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Management Buyouts and Managerial Ethics

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Because of their unusual terms, size, and number, management buyouts (MBOs) have emerged as one of the more arresting features in the corporate landscape. W. T. Grimm and Company estimated that in 1979 the value of firms going private was $636 million.[1] By 1986, Mergers and Acquisitions estimated the value of firms going private to be $40.9 billion.[2]

As the volume of management buyouts rises, so does the volume of criticism. There are several avenues of attack. For instance, many critics doubt the social value of these transactions. They argue that MBOs threaten the financial stability of the American economy and are only financial rearrangements having no effect on the utilization of real assets.[3]

The attack most interesting from the standpoints of directors, senior managers, and shareholders rests on the claim that buyouts are unethical because of management's conflict of interest. In a buyout, managers' personal interests are pitted against their fiduciary duties to shareholders. Critics ask whether stockholders are getting the managerial loyalty to which they are entitled.[4] Commenting on the going-private transactions of the early seventies, a former commissioner of the SEC said:

> What is happening is, in my estimation, serious, unfair, and sometimes disgraceful, a perversion of the whole process of public financing, and a course that inevitably is going to make the individual shareholder even more hostile to American corporate mores and the securities markets than he already is.[5]

In the 1970s, the SEC considered banning buyouts, but eventually opted for fuller disclosure requirements. Nevertheless, it is safe to say that there remains widespread suspicion about the ethics of buyouts.[6]

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Management Buyouts and Their Critics

A Typical Buyout—A management buyout (MBO) occurs when the management of a publicly held company joins forces with other investors and buys the company from the public.[7] Management members of the buying group may include directors as well as senior executives. Buyouts are sometimes initiated by management, but frequently they are the brainchild of investment bankers who tap management as an essential participant in a buyout scheme. There are a variety of circumstances in which it may make sense to take a company private. A buyout may be the only avenue for turning a failing company around, or the most appealing way to fend off a hostile takeover. More simply, it may offer management the opportunity to get rich or to move from the status of salaried employee to owner.

In many instances, board approval and a shareholder vote are required before the acquisition can be consummated. However, the buyout group can bypass the board and possibly the voting process by making a tender offer. If sufficiently successful, the buyout group may be able to cash out remaining shareholders without their consent.

Management buyouts are typically financed by borrowing against the assets of the firm. Once the buyout group acquires the company, the firm's assets can be pledged as collateral for the loans necessary to finance the acquisition. The loans are then repaid over a period of years from the cash flow generated from tax savings and after-tax profits. Two categories of tax savings are significant: the tax shields provided by interest payments and depreciation expense. The premium paid to acquire the firm, so long as not exceeding fair market value, can be allocated to depreciable assets and depreciated. Both sources of savings generate cash which can be used to repay the loans.

While the 1986 tax reforms diminish the tax savings available from going private,[8] a private firm may still be able to lever itself more heavily than a public one, and thus will continue to have the benefit of some tax savings not available to the public firm. But the tax considerations which made certain corporate assets more valuable in the hands of the acquirer than in the hands of the seller have been reduced.

Some observers have claimed that buyouts generate significant operating efficiencies which also contribute to enhanced cash flow in the private firm.[9] Others have argued that by comparison to the tax savings available before the 1986 reforms, these operating efficiencies are not material.[10]

Buyouts are attractive to management because they involve an improved equity position and enhanced compensation package. One study found that, on average, going private enhances a chief executive officer's annual salary by $24 thousand and his equity stake rises to 26 percent.[11] Much of the value obtained by managers is realized upon the eventual resale of the com-

pany.[12] For instance, John Puth, the president of Vapor Corporation, which was bought out in 1972 and taken public again in 1976, received a $2.1 million profit on an initial investment of $175,000.[13]

The Problem with Buyouts—In recent years, management buyouts have offered shareholders attractive returns. The cash flow gains from increased leverage and depreciation have permitted buyers to pay a premium over market price and at the same time to earn supernormal rates of return. On average, it appears that sellers receive almost a 30 percent premium for their equity claim.[14] On the buyers' side, detailed case analyses suggest substantial internal rates of return on investment ranging from 25 to 50 percent. Superficially at least, it appears that both sides of the transaction win. Why, then, has management's role in buyouts been so heavily criticized?

The criticism is about fairness for the public shareholders. Management's position on both sides of the bargaining table may make buyout prices suspect even when shareholders are bought out at premiums. Critics find it difficult to see how management members of the buyout team can serve effectively as fiduciaries of selling shareholders and at the same time negotiate on their own behalf as buyers. As fiduciary, management's objective should be to obtain the highest price possible. As members of the buyout team, however, it would be natural for management to try to push the price as low as possible. A low price makes the purchase more attractive and enhances the potential future gains from going public again.

The risk is that management may take advantage of shareholders; but

Even if the management buyout team offers shareholders a fair deal—one that satisfies its fiduciary obligations—the deal may not be perceived as fair by those who are aware of management's conflict of interest.

even if the buyout team offers shareholders a fair deal—one that satisfies its fiduciary obligations—the deal may not be perceived as fair by those who are aware of management's conflict of interest. The bevy of shareholder derivative lawsuits that have followed recent buyouts, even those at premium prices, and the criticisms produced by academics and policy makers indicate that shareholders lack confidence in the fairness of the prices they are offered.

Management's conflicting objectives are one source of concern about buyouts, but other issues are also involved. Management's superior knowledge exacerbates the problem of conflicting objectives. As insiders, managers have privileged access to information, sometimes secret, about the

firm's prospects, and they have a unique feel for the company's value which comes from experience in handling its day-to-day affairs. Their knowledge of the firm and their special appreciation for its value give managers a decided advantage vis-à-vis shareholders and potential competitors when proposing a buyout price. A price which appears fair in light of publicly available information may be unfair when undisclosed plans, discoveries, and inventions are taken into account.

Management also has the ability to affect the company's stock price by controlling the flow of information, by its choice of accounting procedures, and by timing its strategic decisions. Opportunities to manipulate share price in conjunction with a buyout bid are significant. Quite apart from any deliberate efforts to manipulate stock prices, however, management has a unique ability to choose the most opportune time to propose a buyout.

Presumably, management proposes or participates in a buyout only if it is advantageous to management to do so. If management believes the share price is significantly below what could be obtained by releveraging or liquidating the company, it makes sense for management to buy the company and take steps to redeploy its assets. Under these circumstances shareholders may justifiably wonder whether management is taking for itself some opportunity that properly belongs to the corporation. Traditionally, under the corporate opportunity doctrine, the law has prohibited officers, directors, and senior managers from taking personal advantage of opportunities that come to them in their official capacities and are of potential benefit to the corporation.[15] If corporate leaders exploit corporate opportunities for themselves, the law permits shareholders to impose a trust on the profits earned. Couldn't management relever or liquidate directly to benefit shareholders rather than first taking the company private? On the face of it, the MBO appears to be a mechanism for transferring value from shareholders to management.

Management's Fiduciary Obligations—The concerns about conflicting interests, insider advantages, and misappropriation of corporate opportunities reflect management's special obligations to the corporation and its shareholders. In contrast to the arm's-length relationship that normally obtains between buyers and sellers in the marketplace, managers have a fiduciary responsibility toward the corporation and shareholders for whom they work.

According to the orthodox theory of the corporation, shareholders own—or at least invest in—the firm, while management runs it. In order for this arrangement to work, shareholders must be able to trust that management will devote adequate attention to corporate business and run the business competently in a way that promotes the shareholders' interests. This trust is in part promoted through the board of directors, whose job it is to monitor management's performance on behalf of shareholders. But it depends more

fundamentally on the continuing good faith performance by men and women in management positions.

The classic legal statement of the responsibility of corporate fiduciaries is found in the well-known case of *Guth v. Luft* decided by the Supreme Court of Delaware in 1939:

> A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives . . . demands of a corporate officer or director . . . the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers.[16]

The central element of this ideal is that management be dedicated to advancing the interests of the corporation, but most especially that management should not advance its own interests at the expense of the corporation.

The separation of ownership and control which underlies the modern public corporation is possible only if shareholders trust corporate leadership. In the absence of trust, monitoring management's performance becomes very costly. Without some fundamental assurance that their interests will be protected, equity investors would have little incentive to put their capital in the hands of professional managers. The benefits of corporate enterprise that flow to consumers, employees, suppliers, communities, and the general public—as well as to shareholders—are in jeopardy if management loses sight of its fiduciary obligations.

An Ethical Perspective on Management Buyouts

Management buyouts threaten to undermine shareholder trust in corporate leadership if they are seen as or used as techniques for shrewd managers to benefit at shareholders' expense. Management's personal interest in buyouts, coupled with the absence of any generally accepted standard of fairness for evaluating buyout bids, make them especially potent threats to investor confidence. If there were no potential benefits for shareholders in these arrangements, there would be every reason to prohibit them. But, as noted earlier, buyouts sometimes offer shareholders the best alternative for protecting their investment or realizing its value. For example, management may be able, because of its position and superior knowledge, to see potential where outsiders do not, and thus be willing to take a seemingly moribund company private and rejuvenate it.[17] Management may, because of its position, be able to take a company private to ward off a hostile takeover bid offering a lower price.[18] Even in the absence of threatening conditions, a buyout may offer shareholders the best opportunity to realize the value of their investment because of the tax advantages and leveraging opportunities available as a result of going private. Any discussion of buyouts must recognize that sometimes they may be in shareholders' best interests.

From the perspective of managerial ethics, the practical challenge, then, is both to specify the conditions under which going private is consistent with management's fiduciary obligations and to motivate managers to propose only buyouts which satisfy those conditions.

Management's Conflict of Interest

The Ethical Problem—Some observers consider buyouts inherently inconsistent with management's fiduciary obligations because of management's conflicting personal interests. These observers and many others apparently take the position that it is unethical to place oneself in a position in which personal interest may conflict with obligation.[19] The appeal of such a position is obvious. In conflict of interest situations, there is always the possibility that personal interest will overwhelm obligation, that an abuse of trust will occur. However, the principle may be criticized on two grounds.

First, it is based on a misconception of conflicts of interest, one which sees potential conflict as characteristic of discrete, identifiable situations—which can be easily marked off from the normal state of affairs.

In fact, whenever a person is charged to act for the benefit of another—as corporate fiduciary, as parent, as employee—a conflict between personal interest and obligation to promote the interests of the other can erupt. The conflict may arise in connection with almost any type of decision or activity. An employee's decision not to search more widely for a competitive supplier, for example, may involve such a conflict. Potential conflict is not limited to exchanges between the agent and principal. Recognition that the potential for conflict exists continuously in every agency relationship renders the principle requiring avoidance of potential conflict totally unworkable. It is impossible to eliminate all potential conflicts without eliminating the relationships that give rise to them, and that would be too great a price to pay. Practical judgment is required to identify situations in which the potential gain to the agent or loss to the principle is great enough to warrant steps to monitor or restrain the agent's behavior.

The principle requiring avoidance of all potential conflict situations may also be criticized because it sometimes penalizes the very party it is meant to protect. If, for example, corporate directors were flatly prohibited from doing business with the corporations they serve, some opportunities advantageous to the corporation would have to be foregone. Courts and state legislatures have long recognized the possibility that a flat prohibition on dealing between a corporation and its directors can in some circumstances work to the detriment of the corporation.[20]

Conflicts of interest are problematic not because they are themselves unethical, but because they may lead to conduct that is unethical. It may be difficult to do what obligation requires when important personal interests seem to point in a different direction. More commonly, personal interest

may threaten the objectivity or integrity of professional judgment. When personal interests loom large, the decision maker may have difficulty determining where his firm's interests lie. There is a very natural tendency to want to see the interests of the firm and self-interest as aligned, even if, from a more objective perspective, they are not.

While there is little reason to recommend avoiding all situations in which personal interest may conflict with fiduciary obligation, there is good reason for looking more closely at situations in which a conflict creates a risk of significant losses to the principal or benefits to the agent. A buyout is just such a situation.

Conscientious management may see a buyout as the best course of action for shareholders when it is not. Unscrupulous management may go forward with a buyout knowing the price is unfair to shareholders. What is the appropriate response to management's conflict of interest? An appropriate response will be one which encourages buyouts that satisfy management's fiduciary duties and blocks those which do not.

Dealing with Conflicts—The frequency of significant conflicts of interest has led many organizations to devise procedures and rules for dealing with them.[21] There are several common approaches: non-participation, delegation, disclosure, and independent review.

Avoidance of Conflicts—Avoidance of situations likely to call for decisions involving significant conflicts is a viable and wise strategy when there are substitute opportunities which do not pose the same conflict potential. For

A flat prohibition on buyouts, as well as a prohibition on management participation, would not necessarily be in shareholders' best interests.

example, prohibiting bank loan officers from dealing with themselves and their families makes good sense when there are others of equal desirability as borrowers. If there are no equally good substitute opportunities, however, the potential conflict may be dealt with by delegating the transaction or relationship to a disinterested employee of the organization. Especially when the conflict of interest relates solely to the personal interests of a particular employee, delegating the decision to a disinterested party may be the best approach.

Following the avoidance-of-conflict line of thinking, some commentators have advocated prohibiting buyouts on the grounds that the risks of abuse and misjudgment are too significant to permit management to participate.[22]

This recommendation, however, imposes a burden on the corporation as well as on management members who may wish to participate in a buyout since it would prohibit *all* buyouts—even those in the shareholders' interests.

A seemingly less sweeping recommendation, prohibiting management participation in going-private transactions, amounts essentially to the same thing, and it may be very costly to the firm. Investors in a buyout want, and usually require, management participation. The presence of experienced management is essential to produce the cash flow from continuing operations necessary to service the additional debt acquired.[23] Management is central to the nexus of relationships in a going-private transaction. The very relationship which gives rise to the conflict of interest problem is central to the transaction.

While avoiding significant conflicts is generally a good idea, it has particular costs to the firm in the buyout context. Similarly, in most cases, management cannot delegate its role in the transaction to a disinterested party without destroying the rationale for the transaction. A flat prohibition on buyouts, as well as a prohibition on management participation, would not necessarily be in shareholders' best interests.

Disclosure and Review—When it is impractical or impossible to avoid a decision involving personal interest, disclosure of the conflict and the basis of the decision is another approach for discouraging breach of obligation. Disclosure and the possibility of review help protect the decision maker from unintentional bias, deter obviously self-interested decisions, and enhance the ability of others to protect themselves. Permitting unilateral action on a matter involving personal interest poses the greatest risks to the firm. Disclosure is most effective in the context of a review procedure designed to insure that the decision is not tainted by the self-interest of the decision maker: that the decision is justifiable on grounds independent of the decision maker's own interests.

Disclosure and review are an adequate response to conflict of interest problems only when the disclosure is complete enough to provide a basis for review, and when the review is itself disinterested, informed, and competent. The questions that arise repeatedly when this procedure is used are whether disclosure is adequate and whether the reviewers are informed and qualified.

These procedural moves to deal with conflicts of interest are all designed to minimize decisions or actions that violate responsibilities to the organization. They are based on the correct view that conflicts of interest are not unethical in themselves, but they pose a threat to the integrity and objectivity of judgment and may lead to decisions or actions which are unethical or in violation of responsibilities to act in the best interests of the firm.

A partial solution to the conflict of interest problem in management buyouts lies in an adequate disclosure and review process. A possible approach would be to require pertinent disclosures from the buyout team and to charge board members not affiliated with the buyout group with the task of assessing the adequacy of the bid, negotiating on behalf of unaffiliated shareholders, and rejecting the buyout proposal or accepting it subject to shareholder approval.[24] This general approach is approved, but only partially mandated, in current law. For example, appointing a committee of independent directors to assess a buyout proposal is a factor courts take into account when assessing fairness; but use of an independent negotiating committee is not required, nor does it guarantee that the transaction will be found to be fair.[25]

Federal securities laws currently require disclosure of, among other things, the purpose of the buyout; what alternatives, if any, were considered; the reasons for the structure of the buyout; the effect of the buyout on the company and its affiliated and unaffiliated shareholders; and whether the buyout is believed to be fair to unaffiliated shareholders.[26] The belief must be supported by a discussion of the factors upon which the belief is based.[27] Also mandated are disclosure of whether or not the transaction is structured to require approval of at least a majority of unaffiliated security holders and whether the transaction was approved by a majority of the company's independent directors.[28] State law requirements, such as Delaware's "obligation of complete candor," may call for other disclosures as well.[29] Nevertheless, questions about the scope and adequacy of required disclosure remain. Must a buyout team disclose its top price, or must it disclose the projections and forecasts upon which its negotiations are based?[30] These questions are particularly pressing if the unaffiliated board members who vote to approve a buyout are all outsiders. Outsiders generally do not have the intimate knowledge of the firm that would permit them to develop forecasts of their own, and there is no general requirement that forecasts and projections be disclosed.

Any attempt to assess and recommend disclosure and review guidelines or to evaluate current practices, however, must rest more fundamentally on a conception of fair price in the unique circumstances of a buyout. Earlier, we said that adequate disclosure and review procedures provide only a partial solution to the conflict of interest problem in management buyouts. More basic than these procedures is a conception of fair price. The objective of a third-party review of a buyout proposal is to insure that the offer comports with management's fiduciary obligations to shareholders. The reviewer—whether a disinterested board committee, an investment bank rendering a fairness opinion, or a shareholder—must have a conception of what that fiduciary obligation requires in the buyout situation. The key factor in determining whether a buyout satisfies management's fiduciary obli-

gations is whether the price to shareholders is fair. A conception of fair price in going-private transactions is essential if management is to retain shareholder confidence.

Fair Price

Who is entitled to the gains from management buyouts? Selling shareholders may believe that the gains from the buyout should be theirs. The value created derives from unused debt capacity and a depreciable asset base. Shareholders own both of these before the transaction. Buyers, no doubt, believe that their ability to leverage the company beyond the level normally available to a public corporation entitles them to the gains. In a normal arm's-length transaction, buyers and sellers negotiate from these different perceptions to reach a mutually acceptable price. Should the situation be any different in a management buyout? Should the normal arm's-length standard for fair price apply in the buyout context? Sometimes it is assumed that if buyouts give shareholders a premium over market price, then there should be no complaints.[31] Shareholders should gladly accept the premium and be grateful to management for having taken the initiative to unlock some added value. This position, however, fails to take into account management's fiduciary obligation and the foundation upon which it rests.

A buyout proposal is, in effect, a proposal to convert a fiduciary relationship into an arm's-length relationship. Whether the buyout group should be held to a fiduciary standard under these circumstances is central to the analysis of fair price. Our discussion of disclosure and review was based on the view that management's fiduciary obligations continue even after a buyout is proposed. Permitting management unilaterally to divest itself of its responsibilities to the firm by making a buyout proposal and then permitting the buyout group to negotiate on the basis of information and resources management acquired in its capacity as fiduciary would seriously undermine shareholder confidence. From the time a buyout is proposed until it is consummated or the proposal dropped, management should be held to a fiduciary standard. Unlike the approach which says that anything over market price is fair, our approach to fair price takes management's fiduciary responsibility into account.

As stated earlier, at the heart of management's fiduciary responsibility is the obligation to promote the corporation's interests. But most especially, management must not benefit at the expense of shareholders. Sometimes it is easy to see when corporate fiduciaries are benefiting at the expense of shareholders. When they misappropriate corporate assets for themselves, for example, the harm to shareholders and the corresponding benefit to the fiduciaries is simply measured by the value of the assets taken. Determining the harm to shareholders in a buyout case is more difficult. While shareholders may benefit to the extent that the price exceeds market value, they

may be harmed to the extent that the price is less than it ought to be by some other standard. For example, a buyout bid might be higher than market price, but still not as high as the price the shares would bring if management took certain initiatives such as relevering the company to improve share price.

Moreover, when a fiduciary steals from the corporation, there is no uncertainty about entitlements: the assets belong to the corporation and no reasonable person can claim to have any entitlement to them by virtue of his status in the corporation. However, where the question is the appropriate division of newly created wealth, particularly wealth created through the combined efforts of many people, entitlements are ambiguous. In order to determine whether one party is benefiting at the expense of another, there must be some benchmark or standard for the appropriate division of the gains. In the buyout situation, if shareholders get too little, then the buyout group benefits at their expense. Part of the problem of identifying buyouts which satisfy managements' fiduciary obligations is to specify a standard for determining whether the price is appropriate or fair.

Perhaps the most obvious standard is the firm's stock price before the buyout. Under the theory of capital market efficiency, the firm's value in the open market is fair in the sense that it reflects all public information about the company. One defect of this standard for evaluating buyout bids is that it is vulnerable to the asymmetry of information between insiders (i.e., managers) and outsiders (i.e., public shareholders). Asymmetries can arise because of differences in technical expertise between managers and the public, the possibly high cost of information gathering, and the size and

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complexity of the firm. A second defect of this standard is that it fails to distinguish between management's existing policies and those that might prevail if the firm were restructured or the management incentive scheme changed. To the extent that stock price before a buyout reflects managers' failure to utilize all their skills and abilities to maximize shareholder wealth, using it as a standard of fair price endorses managerial inefficiency.

A second standard is the price the firm would fetch if sold in an open auction. This standard explicitly controls for the fact that the buyout bid is not derived from arm's-length bidding. Certainly any bid lower than what an open market auction would bring is too low and may indicate that management is seeking to take advantage of shareholders. But the open market

rule has the limitation that competing arm's-length bids are rarely available unless solicited, and even then may not be forthcoming. Nevertheless, this is an important standard because competing open market bidders have been known to intervene in instances of apparently low management bids.[32] Some commentators advocate a rule of open bidding once a management buyout is proposed.[33] Such a rule has much to be said for it, but in the absence of actual interested bidders, it fails to give much guidance for assessing buyout bids.

A third and more useful standard of comparison is the value shareholders could obtain if they synthesized the buyout on their own: borrowed heavily, repurchased a large percentage of shares, and increased the shareholdings of managers (by sale or outright gift). Even the value created by depreciation tax shields can be synthesized by selling plant and equipment and then leasing them back.[34] This standard is not only more useful, since it does not depend on the presence of competing bidders, but it is also more consistent with management's duty of loyalty to shareholders. Management's fiduciary duty requires that it put forth its best efforts on shareholders' behalf. A synthetic MBO offers some measure of what management could do to increase share price short of going private. It must be emphasized that the synthetic MBO does not replicate perfectly the benefits of an actual MBO. Since the firm would continue to be publicly held, the synthetic standards would not take account of savings from being private, e.g., eliminating large annual meetings, shareholder relations costs, glossy annual reports, etc. Nevertheless, an estimate of the gains from this synthetic MBO reveals what value shareholders can create for themselves. This, then, is the rational "floor" that directors should use in negotiations with managers.

There is some precedent for this synthetic standard (which has since been named "leveraged cash-out"). Colt Industries and FMC Corporation effected radical restructuring along these lines in 1986. For instance, in February 1986 FMC Corporation borrowed $1.7 billion in debt, paid shareholders $1.47 billion in an extraordinary dividend, and gave managers 7.9 million new shares instead of the dividend. *Ex post*, managers owned nearly 22 percent of shares outstanding. The share price rose from $74⅞ to $99 as a result of the announcement. The CEO of FMC explained this restructuring by saying that he had been approached with numerous MBO proposals but rejected them on grounds that they did not adequately allocate the gains from restructuring to the selling shareholders. (See Appendix for a more detailed description of the FMC case.)

Although buyouts, with their huge purchase premiums and cash payments, are not easily compared to other strategic options which might take years to bear fruit, the synthetic MBO standard does provide a rough guideline for what is fair to shareholders under the circumstances. A buyout offer which at least equals the value shareholders could achieve on their own satisfies management's fiduciary responsibilities to shareholders.

If the management bid equals the synthetic standard of comparison, is there still an ethical objection to the buyout? The answer must be no. Would it be wrong for management to make a lot of money in the deal? So long as the buyout bid is consistent with management's obligation to promote and protect shareholder interests, gains to managers are not ethically objectionable. If management were to decline to participate in a buyout, shareholders would be deprived of the most attractive option open to them to realize the value of their shares since investors in a buyout normally require the continuing of services of proven management as a protection for their investment.

Management's major gains in wealth from a buyout come from increasing the size of its equity position in the company. Prohibiting management from increasing its equity participation would seem to be an irrational penalty for management without any corresponding benefit to shareholders. The price the buyout group is willing to pay public shareholders will depend upon the extent of anticipated improvements, cost reductions, and tax advantages resulting from going private, as well as on what competitors are offering. Decreasing the size of management's equity position, a negotiable matter among members of the buyout group, will not necessarily increase the price paid to shareholders. The opportunity to increase its ownershp position through a management buyout appears to be an appropriate incentive for encouraging management to fulfill its responsibility to promote shareholder wealth.

Conflict of Interest Reconsidered

General acceptance of the synthetic standard for evaluating buyout proposals does not entirely assuage concerns arising from management's conflict of interest. The standard is not self-applying: its application requires judgment. Even if the standard is helpful to conscientious managers who want to take their company private, there is still the possibility that some managers will unwittingly interpret the standard in a way that is advantageous to themselves or that the unscrupulous will attempt to get away with offering less than the synthetic standard. This re-emphasizes the importance of procedures of disclosure and review.

The practical ethical challenge as described earlier was to specify conditions under which buyouts satisfy management's obligations to shareholders. The institutional or policy problem is to design a system which permits buyouts that satisfy those responsibilities and discourages those that do not. Institutional arrangements must recognize the role of managerial self-interest in buyouts. That is not to say that buyouts should be prohibited because of potential abuses by self-interested managers.[35] Prohibition, as discussed earlier, would eliminate buyouts good and bad, those in shareholders' best interests as well as those harmful to shareholders. If buyouts

or conflicts of interest were inherently unethical, prohibition might be an appropriate suggestion. Under the circumstances, a more fitting response is to increase awareness of management's conflict of interest, to promote public understanding of these transactions, and to institute procedures to protect against failures of judgment and misuse of position in buyout situations. The objective of our proposals is two-fold: to block buyouts which are not in shareholders' interests and to enhance shareholder confidence in management.

Widespread recognition of the synthetic standard for evaluating going-private proposals is essential. Recognition by shareholders, corporate directors, investment bankers in the business of giving fairness opinions, and judges evaluating the fairness of MBOs would enhance shareholder confidence in management and in the securities markets generally by upholding the standard of fiduciary duty. Expansion of disclosure requirements under federal securities law could promote acceptance of this standard of fair price. Specifically, management buyout teams could be required to use the synthetic MBO standard when justifying their belief in the fairness of the going-private transaction. As mentioned earlier, current law requires disclosure of whether an MBO is believed to be fair to unaffiliated shareholders and it requires reasonably detailed discussion of the factors on which the belief is based.[36] The value that could be created for shareholders by a synthetic MBO and a description of the structure of such a transaction could be required as part of this discussion.

Even if this requirement is not embodied in law, however, management's fiduciary duty to shareholders requires that the synthetic MBO standard be recognized as a benchmark of fair price in going-private transactions.

Conclusion

Our analysis rests on two simple but powerful ideas: fiduciary duty and synthesis. The synthetic MBO provides a standard against which the behavior of agents should be evaluated. Synthesis is a concept with potentially broad application to the theory of choice. It has special and increasing relevance to financial settings where new developments in the structure of capital markets enhance our ability to synthesize the investment value in a wide range of financial assets: firms, securities, loans, etc. The concept of fiduciary duty is the linchpin of the modern public corporation. Without shareholder confidence in management and trust between the corporation and its employees, the corporate structure will fail.

Our analysis also suggests the feasibility of self-regulating solutions to these kinds of conflicts. Obviously we see the role of government in stimulating disclosure as healthy. Disclosure permits participants in economic transactions to protect their interests and to make informed decisions. More vigorous government intervention in the form of a ban on buyouts would

impose on buyout participants—shareholders and management alike—decisions which they might not otherwise make.

Finally, our analysis suggests the ability of ethics and economics to inform and reinforce one another. Economic analysis can contribute to our understanding of management's fiduciary duty, and fiduciary duty can point toward a certain type of economic analysis.

Appendix

The Case of FMC Corporation

There is some precedent for the synthetic standard, which has since been named "leveraged cash-out." FMC Corporation, among others, announced a radical restructuring in 1986. This called for borrowing $1.3 billion in bank debt and $.4 billion in subordinated debt. Public shareholders would receive a cash dividend of $70 per share for each of the 25.92 million shares outstanding. Managers (who owned 19 percent of the company) would receive 7.88 million shares instead of the cash dividend. The number of shares after the restructuring would be 33.8 million. On February 21, 1986, the day before the restructuring announcement, the stock price was $74.875 per share. The effect of the restructuring is shown in Table 1 in the book value and market value balance sheets. (The elements of this transaction have been simplified somewhat for presentational purposes.)

The net result is that the share price should rise to $109 from $74- 7/8. (In fact, the share price rose to only $99.)

$$\text{New Price} = \text{Dividend} + \frac{\text{New Market Value of Equity}}{\text{Number of Shares}}$$

$$= \$\ 70 + \frac{1321}{33.8}$$

$$= \$109$$

Table 1. FMC Corporation Balance Sheets (in $ millions)

	Book Value Before	Adjustments	Book Value After
Net Working Capital	$ 127	1700[a]–1470[b]	$ 357
Long-Term Assets	1,586	—	1,586
Total Assets	$1,713		$1,943
Debt	341	1700[a]	2,041
Other Long-Term Liabilities	6	—	6
Equity	1,366	–1470[b]	(104)
Total Liabilities and Equity	$1,713		1,943

	Market Value Before	Adjustments	Market Value After
Net Working Capital	$ 127	1700[a]–1470[b]	$ 357
Long-Term Assets	1,990	—	1,990
Present Value of Debt Tax Shield	171	850[c]	1,021
Total Assets	$2,288		3,368
Debt	341	1700	2,041
Other Long-Term Liabilities	6	—	6
Equity	1,941[a]	850[c]–1470[b]	1,321
Total Liabilities and Equity	$2,288		3,368

[a] 25.92 million shares times $74.875/share.

[b] The amount of the extraordinary dividend paid to public shareholders.
(1 – .19) 25.92 × $70 = $1.47 billion

[c] An estimate of the present value of the reduction in tax expense due to the deductibility of interest.
Present Value = 0.5 × 1.7 = $850 million
This assumes that the debt is perpetually outstanding and thus probably overestimates the value.

References

1. News release, Doremus & Company, Chicago, January 12, 1984, p. 2.
2. "1987 Profile," *Mergers & Acquisitions* (May/June 1986), p. 71.
3. Louis Lowenstein, "No More Cozy Management Buyouts," *Harvard Business Review* (January/February 1986), pp. 147–156.
4. Benjamin J. Stein, "Going Private is Unethical," *Fortune*, November 11, 1985, p. 169.
5. A. Sommer, "Going Private: A Lesson in Corporate Responsibility" (address at Notre Dame Law School), reprinted in *Sec. Reg. & L. Rep.* (BNA) No. 278, D-1, November 20, 1974.
6. For example: Victor Brudney and Marvin A. Chirelstein, "A Restatement of Corporate Freezeouts," *The Yale Law Journal*, 87 (1978): 1365–1370; Stuart Kaplan, "Corporate Morality and Management Buyouts," *Washington and Lee Law Review*, 41 (Summer 1984): 1015–1043; Louis Lowenstein, "Management Buyouts," *Columbia Law Review*, 85 (1985): 730–784; Gregory J. Schwartz, "Regulation of Leveraged Buyouts to Protect the Public Shareholder and Enhance the Corporate Image," *Catholic University Law Review*, 35 (1986): 489–544; Benjamin J. Stein, "Shooting Fish in a Barrel: Why Management Always Makes a Bundle in an LBO," *Barrons*, January 12, 1987, p. 6.
7. Buyouts frequently take the form of a negotiated merger of the publicly held corporation into a shell corporation wholly owned by the buyout group. A common alternative is a two-tiered transaction: a tender offer followed by a merger.
8. The repeal of the so-called "General Utilities" doctrine is probably the most significant change, although lengthened depreciation periods have also diminished the tax savings available from MBOs. See *Internal Revenue Code* §336 (1987).
9. See e.g., H. DeAngelo, L. DeAngelo, and E.M. Rice, "Going Private: Minority Freezeouts and Stockholder Wealth," *Journal of Law and Economics*, 27 (1984): 367; Frank H. Easterbrook and Daniel R. Fischel, "Corporate Control Transactions," *The Yale Law Journal*, 91 (1982): 698–737.
10. E.g., Lowenstein, (1986), op. cit.
11. Robert F. Bruner, "Management Buyouts and Shareholder Welfare: Self-Dealing Versus Financial Signaling," Working Paper, University of Virginia, 1986, p. 26.
12. Marci Baker, "Buyouts Seek Public Entry," *Pensions and Investment Age*, October 28, 1985, p. 31; Lowenstein, (1986), op. cit., pp. 147–148.
13. Nicholas Wallner, "Leveraged Buyouts: A Review of the State of the Art, Part II," *Mergers & Acquisitions* (Winter 1980), p. 24.
14. DeAngelo, DeAngelo, and Rice, op. cit., p. 388.
15. E.g., *Durfee v. Durfee & Canning, Inc.*, 323 Mass. 187 (1948). See generally, Victor Brudney and Robert Charles Clark, "A New Look at Corporate Opportunities," *Harvard Law Review*, 94 (1981): 997–1062.
16. *Guth v. Loft*, 5A.2d 503, 510 (Del. Supr. 1939).
17. For instance, employees at Weirton Steel saved it from imminent closing, then took a 19% pay cut, and raised $300 million to buy the assets in 1983. Since then, Weirton has embarked on a significant modernization program.
18. For instance, in April 1987, Dart Group, Inc., made an unsolicited takeover bid for Supermarkets General Corporation for $1.75 billion. Two weeks later, management offered to take the company private for $1.8 billion.
19. This view was forcefully expressed by Justice Davies who spoke, in 1859, of "our great moral obligation to refrain from placing ourselves in relations which excite a conflict between self interest and integrity." *Cumberland Coal and Iron Co. v. Sherman*, 30 Barb. 553, at 578-79 (N.Y. Sup. Ct. 1859). Quoted in Harold Marsh, Jr., "Are Directors Trustees?" *The Business Lawyer* (November 1966), pp. 35–76, at 39.
20. Marsh, op. cit.

21. Bank loan officers, for example, may not lend money to themselves, their families, or organizations in which they have a financial interest. Procurement officials, to take another case, are frequently forbidden to purchase from suppliers in which they have a financial interest.
22. E.g., Brudney and Chirelstein, op. cit.
23. There *are* instances of going-private transactions in which senior management changed (e.g., Beatrice Foods, 1986), but these remain relatively rare.
24. In an important case involving a parent buyout of a subsidiary, the court suggested appointing an independent negotiating committee of outside directors. *Weinberger v. UOP, Inc.*, 457 A.2d 701,709,n. 7 (Del. Supr. 1983).
25. For example, one court found that approval of a leveraged buyout by a special committee of outside directors did not protect participants when the committee gave their colleagues an inside track and did not foster a real bidding process. *Edelman v. Fruehauf Corp.*, 758 F.2d 882, 885 (6th Cir. 1986).
26. 17 C.F.R. §§240.13e-3, 13e-100.
27. 17 C.F.R. §240.13e-100, Item 8.
28. Ibid.
29. See *Weinberger v. UOP, Inc.*, at 710.
30. See generally, Leo Herzel and Dale E. Colling, "Establishing Procedural Fairness in Squeeze-out Mergers After *Weinberger v. UOP*," *The Business Lawyer*, 39 (August 1984): 1525–1539. See also *Joseph v. Shell Oil Co.*, 482 A.2d 335 (Del. Ch. 1984) on required disclosure.
31. DeAngelo, DeAngelo, and Rice, op. cit.
32. For example, competitive bidders intervened in response to J.B. Fuqua's 1981 attempt to buy out Fuqua Industries and in response to Chairman David Mahoney's 1983 proposal to take Norton Simon, Inc., private.
33. E.g., Lowenstein (1986), op. cit., p. 155.
34. Formally, the benefits of depreciation belong to the lessor, but as a practical matter, these benefits are shared with lessees.
35. The argument for prohibition can be found in Brudney and Chirelstein, op. cit.
36. 17 C.F.R. §§240. 13e-3, 13e-100 (Rule 13e transaction statement pursuant to section 13(e) of the Securities Exchange Act of 1934 and Rule 13e-3 thereunder).