"GOING PRIVATE" SEVENTEEN YEARS LATER

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THE 1974 SPEECH

In November 1974 I gave a speech at Notre Dame Law School entitled *"Going Private": A Lesson in Corporate Responsibility*. At that time there was a good deal of discussion concerning corporate responsibility as a consequence of the disclosures that American corporations had been engaged in extensive violations of our laws concerning corporate contributions to political campaigns and questionable payments abroad to secure preferment.

I chose in the Notre Dame speech to focus on a less publicized, then less recognized, problem of corporate responsibility. The staff of the Commission had for several months before the speech been calling my attention to something called "going private." They had suggested that there was a growing tendency of corporations which had fairly recently gone public to buy back their stock at prices substantially lower than the prices at which they had gone public. In many instances the initial public offerings had involved substantial offerings by controlling shareholders who realized tremendous gains from those offerings.[1] In 1975 and thereabouts the market prices of most companies were severely depressed,[2] hence the prices offered in the "going-private" private transactions, which were usually significantly more than the current market price, but substantially under the initial offering price, were very attractive to the companies' shareholders and they responded enthusiastically to the offers.

A variety of techniques was being used to accomplish the goal of going

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1. *See Full Text of Commissioner Sommer's Remarks on "Going Private,"* Sec. Reg. & L. Rep. (BNA) No. 278, at D-1 (Nov. 20, 1974). In the Notre Dame speech I cited a company (Wells, Rich, Greene, Inc., though I did not identify it by name in the speech) that had made public offerings in which the selling shareholders received $12.5 million ($17.50 a share in one offering and $21.75 in another). Not long thereafter the company went private at $3.00 a share cash and an $8.00 ten-year subordinated debenture. None of the consideration came from the shareholders who had sold in the public offering.

2. "By the end of 1974, the Dow Jones Industrial Average, the traditional index of stock market performance, collapsed to below 600, from a January, 1973, peak of over 1000. In the vicious '73-'74 bear market, stocks began selling at ever lower price/earnings ratios." ARTHUR M. BORDEN, GOING PRIVATE 2-7 (1982).

private.[3] In some cases the management organized a new corporation into which they placed their shares, which then tendered for the publicly held stock, and when the new company had control, any remaining public shareholders were "squeezed out" through a merger in which they received cash. Even though the effectuation through this means depended on voluntary responses by public shareholders (unless management and its cohorts had effective control before the offer), there was nonetheless a coercive element present: the shareholder, even if tempted to forgo the rich premium over market, had a fear that his or her fellow shareholders would respond and he or she would be left with an illiquid holding at the mercy of a possible future squeezeout on less favorable terms.

In some cases management dispensed with the tender offer and, after setting up the new corporation having management's stock as its asset, submitted to shareholders a proposal to merge with the new company, with the merger agreement providing that all shareholders except the new company would receive cash.

Another method was the reverse split. Management would submit to shareholders a proposal to issue, say, one share for each thousand shares held, with fractions to be paid in cash. In such cases typically the members of management were most of the holders with holdings sufficiently large to end up with whole shares, thus either owning or controlling the company at the conclusion of the process, with virtually all other shareholders ousted with cash. Again there was the lure of the premium.

Whatever the method, one circumstance was omnipresent: the assets of the corporation, which belonged to the shareholders, were used to buy them out.[4] In many instances the cash consideration was procured in whole or in part by borrowing; such borrowing was only possible because of the value of the corporation's assets or its earning power, both of which belonged to the shareholders.

My initial reaction to the concerns of the staff was "So what?" The shareholders were receiving more than the market price; where the insiders lacked control the public shareholders were free to accept or reject the offer; if the price they received was "fair"—where was the problem?

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3. The various methods of "going private" are discussed in BORDEN, *supra* note 2, at 3-3 to 3-16.

4. This was so even when all or part of the consideration was debt, as in the Wells, Rich, Greene, Inc. case, for the value of the debt derived from the assets of the corporation that belonged to the shareholders.

The more I reflected on the problem, however, the more concerned I became with this phenomenon. While nominally it appeared the shareholders had a free choice of responding or not to the proposal of management, and while the prices offered were typically more than the market price, in many cases opined as "fair" by estimable investment bankers, it became clearer to me that the freedom of choice of the shareholders was often ephemeral. Often the transaction was framed in a manner that was coercive (e.g., a tender offer posing the danger that a non-tendering shareholder might receive less in a squeeze-out merger or be left hanging with an illiquid security), or management effectively controlled the vote, or the public shareholders having seen the the value of their investment battered in the bear market happily grabbed the apparently generous premium. Moreover, it appeared that the insiders were taking advantage of the unusually depressed state of the market in the mid-70s to avail themselves of the opportunity to bring their companies back to their private status, meanwhile having enriched their companies and themselves with the proceeds of offerings made when the market was most hospitable to new offerings. That did not strike me as fair. More, it struck me as posing some troublesome questions legally. The officers and directors who initiated the offering had fiduciary responsibilities to the shareholders to whom they made the offer. Was their conduct consistent with those responsibilities? I doubted it.

The speech did not go unnoticed. It was delivered on a Thursday, reported in the press on Friday, and on Tuesday a delegation representing one of the companies then in the process of going private was in the office of SEC Chairman Ray Garrett, Jr. protesting my remarks. Chairman Garrett, my very dear friend (and the one who persuaded me to accept appointment to the Commission), notwithstanding having told me he did not agree with my speech, to his everlasting credit strongly defended to the group the propriety of my remarks and gave them no solace. Another Commissioner, strongly in favor of free markets, felt that any governmental intervention in the going-private process would be an unwarranted interference in the freedom of buyers and sellers.

THE SEC AND "GOING PRIVATE"

Notwithstanding these misgivings, the Commission decided to undertake to consider rules governing the practice. The first effort consisted of the proposal of alternative rules; under one the consideration in a going-private transaction would have to "constitute fair value" and under the

other the terms of the transaction would have to be fair and there would have to be a valid business purpose. Both proposals would have mandated considerable disclosure.[5]

Critics of the Commission's proposals, notably the Federal Regulation of Securities Committee of the American Bar Association Section on Business Law, quickly charged that the Commission was exceeding its power in imposing substantive, as distinguished from disclosure, requirements with respect to these transactions.

In late 1977 (*three* years after the Notre Dame speech) the Commission proposed a rule that would have required both substantive and procedural fairness.[6] The Commission responded to its critics and asserted forcefully its belief that it had the power to impose substantive requirements:

> Neither the language of the subsection [section 13(e) of the Securities Exchange Act of 1934] nor its legislative history limits the rulemaking authority of the Commission solely to disclosure requirements. Consequently, in adopting rules for the protection of investors and in the public interest to prescribe means reasonably designed to prevent fraudulent, deceptive or manipulative acts and practices, Commission rulemaking under Section 13(e) may include substantive provisions as well as disclosure requirements.[7]

The protesters carried the day, and the Commission adopted a rule which was, indeed, confined to disclosure.[8] The disclosure pushed as close to substantive regulation as it could. The entity undertaking the transaction was required to disclose:

whether it had considered other means of accomplishing the purposes of the proposed transaction and why they were rejected;

the reasons for the proposed transaction and why it was undertaken at the present time;

whether the entity undertaking the transaction reasonably believed the transaction was fair or unfair to shareholders and the factors upon which the belief was based;

5. "Going Private" Transactions, Securities Act Release No. 5567 [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,104 (Feb. 6, 1975).

6. Going Private Transactions by Public Companies or Their Affiliates, Securities Act Release No. 5884 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,366 (Nov. 17, 1977).

7. *Id.* at 88,742. The Supreme Court confirmed the validity of the critics' position in Green v. Santa Fe Industries, Inc., 430 U.S. 462 (1977).

8. Going Private Transactions by Public Companies or Their Affiliates, Securities Act Release No. 6100 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,166 (Aug. 2, 1979).

whether the entity undertaking the transaction had received any report, opinion or appraisal from an outside party and the details of any such report;

and a good deal of other information besides.[9]

The disclosure requirements did not deter going-private transactions. As is typical, there developed a routine disclosure pattern that concealed as much as it disclosed.

THE STATES AND "GOING PRIVATE"

Of course, the securities laws were not the only laws involved in going-private transactions. Until roughly the beginning of this century the law typically provided that a transaction between a corporation and a director was voidable by the corporation regardless of fairness.[10] Since this rigorous rule in many cases denied corporations the opportunity for transactions that might be desirable, even though a director was the opposite party, gradually the voidability rule evolved into a rule that in such a transaction the director bore the burden of establishing that the transaction was fair, in which case it was not voidable, and there then developed the "safe harbor" which is a part of virtually all, if not all, state corporation laws which validates the transaction if it has been approved by directors or shareholders not involved in the transaction after full disclosure of the director's conflict and the nature of the transaction. Even when the statutory safe harbor was invoked to validate the transaction, courts were not indifferent to the fairness of the transaction.[11]

The typical going-private transaction involving management (the MBO), of course, was an interested-party transaction, the corporation on one side, members of management, at least some of whom were directors, on the other. During the 70s the state courts (and federal courts applying state law) wrestled with the problems posed by these transactions. In *Bryan v. Brock & Blevins Co.*,[12] the Fifth Circuit Court of Appeals reviewed a transaction involving the squeezeout of a minority shareholder

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9. *Id.*

10. NORMAN D. LATTIN, THE LAW OF CORPORATIONS 290 (2d ed. 1971); HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS 637 (3d ed. 1983); 1 MODEL BUSINESS CORP. ACT ANN. § 41, ¶ 2 (1971); Harold Marsh, Jr., *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35 (1966).

11. Remillard Brick Co. v. Remillard-Dandini Co., 241 P.2d 66 (Cal. Ct. App. 1952); Scott v. Multi-Amp Corp., 386 F. Supp. 44 (D.N.J. 1974).

12. 490 F.2d 563 (5th Cir.), *cert. denied*, 419 U.S. 844 (1974).

and concluded the transaction was illegal, among other reasons, because there was no valid business purpose.

For a period the Delaware Supreme Court subscribed to the idea that such transactions had to have a business purpose,[13] but in *Weinberger v. UOP, Inc.*[14] it retreated from that position. However, it stated that any such transaction had to satisfy two fairness tests: one, fairness of price, and two, "fair dealing," which the court said ". . .embraces questions of when the transaction was *timed*, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders was obtained."[15] In my speech I had suggested that one of the unfairnesses of the then current going-private transactions was the selection by managements of a time when the entire stock market was depressed to make their offer.

THE DEVELOPMENT OF MBOs IN THE 80s

With the federal disclosure rules in place, and the state law fairly well articulated, the way was clear for the efficient accomplishment of MBOs. A pattern developed. Management would make an offer backed by the opinion of an investment banking firm concerning its fairness. The independent directors on the board, or a portion of them, would be constituted as a committee to determine the fairness of the transaction. The committee would select its own counsel and employ investment bankers to advise them on the fairness of the offer. In some cases (the RJR Nabisco transaction is a notable example)[16] the committee would negotiate with management and any other bidders that might emerge in an effort to secure the best price for the shareholders.

Commonly these transactions elicited lawsuits questioning the independence of the committee, the adequacy of the ultimate price, and other terms of the transaction. Generally the conduct of the committee was protected by the business judgment rule.[17] And of course, in the typical transaction there was some action by shareholders, either by tendering or voting for the transaction.[18]

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13. Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977).

14. 457 A.2d 701 (Del. 1983).

15. *Id.* at 711 (emphasis supplied).

16. *See* BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE (1990).

17. Marciano v. Nakash, 535 A.2d 400, 405 n.3 (Del. 1987) (dictum).

18. Of course, even a shareholder vote may be insufficient to overcome a flawed directorial action. *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

At the time of my speech in 1974 "going private" was "small potatoes." Professor Louis Lowenstein has noted that one study showed that the mean market value of publicly held securities of forty-five companies listed on the New York Stock Exchange or the American Stock Exchange which went private in the 1970s was only three million dollars.[19]

The 80s, of course, were a different story.[20] The full potential of leverage became clear and the size of LBOs (and MBOs) increased dramatically, culminating in the RJR Nabisco transaction in which the company was sold for twenty-five billion dollars. This had started as an MBO, instigated by Ross Johnson, the then CEO, but his group was outbid by one headed by Kohlberg Kravis Roberts.[21]

During the middle 70s, when the going-private phenomenon came into public focus, the typical MBO did not lead to a competitive bidding contest between management and one or more rivals. The reasons for this are not certain, but certainly the then depressed state of equity markets and the conservatism of lenders acted as restraints. Thus the dynamic discussed above—management bid, independent directors validating the fairness of the price, general judicial concurrence in the propriety of the procedure—was the prevailing pattern.

This troubled some commentators. In 1983, then SEC Commissioner Bevis Longstreth, in a speech before a committee of the International Bar Association Section on Business Law in Toronto, expressed misgivings about whether the prevailing pattern operated to assure fairness to shareholders:

> In management buyouts, the current rules of the game—both federal and state—fail adequately to assure to public shareholders a fair deal—that is, the highest current price reasonably obtainable, whether from management or one or more third party purchasers of stock or assets.[22]

Commissioner Longstreth recommended that whenever management proposed to buy out the public shareholders there should be mandated an auction. All interested bidders would be provided with all material information necessary to frame an informed bid and the highest bidder would prevail. His approach ignored the fact that there was no practica-

19. Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 735 (1985).

20. In 1987 and 1988 public-company buyouts approached half a billion dollars per year. Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 65.

21. *See* BURROUGH & HELYAR, *supra* note 16.

22. Bevis Longstreth, Management Buyouts: Are Public Shareholders Getting a Fair Deal?, Address Before the Section on Business Law, Committee Q, Securities Issues and Trading, Toronto, Canada (Oct. 6, 1983) (copy on file with author).

ble way to put outsiders on an informationally equal basis with management: no matter how much information was furnished, the management would always know more about the business, its strengths, its weaknesses, its prospects, than any outsider, regardless of the disclosure made.

Even as Commissioner Longstreth spoke, the auction he sought was becoming a commonplace. With generous bank financing, and then "junk bonds," increasingly available, almost every bid by management to take over a company was contested. This led to bidding wars in which often the ultimate price paid by the successful bidder was by any standard of sound investment astronomical.[23]

As the 80s wore on, the LBOs (and the subspecies, MBOs) became more commonplace, steadily larger, more heavily leveraged, and generally upheld by the courts. As the boom of the 80s continued, many of these transactions appeared to fulfill the abundant optimism of their promoters: significant tax savings, the benefits of leverage, greater efficiencies, poor performing assets sold and other circumstances resulted in considerable benefits. Earnings and cash flow reflected the heavy interest burdens and the requirements of principal amortization under the indebtedness incurred to finance the transaction. The degree of leverage steadily grew reflecting the increased flexibility of bank lenders and the increasing availability of junk bonds.

There appears to be a good deal of uncertainty among economists about the sources of these extraordinary gains. Tax benefits are one source, though some have tended to minimize the significance of these.[24] Another is supposedly the additional incentive provided to management, because of their newly enhanced ownership interest, to manage the assets of the enterprise more efficiently, more aggressively, and ultimately more profitably.[25] Such entrepreneurial resourcefulness has included selling off properties, in some cases because of their drag on profitability, in others because they could be sold at extremely favorable prices.

THE PROBLEMS OF MBOs

Notwithstanding the willingness of the courts to sanction these transactions and notwithstanding the immediate benefits received by shareholders, there still remain some formidable legal issues stemming from

23. Lowenstein, *supra* note 19, at 738-39.

24. Yakov Amihud, *Leveraged Management Buyouts and Shareholders' Wealth*, *in* LEVERAGED MANAGEMENT BUYOUTS 26 (Yakov Amihud ed., 1989).

25. Jensen, *supra* note 20, at 68.

the fiduciary responsibility which management owed to the shareholders of the enterprise before it was taken private.

The first such problem derives from the simple fact that those in management are fiduciaries for the shareholders and may not take or use corporate assets for their own gain. If management is willing to pay a premium over the market for the publicly held stock, it can only be because it believes there is unrealized value in the company *above* the price it is willing to pay; otherwise there would be no reason for it to make the offer to purchase. Doesn't that value belong to the shareholders? But more important, doesn't the fiduciary duty which management owes the shareholders require it to bend every effort to see to it that benefit is realized by the shareholders?

Some commentators have identified other corporate assets that management appropriates to itself when it causes the company it serves to go private. For instance, the author of a note in the *Yale Law Journal* has said,

> A dynamic view of going private reveals the issue of insider self-dealing through the misappropriation of a corporate asset—the ability to go public, at a profit, when the stock market finally reverses itself. Insiders are correct when they state that going private represents a good investment: that investment value, however, does not derive from the public marketplace, which by definition does not deal in privately held companies, but from the possibility of returning to that marketplace at a figure considerably higher than the value at which the company withdrew.[26]

A frequent justification for the enormous benefits which usually accrue to management in the course of a buyout is that such are necessary to provide the incentive to maximize the realization of the value of the assets of the enterprise. Are we to believe that as generously as managements are compensated, it still is not enough to elicit their best endeavors on behalf of the shareholders? There is a troublesome anomaly here: conventional methods of executive compensation plus fiduciary duty are not sufficient to maximize management efforts to realize the greatest profit from the resources made available to them. Thus, any enterprise where there are no entrepreneurial profit opportunities like those provided in MBOs available to management will be less efficiently and profitably managed than one where such opportunity is available. Thus giant

26. Edward D. Kleinbard, Note, *Going Private*, 84 YALE L.J. 903, 931 (1975). *See also* Bill Shaw, *Resolving the Conflict of Interests in Management Buyouts*, 19 HOFSTRA L. REV. 143, 150 (1990).

enterprises which cannot be practicably taken private—USX, General Motors, Exxon, and innumerable others—will be managed less successfully than might be the case were they taken private, regardless of the generosity of compensation arrangements provided by their boards. This concept, eerily reminiscent of the theory espoused by Henry G. Manne that insiders should be permitted to trade on inside information because that is the only way to adequately compensate them,[27] bodes ill for the American economy since, notwithstanding the multitude of LBOs, most of this country's economic wealth is in the hands of publicly held corporations. One would be tempted to attribute to this circumstance the decline of American competitiveness, but for the fact that the wealth of our competitors is also concentrated in corporations having substantial public ownership.

The necessity of the sort of "entrepreneurial" compensation received by managements in MBOs has been woven into a comprehensive economic and social explanation of the going-private phenomenon by Michael Jensen of the Harvard Business School entitled *The Eclipse of the Public Corporation.*[28] Professor Jensen sees the wave of the future, at least in some industries, as corporations in which the equity is held by management and by one or a limited number of organizations like KKR (Jensen calls them "LBO associations") and the corporation is heavily leveraged. In Jensen's estimation, this configuration provides several benefits. The leveraging places additional pressure on a management already heavily motivated because of their equity interest to maximize performance. Second, the other holders of equity provide the oversight function which he finds lacking in the conventional publicly held company. And the heavy leverage permits an earlier signal of declining performance of the corporation than in the case of a corporation less heavily leveraged.

Jensen's theory appears to have had a short life span. Notwithstanding the purported benefits to the economy, to the public holders of companies that follow the MBO route, and to the investors in the capital pools organized to invest in the enterprises taken public, economic events have conspired to suggest that Jensen's bold insight into the future was the fruit of a euphoria born of the excesses of the 80s. Beleaguered banks which have had to take huge reserves against the LBO financings of the

27. HENRY G. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966).
28. Jensen, *supra* note 20.

80s are reluctant to repeat their mistakes; with the Drexel Burnham-Milken disaster, the opportunities to market junk bonds to facilitate MBOs have diminished sharply; and strangest of all, the number of new issues is reaching all-time highs. There are few willing to ride the wave of the future identified by Jensen and plunge into the sort of transactions he commends. Not only have events refuted Jensen's grandiose thesis, but also thoughtful commentators have soundly belabored it.[29]

There is no reason why, in most cases, the management of enterprises publicly held could not have accomplished most of the same dramatic gains in profitability and efficiency without an MBO if they so chose.[30] They could have done the same sort of restructuring, sold off underperforming operations and assets, taken advantage of hefty prices for divisions, even incurred sharply higher levels of debt with the proceeds distributed to shareholders if necessary to put their feet to the fire, if they wished. It is difficult to believe that going private somehow or other stimulated creative juices in management that opened their eyes to opportunities never before beheld. And if there were concern about the acceptability of such a program to shareholders, it could be submitted to shareholders and in all probability they would have acquiesced in it.

The fairness problem is compounded when companies that had only lately gone private in MBOs surface again in the equity markets and they are once more publicly held, notwithstanding the alleged benefits of being privately held: avoidance of shareholder litigation, savings on the expense of compliance with SEC disclosure requirements and shareholder communications, the ability of management to think and plan long term, and so on.

Not uncommonly the expectation of going public was a part of the

29. Alfred Rappaport, *The Staying Power of the Public Corporation*, HARV. BUS. REV., Jan.-Feb. 1990, at 96.

30. "Since an MBO brings no new resources—whether operating, financial or managerial—to the target company, each of the potential sources of gain from the transaction is at least theoretically available to the target company even without an MBO." Ronald J. Gilson, *Market Review of Interested Transactions: The American Law Institute Proposal on Management Buyouts*, *in* LEVERAGED MANAGEMENT BUYOUTS, *supra* note 24, at 217, 219. Gilson then goes on to discuss each of the purported benefits of the MBO—taxes, debt, management incentives—and shows how each is replicable in the context of the public corporation. *See also* Rappaport, *supra* note 29, at 100: "An institutionalized shareholder-value program can spur the same performance improvements as an LBO. The program seeks a *buyin* from management rather than a *buyout* of shareholders." Rappaport then sets forth in detail how such comparable performance may be accomplished. A similar program is detailed in G. Bennett Stewart, *Remaking the Public Corporation from Within*, HARV. BUS. REV., July-Aug. 1990, at 126.

initial planning, with indebtedness structured so that there would be a "balloon," say, five years out which would be paid off with the proceeds of the offering. Such "round trips" have been extremely lucrative.[31] Leslie Fay, which was taken private in April 1982 for fifty-eight million dollars, went public in August 1986 for $360 million.[32] Fred Meyer, which went private in December 1981 with a payout to shareholders of $420 million, publicly offered its retail operations for $380 million in 1987, while the management and its financiers continued to hold the real estate, estimated to be worth over $500 million, formerly owned by the company (along the way while privately held management secured other significant gains with virtually no cash investment).[33] Michael C. Jensen summarized a study by Steven N. Kaplan which aptly captures the enormous gains realized by "roundtrips" and other transactions in which the private company was disposed of:

> . . . in buyouts that go public again or are otherwise sold (which occurs on average 2.7 years after the original transaction), total shareholder value increased by an average of 235%, or nearly 100% above market-adjusted returns over the same period. These returns are distributed about equally between pre-buyout shareholders and the suppliers of debt and equity to the transaction. Prebuyout shareholders earn average market-adjusted premiums of 38%, while the total return to capital (debt plus equity) for buyout investors is 42%. This return to buyout investors is measured on the total purchase price of the LBO, not buyout equity. *Because equity returns are almost a pure risk premium, and therefore independent of the amount invested, they are very high. The median market-adjusted return on buyout equity is 785%, or 125% per year.*[34]

In the case of the public offering following an MBO, the management capitalizes on the benefits it denied to the first generation of shareholders by selling them to a second generation of shareholders. Steven N. Kaplan has estimated that the total gains realized by pre-buyout public shareholders and post-buyout investors beat the market return by about

31. STAFF OF THE SUBCOMM. ON OVERSIGHT AND INVESTIGATIONS OF THE HOUSE COMM. ON ENERGY AND COMMERCE, 101ST CONG., 1ST SESS., LEVERAGED BUYOUTS AND THE POT OF GOLD: 1989 UPDATE 49 (Comm. Print 1989) (prepared by Dr. Carolyn Kay Brancato).

32. *Id.*

33. *Id.*

34. Jensen, *supra* note 20, at 70-71 (emphasis supplied). Other commentators suggest even shorter periods. In an analysis by Kidder, Peabody & Co. in October 1988, the median period between completion of an LBO and launch of an Initial Public Offering (IPO) was 22 months, and more than 70% of the companies were taken public within three years of their LBO dates. KIDDER, PEABODY & CO., ANALYSIS OF INITIAL PUBLIC OFFERINGS OF LEVERAGED BUYOUTS (1988).

eighty percent for most of the 80s, and that this gain was split about evenly between the two groups.[35] However, as indicated by Jensen, when analyzed in terms of return on buyout equity, the proportion of gain going to the buyout investors is vastly greater than that realized by the former shareholders.

At the time of the new IPO, satiated now by their often huge gains in the offering, and the debt having been paid down or to be extinguished out of the proceeds of the offering, thus no longer with their feet in the fire, management's diligence will presumably be lessened, but nonetheless that diligence will typically be priced generously in the offering price to the public. Thus the public investors will be buying something that may no longer be in the company, namely, a highly motivated management.

Some who believe the conflict of interest between management and shareholders in these transactions is so deep and enduring that it cannot be remedied simply by a handsome premium price for the public shareholders stock suggest radical solutions. Victor Brudney and Marvin A. Chirelstein, respectively professors of law at Harvard and Yale Law Schools, and Edward F. Greene, former Director of the SEC Division of Corporation Finance, have suggested an outright ban on such transactions.[36] Others have suggested that some means should be required to permit former shareholders to participate at least to some extent in the riches stemming from going private by, for instance, giving them warrants to purchase shares at a low price if the company were later sold or taken public.[37] Some have urged that if the company is taken public again within twelve months of the buyout at a premium over the price paid in the buyout, some of the premium should be paid to the pre-buyout shareholders.[38]

Seventeen years after my talk, LBOs and MBOs continue to command the attention of lawyers and economists. Lawyers continue to fret about such matters as those discussed in this Article.

All the while the *process* of going private has become relatively routine. The SEC and the courts have sufficiently articulated the ground

35. Steven N. Kaplan, *Sources of Value in Management Buyouts*, *in* LEVERAGED MANAGEMENT BUYOUTS, *supra* note 24, at 98.

36. Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1376 (1978); Edward F. Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 512 (1976).

37. Shaw, *supra* note 26, at 165-66.

38. Arthur M. Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987, 1040 (1974).

rules so that attorneys may advise clients with confidence about how to take a company private. And while the recession, the retrenching of banks, and the departure of Michael Milken and Drexel Burnham from the economic scene have slowed the pace of such transactions, they continue to be done.

CONCLUSION

To use the English version of an old French proverb, the more things change, the more they are the same. The same questions of overall fairness and fiduciary responsibilities hang like a shadow over the process. The courts in effect sanction the transactions if the proper disclosures are made and the conventional procedures—investment banker opinion, approval by disinterested directors, satisfaction of the minimal restraints of the business judgment rule—are followed. But there continue to be doubters that the legal analysis has been rigorous enough.

As indicated above, a number of solutions, some radical, have been proposed to deal with the buyout phenomenon. Less aggressive suggestions urge procedures to strengthen the reliability of the investment banking opinion and the independence of the committee of directors which reviews the proposals.[39]

There appears to be a considerable degree of comfort with the state of the law as it exists today with respect to going-private transactions. Of course, their incidence has diminished sharply in the last two or three years, hence there is less occasion to dwell upon them. However, they pose one of the most troubling problems in corporate law: to what extent may management put its self-interest ahead of the interests of shareholders? Troubling are suggestions of the sort put forward by Professor Gilson that suggest management has a free rein to consider what is in its interests, and if an MBO is the best means of accomplishing management's purposes, then it should opt for an MBO.[40]

One modest approach urged by this writer before a congressional committee was that management should be permitted to bid for a company only if a third party had first made a bid. In that situation management should not be precluded from participating in an auction initiated by third parties. Such an approach satisfies the concerns of former Commis-

39. Dale Arthur Oesterle & Jon R. Norberg, *Management Buyouts: Creating or Appropriating Shareholder Wealth?*, 41 VAND. L. REV. 207, 249-59 (1988).

40. Gilson, *supra* note 30, at 220.

sioner Longstreth and prescinds from the shortcomings of investment banker opinions and the infirmities of special committees. It removes the danger of management "low balling" in their bid and assures the price ultimately paid is a market price. Once the outside bidder has commenced an offer, there is little reason to preclude insiders from entering the fray. If the assets of the company, including its future prospects, are to be acquired by someone, there is no sound reason why that someone should not be management.

Thus we come to this proposal. Management should not be allowed to determine unilaterally the price of the corporation, and they should not be allowed to hide behind investment banker opinions and independent director committees. Only if there is a third party expressing a willingness to buy the company should insiders be allowed in the arena. In that situation any enrichment that management may realize is the same as the enrichment that would accrue to outsiders did they not join the bidding. It is difficult to fault management in this situation.

The "going-private" phenomenon continues to be with us. It is a continuing challenge to the ethics of the corporate community and to the law governing interested transactions.