A Primer on the Sale of Corporate Control (reviewing David Cowan Bayne, The Philosophy of Corporate Control: A Treatise on the Law of Fiduciary Duty (1986))

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Book Review

A Primer on the Sale of Corporate Control

THE PHILOSOPHY OF CORPORATE CONTROL: A TREATISE ON THE LAW OF FIDUCIARY DUTY. By David Cowan Bayne.† Chicago: Loyola University Press, 1986. Pp. xiv, 414. $19.95‡

Reviewed by Saul X. Levmore*

Arguments over issues of corporate control depend upon the analytic framework through which the observer examines the role of law in governing corporations. David Cowan Bayne's book, *The Philosophy of Corporate Control: A Treatise on the Law of Fiduciary Duty*, argues from a view of corporate law that is fundamentally dissimilar from my own. I take issue with Bayne's implicit assumption that cases should be decided on their own terms, uninfluenced either by the effects of decisions on future behavior or by the economic effects of the very behavior at issue in a given case. In order to comment on Bayne's book, I must first familiarize the reader with alternative assumptions about the problems surrounding the sale of corporate control.

The analytical questions raised by the sale of corporate control are not especially difficult, however unusual it is to find them resolved in the case law or academic commentary. When a minority shareholder complains that a controlling block of shares has been sold to an outsider at a large premium above market price, there are, roughly speaking, five possible explanations for the purchase price:

(1) The outsider intends to "loot" the company;
(2) The outsider was forced to pay this premium because inframarginal shares of the corporation were more highly valued than marginal shares;
(3) The outsider paid the premium because it expected to guide the firm to new heights by bringing in better management or a better idea for the "target"; the selling shareholder may have realized the value of the firm's assets to this outsider and thus negotiated a premium;

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(4) The outsider (and the seller) expects to be able to exclude minority shareholders from some plan (other than looting) that has ripened inside the corporation; this exclusion may be accomplished by liquidating the company or perhaps by forming some wholly owned second corporation that will do what the first corporation might have done; or

(5) The outsider has superior management skills or a true innovation that can be brought to bear on the firm; but again, the outsider expects to capture the full value of this innovation by somehow excluding other shareholders.

The legal consequences attaching to each of these possibilities are easy to predict. When looting occurs, we can expect the law to punish the looter. Innocent shareholders might be allowed to recover from the seller, who enabled the (judgment proof) looter to come in, because the seller was undoubtedly in the best position to check on the reputation and financing of his buyer.[1] Inasmuch as embezzling and other looting schemes can be developed at any time and are unlikely to be highly correlated with the recent purchase of a controlling block of stock, it would be surprising if the law sought to deter looting by always allowing minority shareholders to share in control premiums regardless of whether looting later took place. Looting is simply an independent problem, and not surprisingly, the law treats it as separate from the sale-of-control problem.

Possibility (2) also fails to suggest a reason for an "equal opportunity"[2] rule in the sale-of-control context. If the premium is modest enough to suggest that nothing more than the extraction of inframarginal shares has taken place, then nonselling shareholders retain equal opportunities, for there is no reason to think that their shares have lost value as a result of the sale of a controlling block.

Of the articulated explanations, possibility (3) certainly does not suggest a need for legal intervention on behalf of the nonselling shareholders. Presumably, the buyer expects the target firm's worth to increase to a per-share level that is *above* that paid for the controlling shares, for otherwise the buyer would not have paid as much as it did for its new shares. The buyer may have stopped short of purchasing more of the target's shares and excluding other shareholders from this attractive future because it did not want to invest more in this single project, because it projected that state law would allow it to exclude free riders later

1. On the obligations of sellers of control in circumstances in which looting is foreseeable, see R. CLARK, CORPORATE LAW § 11.4, at 478-80 (1986).

2. On the rule of equal opportunity in the sale-of-control context generally, see Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965).

on,[3] or because capital markets were insufficiently perfect to finance such a maneuver.

In all these situations, there is more reason to envy than to pity the nonselling shareholders. Indeed, to decide a sale-of-control case in their favor—that is, to hold that fiduciaries who sell stock must share their profit with nonsellers—is to give them, in the generic case, a double advantage: not only will they extract part of the premium received by the selling shareholders, but also they will remain to ride the "coattails" of the new managers as the share price rises. For instance, if *A* buys *C*'s fifty percent shareholdings for $25 per share when their market price was $18 and, as *A* anticipated, all the shares soon rise to $28 per share, a rule requiring *C* to share her profits with the nonselling shareholders would give them $3.50 per share at the outset (their portion of the $7 premium received by *C*) *and* $10 per share later when they sell their shares in the market. This is not to say that the buyer will always succeed in the takeover game: sometimes the innovation or managerial change planned by the buyer will fail. But, *ex ante*, there is every reason to think that the buyer who pays a premium expects that, *on average*, the firm's future will be profitable enough to warrant paying the premium for control.

This leaves possibilities (4) and (5) in which, without legal intervention, the nonselling shareholders will by assumption share neither in the premium received for the sale of control nor in the future success of the firm. When the source of improvement comes not from the outsider but is *known* to be already within the firm, as sketched in possibility (4), then no matter how much a legal system is oriented toward rewarding and encouraging innovation, there is no reason to expect that controlling shareholders (new or old) will be permitted to appropriate for themselves a disproportionate share of the value of the improvement. Furthermore, as a normative matter it may be efficient (not to mention fair) to block such attempts by those in control because we would not want to encourage insiders to suppress and delay an innovation in order to arrange a transaction that allows them to enjoy a larger share of the innovation's value. Conversely, when, as in possibility (5), the innovation originates with the outsider, there is reason to expect that the law will do little to block the transfer of ownership to this acquirer.[4]

3. A discussion of the sale-of-control problem should ideally include or even depend on an understanding of what the law needs to do when shareholders are frozen out. But inasmuch as *The Philosophy of Corporate Control* does not focus on this question, it is not analyzed in this Review. For a discussion of one remedy available to shareholders who are frozen out, see Kanda & Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985).

4. This expectation derives from the familiar treatment of innovators and explorers in contract law. This treatment is discussed in Kronman, *Mistake, Disclosure, Information, and the Law of*

But what about cases in which we do not know whether it is possibility (4) or (5) that confronts us? One *could* imagine a legal system, motivated by a desire to stimulate innovation, declining to intervene on behalf of nonselling shareholders whose claim to that aspect of the target that attracts the acquirer is uncertain. Such a rule of law would assume, when in doubt, that possibility (5) and not (4) was at issue and that from an efficiency (or fairness) perspective, nothing would be gained by giving passive shareholders a piece of the buyer's insight or innovation. Much as our own contract law protects explorers' and inventors' profits by not requiring full disclosure in transactions with other parties,[5] so too it would not be surprising to find few impediments to privately arranged sale-of-control transactions because *at least sometimes* the acquirer in these transactions brings something new to tired assets. But one could also imagine a legal system that sought to distinguish cases in which the outsider brought in a true innovation from those in which the controlling insider simply usurped a corporate opportunity in collusion with an outsider. Premiums accompanying sales of control would be permitted only in the former situations.

The legal system that would be harder to imagine is one with a universal "equal opportunity rule" that always assumed away the possibility that buyers had innovations or better management to offer at a price. A legal system that provides incentives for inventors and innovators (as all do) should hardly be expected to legislate and adjudicate as if there were no need at all in sale-of-control cases to provide incentives to acquirers of corporations. Stated differently, a legal system that was so suspicious of fiduciaries selling control would hardly want to channel decent buyers toward the purchase of assets when there is even more reason to be suspicious of the shareholders' agents.[6]

The preceding analytic constructs are (or should be) relatively uncontroversial, for they reflect little more than common sense about rewards for innovation on the one hand and "coattails effects" on the other. I think it fair to say that the instincts and politics of most serious students and observers of corporate law cause disagreement about the application of such constructs to actual cases, but not about the analytic principles themselves.

Even the most controversial of the decided cases do not wander far

Contracts, 7 J. LEGAL STUD. 1, 9-18 (1978); Levmore, *Securities and Secrets: Insider Trading and the Law of Contracts*, 68 VA. L. REV. 117, 132-42 (1982).

5. *See* Levmore, *supra* note 4, at 133-34.

6. These agents may, for example, receive promises about their positions or compensation once the acquirer is in control.

from the norms suggested by some plain thinking about behavioral effects in general, and innovations and coattails in particular. Thus, there is no general legal requirement to share an opportunity to sell one's stock at a premium.[7] As we have seen, a contrary rule would allow nonselling shareholders to enjoy both a recovery and a coattails effect. "Equal opportunity" is enjoyed naturally rather than legally. In contrast, the few cases that might support an equal opportunity rule concern circumstances in which there is every reason to think that the buyer brings in no innovation. In the most famous of these cases, *Perlman v. Feldmann*,[8] a consortium of buyers of steel from the Newport Steel Company purchased from Feldmann a controlling block of shares of Newport at a premium above market price. Feldmann had devised a plan under which Newport had been requiring low-interest loans from its customers in lieu of higher prices. The point of this plan was quite clearly to profit from market conditions during the Korean War without resorting to blatant price increases, which might have brought on explicit price controls or other unpleasant consequences. Inasmuch as the buyers of Newport stock were none other than its customers, it is quite plain that they intended to do away with the "Feldmann Plan" and sell steel to themselves at an artificially low price.

In normal circumstances one might simply allow such a sale of control and assure the plaintiff-nonselling shareholders that if any customer-insider should try to take more than its pro rata share of a corporate asset by selling steel to a related enterprise at less than an arm's-length price, then the law would at a minimum require the fiduciary to make Newport, the wronged firm, whole. But *Perlman* concerns abnormal circumstances. Inasmuch as many citizens, and therefore courts, would disapprove of hidden steep price increases in a basic commodity during wartime, the buyer of a controlling interest in Newport stock possibly would have succeeded in defeating the rights and expectations of minority shareholders later on.

A suit about illicit intercorporate pricing (between Newport and the customers controlled by the new Newport insiders) might well have failed. The decision in *Perlman* requiring Feldmann to share the premium that he received with the nonselling shareholders can thus be related perfectly to the likely failure of corporate law to prevent wrongful behavior in the future. Alternatively, one can view the decision as simply opposed to wartime price increases (and possible windfalls). Feldmann's extraction of a premium for his stock was presumably a substitute for

7. *See* R. CLARK, *supra* note 1, § 11.4, at 478.
8. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

wartime profit-taking over some time. Moral opposition to the latter might lead to a decision denying the former. Either way, the decision in *Perlman* is best understood by bearing in mind not only the circumstances of wartime but also the nature of the innovation and coattail effects stirring within the case.

The analytic concepts associated with innovations and the buyer's coattails can be seen from a different angle in perhaps the second best-known exceptional (proplaintiff) case involving control transactions, *Jones v. H. F. Ahmanson & Co.*[9] In that case, the controlling shareholders of a company with shares ripe to be split (in order to bring them within the price range desired by and affordable to most investors) refused to effect a stock split, but simply formed a second company to hold their (eighty-five percent) shares of the first, and then sold shares of the second company to the public. The "innovation," that is, the technique of splitting stock—known to every student of the stock market and hardly much of an innovation at all—essentially was denied to the minority shareholders of the first company. Instead, the controlling shareholders usurped that opportunity in a way that allowed them to enjoy one hundred percent, rather than eighty-five percent, of the profit. It would be easy to understand a ruling that forced the sharing of brilliant innovations (developed on company time) with passive, outside shareholders, for any other rule might discourage the pooling of capital and encourage delay in innovating. It is especially easy to understand such a ruling when the innovation is as straightforward as that at issue in *Ahmanson*.

I might add that had *Ahmanson* also involved a sale of control prior to what might be regarded as the discriminatory stock split,[10] one should not have expected nonselling shareholders to have succeeded in a *Perlman*-style claim for a share of any premium. One might wonder at the existence or size of such a premium, but because there is reason to expect (unlike in *Perlman*) that the law would prevent fiduciary breaches (such as discriminatory stock splits or below-market intercorporate pricing) later in time, as it in fact did in *Ahmanson* itself, there is no reason to intervene when control is transferred. It is, after all, always possible that the acquirer brings in some true innovation that would be discouraged by a rule that required the sharing of premiums.

I will not extend this primer further. It is meant to convey that

9. 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

10. Imagine, for example, that an outsider bought 85% of the stock at a premium above market price and *then* proceeded, as in *Ahmanson*, to put this stock in a holding company and sell its shares to the public.

which I suspect is conveyed in any given week's material in any good modern corporate law course: whatever else is suggested (and there is plenty) by those disputes we study in corporate law, one must learn to keep track of incentives (here the rewards available to innovators) and effects on markets (here the notion that nonselling shareholders will sometimes derivatively enjoy whatever it is that causes an acquirer to pay a premium).

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As the above sketch of several corporate law concepts implies, there is much that we do not know about transactions involving corporate control. To learn more about such transactions requires additional casework, for we need to know whether other cases fit (or could be made to fit) the framework outlined above and (we are curious to know) whether courts are consciously concerned with things like rewards to innovation, including better management. Empirical studies are also needed to assess the eventual distribution of control premiums, the timing of innovations, responses to judicial decisions, the cost of innovators' gaining control of corporations, and so forth. And surely more philosophical work on such questions as the conditions under which we would want to sacrifice some citizens' wealth in order to increase aggregate wealth is needed. In some sense, *The Philosophy of Corporate Control* adds to our knowledge on two of these fronts (it is not an empirical study); in another sense it adds not at all.

Bayne's main argument, familiar to many readers of law reviews, for he has been a prolific scholar, is that a contrôleur[11] is a "strict trustee" and that sales of control are therefore "intrinsically illegitimate." The argument is developed through Bayne's obvious interest in language, in particular the language found in judicial decisions. The language of these opinions is taken quite seriously: references to directors' duties or trustee-like responsibilities are duly recorded and set out as evidence in favor of the central argument.[12] But Bayne does not limit himself to the language found in cases. Articles, treatises, and Restatements are also culled for language suggesting that fiduciaries be unselfish and trustee-

11. Bayne defines "contrôleur" as "the office [to which] the custody of the corporation has been entrusted . . . . Upon the office the fiduciary duties exist. To the office all the rights belong. From the office, therefore, all corporate control activities arise." P. 111. Bayne expands on this term at pp. 111-23.

12. *See, e.g.*, p. 137, *quoting* Porter v. Healy, 91 A. 428, 432 (Pa. 1914) ("Although the stock of one who is a director of a corporation is his individual property . . . he has no right, either directly or indirectly, to use it for his own selfish ends . . . ."); *id.*, *quoting* Commonwealth Title Ins. & Trust Co. v. Seltzer, 76 A. 77, 79 (Pa. 1910) ("The director of a corporation is a trustee for the entire body of stockholders . . . ."). Numerous other quotations may readily be found throughout the book.

like.[13]

The philosophical argument, advertised in the book's title, is constructed in the same manner as the argument from precedents in the case law and academic commentary. The reader is treated to numerous quotations and asked to believe that because so many sources are consistent with a given moral viewpoint, it follows that such a viewpoint has been established as superior to all others. Unfortunately, hundreds of quotations (there are more than three hundred substantial, indented quotations in this relatively short book) do not prove much when alternative positions and supporting quotations are well known. Moreover, it is one thing to say that a fiduciary has some duties; it is quite another to establish the specific behavior required by such duties. Bayne does little of the latter. Quotations about the evil of dishonesty might, for example, be sufficient to convince me that dishonesty is morally wrong, but such quotations hardly help me decide what the law ought to do when a public figure is defamed in the press. Similarly, it is unhelpful to be told that someone is a fiduciary when the question to be decided is whether specific transactions make passive shareholders or the surrounding society better or worse off.

Professor Bayne's disinclination to confront the arguments, as opposed to the occasionally useful quotations, in the literature of the last decade makes this book especially frustrating and unsatisfying. Not once does Bayne allow that an acquirer may have paid a premium for a controlling interest because it believed (as did the seller) that in its hands the target company would rise so much in value that the premium would seem like a worthwhile investment—and nonselling target shareholders would be better off.[14] Not once does he treat us to any theoretical or empirical discussion of the coattails effect, so that we may judge whether passive shareholders who win lawsuits against contrôleurs who have sold out might not be overcompensated. Nor, when advancing the view that contrôleurs be obliged to share premiums with fellow shareholders through a tender offer mechanism,[15] does the discussion consider either the disclosure problems involved in such a plan or the possibility that

13. *See, e.g.*, p. 201, *quoting* Berle, *"Control" in Corporate Law*, 58 COLUM. L. REV. 1212, 1220 (1958) ("Any businessman who transfers control of his company regards it as his ethical duty to assure himself that his successors conform to at least minimum standards of character and responsibility."); p. 263, *quoting* RESTATEMENT OF RESTITUTION § 197, at 808 (1937) ("Where a fiduciary in violation of his duty to the beneficiary receives or retains a bonus or commission or other profit, he holds what he receives upon a constructuve trust for the beneficiary."). It is the rare page that has no similar block quotes.

14. *See, e.g.*, pp. 289-94 (discussing the acquisition of stock in Detroit Steel Corp. by American Export Industries, Inc.); 310-27 (same).

15. Pp. 328-33.

controlling shareholders will inefficiently block takeovers unless they can completely depart from the scene.[16] These questions and many others confront the modern observer of transactions in corporate control, and yet they play no important role in Professor Bayne's treatise.

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Although I find Bayne's main argument unhelpful or even untenable, in the epilogue to *The Philosophy of Corporate Control: A Treatise on the Law of Fiduciary Duty*,[17] Bayne expresses two hopes that cannot help but provoke those of us who work in the corporate law area:

> The first hope for the *The Philosophy of Corporate Control* has been to erect a substantial, complete, tenable, corpus of principles . . . .
>
> It has been the glory of both moral theology and the Anglo-American common law—understandably because both are the products of the same ethicolegal rational mind—that each succeeding thinking generation has refurbished, refined, expanded, the scholarly work of each earlier generation. The second hope, therefore, has been that *The Philosophy of Corporate Control* would be sufficiently cohesive and credible as to warrant the further study of scholars, thoughtful commentary, development, elaboration.[18]

Here is a scholar who, like most of us, finds interest in a topic, writes about it, and yet obviously receives little feedback from his colleagues who think about and teach corporate law. Bayne obviously does not share with me the framework set out in the beginning of this Review, yet we have never communicated with one another. If I believe (as I do) that the standard imposed by the law of trusts on a trustee is very different from that imposed on a corporate fiduciary[19]—the terms of "trust,"

16. There is also the possibility that selling contrôleurs will be more likely to stay on board after the tender offer mechanism fails to buy out all their shares. In this case, potential acquirers, needing to purchase a larger interest in order to be unconcerned that this significant minority interest will interfere with its plans, may be somewhat deterred from these acquisitions. This possibility also is not considered in *The Philosophy of Corporate Control.*

17. Despite the book's subtitle, it should be noted that this is neither a treatise in the familiar sense nor about the law of fiduciary duty generally. One is tempted to understand the subtitle as a marketing device: practitioners of corporate law might be attracted by treatises more than by philosophies. But this work is hardly meant as a useful reference for the practicing bar. The index (like the book itself), for example, does not refer to poison pills, two-tier tender offers, leveraged buyouts, going private, or any other development or phrase that is of interest to the contemporary corporate lawyer. It is, however, charming and outrageous. Two of the longest entries are "Disposition of premium-bribe" and "Intrinsic illegitimacy of premium-bribe" (a subcategory of which is "Turpitude, essence of" and, beneath that, "Coalesced turpitude," "Components," and "The perversion" (including "A turning away" and, again, "Essence of")). *See* pp. 409-10. The two most entertaining entries in the index are "Means to end" (cross-referenced under "End, means to") and "Willy-nilly" (referring the reader to eight different pages where the phrase can be found). *See* pp. 410, 412, 414.

18. P. 377.

19. My belief derives both from a theoretical perspective and from the actual law. Under the law, a "real" trustee, for example, is not allowed to "wear two hats" (he must, for instance, return any commissions earned if, as trustee, he employs himself as, say, a real estate broker for the trust).

"duty," and "fiduciary" notwithstanding—then perhaps it is my obligation (and in my interest) as a scholar to communicate with the authors of law review articles when I think I have missed their point or they have missed the point.

An informal survey leads me to think that the average number of letters containing substantive comments received by the author of a law review article is less than one. If we care about ideas, we must raise this average and not expect that, if we are passive, those analyses and contributions that we think clever and correct will somehow prevail.

But a corporate fiduciary only suffers the burden of proving that his conflict of interest did not produce a deal inferior to what an arm's length bargain would have yielded. And as a theoretical matter, the corporate fiduciary is much better monitored than, say, an orphan's trustee, because shareholders and creditors are usually more capable monitors than are orphans and other beneficiaries. It is easy to see why the law and the beneficiaries themselves might give corporate fiduciaries more flexibility (to pursue profit) than "real" trustees. Stated differently, the law can be seen as setting up two distinct kinds of fiduciary responsibilities and allowing investors and grantors to choose the category and attendant legal rules that best fit their needs.