shareholders’ welfare by creating an incentive to produce such gains and thereby to add to the value of the firm. The same is not true with respect to dividends. The payment of a dividend is simply a transfer of assets from a firm to its shareholders. No gains are created in the process. Thus a legal rule allowing unequal distribution of dividends might increase the frequency of dividend payments, but this would not increase the value of the firm. On the contrary, a rule allowing unequal division of dividends would make shareholders worse off because they would have an incentive to incur wasteful expenditures by monitoring the withdrawal of assets from the firm. Thus the rule prohibiting unequal payment of dividends, like the fiduciary principle allowing unequal division of gains resulting from
corporate transactions, is perfectly consistent with the goal of maximizing shareholders' wealth.

In general, the likelihood of a sharing rule turns on two things: the probability that unequal divisions would produce gains, and the number of participants in the venture. As either quantum rises, a sharing rule becomes less useful in maximizing the wealth of investors. Chapter 9, on close corporations, provides further evidence of this.