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# LEVERAGED BUYOUT, MANAGEMENT BUYOUT, AND GOING PRIVATE CORPORATE CONTROL TRANSACTIONS: INSIDER TRADING OR EFFICIENT MARKET ECONOMICS?

## I. Introduction

According to one commentator, a particularly troublesome form of insider trading abuse<sup>1</sup> has developed in the past decade without full public discussion of its ethics or its legality.<sup>2</sup> This abuse has spurred significant commentary.<sup>3</sup> Corporate control transactions of this type, known as insider leveraged buyouts,<sup>4</sup> management buy-

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1. For a discussion of insider trading and its historical development, see *infra* notes 26-134 and accompanying text.

2. Stein, *Going Private is Unethical*, FORTUNE, Nov. 11, 1985, at 169 [hereinafter cited as Stein]. One commentator asserts that "[i]nsider leveraged buyouts are the newest wrinkles in the endless efforts of promoters and entrepreneurs to misuse the system of public corporations. It is time for them to be ironed out." *Id.* at 170.

3. Since the Stein article, other concerns have been raised, not the least of which is that leveraged buyouts are "risky ventures" which may one day collapse, hurting both business and the economy. See Wayne, *Buyouts Altering Face of Corporate America*, N.Y. Times, Nov. 23, 1985, at 1, col. 1 [hereinafter cited as Wayne].

4. A leveraged buyout (often referred to in economic jargon as "LBO") is any acquisition of a company which leaves the acquired operating entity with a greater than traditional debt-to-worth ratio. LEVERAGED BUYOUTS 3 (S. Diamond ed. 1985) [hereinafter cited as Diamond]. Such buyouts are examples of corporate takeovers, and get their name from the enormous leverage, or borrowing, needed to finance them. Wayne, *supra* note 3, at 1, col. 3. In a typical leveraged buyout, a small group of executives and financiers borrows heavily to purchase a company, and then repays this debt with cash from the acquired company or by selling some of the company's assets. *Id.* Several types of financing may be employed to structure leveraged buyouts including "secured financing" and "unsecured financing." "Secured financing" occurs when the assets of the acquired corporation are used to collateralize the debt. The difference between the secured debt and the purchase price is normally covered by a combination of equity contribution by the investing group and promissory notes held by the seller. Diamond, *supra*, at 3. "Unsecured financing" usually "involves some combination of venture capital, 'mezzanine debt' (subordinated debt, generally with an equity kicker [sic], and senior debt (generally owing to banks) aggregating to the total purchase price." *Id.* at 4.

There are also several types of leveraged buyout transactions including "asset acquisitions" and "stock acquisitions."

*Asset acquisitions* involve the formation of a new corporation (or utilization of an existing corporation), which acquires the assets of the target company. Asset acquisitions are generally easier to document, but

outs,<sup>5</sup> and going private,<sup>6</sup> have totaled billions of dollars.<sup>7</sup> On their face, these deals, regardless of their specifics, raise the most basic

they often raise significant tax issues which can affect the purchase price. If the acquired operation is a corporate division rather than a separate corporation, an asset acquisition is the only available type of transaction.

*Stock acquisitions* take many forms: they can include stock redemptions, tender offers, pure stock acquisitions, and reverse mergers. They generally involve the most complex structuring and the greatest number of legal issues. They are most commonly used if the target company is publicly held or if an asset acquisition will result in significant tax issues.

*Id.* at 4 (emphasis in original). For a more detailed discussion of leveraged buyout transaction structures, see *infra* notes 138-46 and accompanying text.

5. Management buyouts, which are leveraged buyouts undertaken by the target firm's own management, are evolving into offensive weapons. Greenwald, *The Popular Game of Going Private*, TIME, Nov. 4, 1985, at 54 [hereinafter cited as Greenwald]; see *supra* note 4 and *infra* notes 135-61 and accompanying text. "[Management buyouts] can be viewed as offers made by internal raiders . . . ." Greenwald, *supra*, at 54 (quoting Alfred Rappaport, Professor of Accounting at Northwestern University's Kellogg School of Management). To begin the transaction, management typically looks to the advice of financial and investment experts. Management may come away with 20%, with big investors getting ownership rights for as much as 45% and with the remainder going to the investment firm that brought the partners together. *Id.* at 55.

6.

Going private, whether effected through an issuer's tender offer, by a leveraged buyout, or simply by merger with a dummy corporation, is a process for eliminating public stockholders by acquiring their stock for a price (generally in cash) that is somewhat higher than the prevailing market price. On the assumption that such transactions are unilateral and coercive—actually coercive to the extent they are mergers; and effectively coercive in the case of initial buy backs by tender offers which threaten the market liquidity of the public's shares—they are likely to force precisely the same inequality as would a disparate distribution on dissolution. The controller keeps the "real" assets and the minority receives cash.

Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072, 1091-92 (1983) [hereinafter cited as Brudney]. "The arguments for going private focus on the 'savings' which the process effects. The essential contention is that by reducing costs, going private increases the profitability and therefore the value of the corporation." *Id.* at 1092 (footnote omitted); see Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. REV. 987, 1006-13 (1974) [hereinafter cited as Borden]; Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 729-30 (1982) [hereinafter cited as Easterbrook & Fischel]; Solomon, *Going Private: Business Practices, Legal Mechanics, Judicial Standards and Proposals for Reform*, 25 BUFFALO L. REV. 141, 143 (1975) [hereinafter cited as Solomon]; Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 978-80 (1980) [hereinafter cited as Wolfson]; Note, *Going Private*, 84 YALE L.J. 903, 907 (1975) [hereinafter cited as *Going Private*]. But see Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1366-67 (1978) [hereinafter cited as Brudney & Chirelstein].

7. In 1984, a record \$18.6 billion was spent on 247 leveraged buyouts, and 1985's frenetic pace was expected to top that. Wayne, *supra* note 3, at 1, col. 2; see *infra* notes 147-52 and accompanying text.

questions of whether security holders are getting the legal and ethical protection they require and, by law, deserve.<sup>8</sup>

It is a fundamental precept of the theory of going private that different groups of security holders<sup>9</sup> of the same class<sup>10</sup> will be treated differently.<sup>11</sup> Furthermore, the arm's-length bargaining<sup>12</sup> that

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8. See Stein, *supra* note 2, at 169; see also Brudney & Chirelstein, *supra* note 6 (going private should be prohibited since it results in a high chance that public stockholders will be treated unfairly). *But see* Easterbrook & Fischel, *supra* note 6 (banning going private transactions would be irrational). For a discussion of the polarized positions taken by Brudney and Chirelstein, on the one hand, and Easterbrook and Fischel, on the other, see *infra* notes 213-17 and accompanying text.

9. "Shareholder" means the person in whose name shares are registered in the records of a corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with a corporation. REVISED MODEL BUSINESS CORP. ACT, § 1.40(22) (1985). Once one sells all of his securities in a corporation, he may no longer claim that he is a security holder of that corporation. See *American Casualty Co. v. M.S.L. Indus., Inc.*, Howard Indus. Div., 406 F.2d 1219, 1221 (7th Cir. 1969).

10.

If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus, a *difference as to voting rights*, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation. However, if two or more groups of shares are identical in every respect except that each group has the right to elect members of the board of directors in a number *proportionate* to the number of shares in each group, they are considered one class of stock.

*Pollack v. Commissioner*, 392 F.2d 409, 410 (5th Cir. 1968) (emphasis added) (quoting Treas. Reg. § 1.1371-1(g) (1959)).

11. R.W. HAMILTON, CORPORATION FINANCE 615 (1984) [hereinafter cited as HAMILTON]; see also Brudney & Chirelstein, *supra* note 6, at 1358 ("[f]reezeouts obviously differ from arm's-length mergers in that all the members of the same class of stockholders do not receive identical treatment: the controlling stockholders *retain* their equity but force the minority, the public investors, to accept cash or debt") (emphasis in original). *But see* Easterbrook & Fischel, *supra* note 6, at 729 n.83 (Rule 13e-3 requires statement regarding the fairness or the unfairness of the transaction).

12. "To be at arm's length . . . a transaction must be between parties with 'adverse economic interests.'" *Crete Mfg. Co. v. United States*, 492 F.2d 515, 520 (5th Cir. 1974) (quoting *Campana Corp. v. Harrison*, 114 F.2d 400, 408 (7th Cir. 1940)). An illustration of what is not at arm's-length is a freezeout, the essential elements of which "include a control group which is able to propose and effectuate corporate action (and which remains in control after the transaction) and one or more shareholders . . . whose interests in the company are eliminated as a result of the transaction." Committee on Corporate Laws, *Guidelines on Going Private*, 37 BUS. LAW. 313, 315-16 (1981) (footnote omitted) [hereinafter cited as *Guidelines on Going Private*].

is present in the majority of intercorporate transactions is absent.<sup>13</sup> Accordingly, going private transactions are often attended by uncertainty and legal risks.<sup>14</sup> For these reasons, among others, substantive and administrative law are beginning to place limitations on the ability of corporations to engage in going private transactions.<sup>15</sup> For example, under recent federal securities regulations, management must publicize its opinion as to the "fairness" or "unfairness" of certain going private transactions.<sup>16</sup>

Yet, there are those who question the effectiveness of these limitations.<sup>17</sup> One commentator argues that persons who participate in a leveraged buyout have better knowledge of the true value of a parcel of real estate, an invention, a pending contract, or a competitor's problems than do the security holders to whom they make their leveraged buyout offer.<sup>18</sup> This commentator concludes that those who initiate leveraged buyout, management buyout, and going private transactions are inevitably acting on inside information for profit.<sup>19</sup>

This Note first examines the historical development and modern application of judicial decisions and statutes concerning insider trading.<sup>20</sup> This Note then discusses the phenomena of leveraged buyout, management buyout, and going private transactions with emphasis on their structure,<sup>21</sup> fairness to security holders,<sup>22</sup> and a possible breach of fiduciary duty to shareholders in the case of management buyouts.<sup>23</sup> Following a discussion of recommendations and policy arguments proffered by other commentators and scholars,<sup>24</sup> this Note recommends that a remedy be afforded to minority security holders

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13. *Guidelines on Going Private*, *supra* note 12, at 313.

14. *Id.* The potential use of inside information in going private transactions presents one such legal risk; i.e. violation of the antifraud provisions of the federal securities laws. For a detailed discussion of this aspect of insider trading, see *infra* notes 204-08 and accompanying text.

15. *Guidelines on Going Private*, *supra*, note 12, at 313.

16. Schedule 13E-3 under the Securities Exchange Act of 1934, Item 8, 17 C.F.R. § 240.13e-100 (1985). For a detailed discussion and commentary on Rule 13e, see *infra* notes 188-98 and accompanying text.

17. For one such commentary, see Stein, *supra* note 2, at 169-70.

18. *Id.*

19. *Id.* These claims are addressed in detail *infra* notes 204-08 and accompanying text.

20. See *infra* notes 26-134 and accompanying text.

21. See *infra* notes 135-46 and accompanying text.

22. See *infra* notes 168-87 and accompanying text and notes 190-98 and accompanying text.

23. *Id.*

24. See *infra* notes 209-18 and accompanying text.

who feel they are being grossly undercompensated, while allowing leveraged buyout, management buyout, and going private transactions to continue in such a way that the principle of fiduciary duty remains untarnished.<sup>25</sup>

## II. Insider Trading: The Rules of the Game and the Players Who Make and Break Them

### A. Historical Overview of Insider Trading

Before the enactment of the federal securities laws,<sup>26</sup> the doctrine of "caveat emptor" generally applied to securities transactions just as it did in other purchase and sale transactions: "competent adult purchasers were deemed to be able to fend for themselves."<sup>27</sup> Al-

25. See *infra* notes 219-23 and accompanying text.

26. S. GOLDBERG, SEC TRADING RESTRICTIONS AND REPORTING REQUIREMENTS FOR INSIDERS 1 (1973) (discussing when insider may trade on inside information) [hereinafter cited as GOLDBERG]. The Securities Act of 1933, 15 U.S.C. § 77(a)-77(aa) (1982), was the first law regulating securities. This act has two basic objectives:

- (1) to provide investors with material financial and other information concerning new issues of securities offered for sale to the public; and
- (2) to prohibit fraudulent sales of securities. Its scope, however, is strictly limited, for jurisdiction is always tied to some use of the mails or of interstate facilities to accomplish a forbidden transaction.

R. JENNINGS & H. MARSH, JR., SECURITIES REGULATION, CASES AND MATERIALS 40 (5th ed. 1982) [hereinafter cited as SECURITIES REGULATION].

The act naturally had its beginnings in the high financing of the Twenties that was followed by the market crash of 1929. Even before the inauguration of Franklin D. Roosevelt as President of the United States, a spectacularly illuminating investigation of the nature of this financing was being undertaken by the Senate Banking and Currency Committee under the direction of its able counsel, Ferdinand D. Pecora. That Committee . . . indicted a system as a whole that had failed miserably in imposing those essential fiduciary standards that should govern persons whose function it was to handle other people's money. Investment bankers, brokers and dealers, corporate directors, accountants, all found themselves the object of criticism so severe that the American public lost much of its faith in professions that had theretofore been regarded with a respect that had approached awe. As the criticism mounted, doubts as to the value of the very system of private enterprise were generated, and a wide demand was prevalent for the institution of procedures of governmental control that would in essence have created a capital issues bureaucracy to control not only the manner in which securities could be issued but the very right of any enterprise to tap the capital market.

Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959-60) [hereinafter cited as Landis].

27. GOLDBERG, *supra* note 26, at 1. In an analogous context, the RESTATEMENT (SECOND) OF TORTS § 352 comment a (1965), sums up the prevailing view regarding

though the doctrine retains its vitality in some areas,<sup>28</sup> it no longer applies to securities transactions.<sup>29</sup>

The prohibition against "insider trading,"<sup>30</sup> the rule that certain

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the liability of a vendor of land:

Under the ancient doctrine of *caveat emptor*, the original rule was that, in the absence of express agreement, the vendor of land was not liable to his vendee, or a fortiori to any other person, for the condition of the land existing at the time of transfer. As to sales of land this rule has retained much of its original force, and the implied warranties which have grown up around the sale of chattels never have developed. This is perhaps because great importance always has been attached to the deed of conveyance, which is taken to represent the full agreement of the parties, and to exclude all other terms and liabilities. The vendee is required to make his own inspection of the premises and the vendor is not responsible to him for their defective condition, existing at the time of transfer.

*Id.* (emphasis added); see also *Philadelphia Elec. Co. v. Hercules, Inc.*, 762 F.2d 303, 312 (3d Cir.), *cert. denied*, 106 S. Ct. 384 (1985) (where corporations of roughly equal resources contract for sale of industrial property, especially where dispute is over condition of land rather than a structure, *caveat emptor* remains the rule under Pennsylvania law); M. FRIEDMAN, *CONTRACTS AND CONVEYANCES OF REAL PROPERTY* § 1.2(n), at 37 (4th ed. 1984) ("in the ordinary sale of realty this doctrine not only applies, it flourishes"). By 1933, the desire to eliminate the dangers created by the doctrine of *caveat emptor* in the securities markets was increasingly prominent, as evidenced by Franklin D. Roosevelt's message to Congress on March 29, 1933:

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933) (remarks of Franklin D. Roosevelt).  
28. See *supra* note 27.

29. GOLDBERG, *supra* note 26, at 1. For illustrations of safeguards protecting against application of *caveat emptor* in securities transactions, see the discussion of insider trading case law *infra* notes 72-125 and accompanying text.

30. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CALIF. L. REV. 1, 1 (1982) [hereinafter cited as Langevoort]; see also Wang, *Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under SEC Rule 10b-5*, 54 S. CAL. L. REV. 1217, 1219 (1981) ("[i]nsider trading" refers to the practice of trading securities on both organized stock exchanges and the over-the-counter market based upon material nonpublic information) [hereinafter cited as Wang]; Note, *An Outsider Looks at Insider Trading: Chiarella, Dirks, and the Duty to Disclose Material Nonpublic Information*, 12 FORDHAM URB. L.J. 777, 777 (1984) (federal securities laws prohibit insider trading) [hereinafter cited as *An Outsider Looks at Insider Trading*].

persons with knowledge of material nonpublic information<sup>31</sup> about an issuer or its securities must either refrain from trading or disclose that information, is now a basic principle of antifraud ideology under the federal securities laws.<sup>32</sup> The pillars of the law on insider trading are section 10(b) of the Securities Exchange Act of 1934<sup>33</sup> and Rule 10b-5<sup>34</sup> enacted thereunder.

Although the extensive legislative history of the 1934 Act is bereft of any explicit explanation of Congress' intent, the relevant portions of that history support the conclusion that section 10(b) was intended to address practices involving some element of *scienter*<sup>35</sup> and should

31. See *infra* notes 56-58 and accompanying text.

32. Langevoort, *supra* note 30, at 1; see Wang, *supra* note 30, at 1219; GOLDBERG, *supra* note 26, at 7 (“[a]n insider in possession of material inside information may avoid any risk of Rule 10b-5 liability by foregoing any trading”); *An Outsider Looks at Insider Trading*, *supra* note 30, at 778 (“[a]t the heart of the prohibition against insider trading is the concept known as the ‘abstain or disclose’ rule”).

33. The text of section 10(b) of the 1934 Act provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

....

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78(j) (1982).

34. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1985).

35. *Scienter* is the “intent to deceive, manipulate, or defraud.” *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). In *Ernst*, the Supreme Court held that a private cause of action for damages will not lie under section 10(b) and Rule 10b-5 in the absence of any allegation of “*scienter*.” *Id.* The Court noted that “[a]lthough verbal formulations of the standard to be applied have varied, several Courts of Appeals have held in substance that negligence alone is sufficient for civil liability under section 10(b) and Rule 10b-5.” *Id.* at n.12; see, e.g., *White v. Abrams*, 495 F.2d 724, 730 (9th Cir. 1974) (standard of “flexible duty”); *Myzel v. Fields*, 386 F.2d 718, 735 (8th Cir. 1967) (negligence sufficient for cause of



not be read to impose liability for conduct that is merely negligent.<sup>36</sup>

The 1934 Act was principally intended to protect traders in securities against manipulation of securities prices by regulating securities transactions on the exchanges and in the over-the-counter markets<sup>37</sup> and by requiring periodic reporting by issuers listing their

action), *cert. denied*, 390 U.S. 951 (1968); *Kohler v. Kohler Co.*, 319 F.2d 634, 637 (7th Cir. 1963) (scienter not required). Other courts of appeals have held that scienter is necessary for such an action to lie. *See, e.g., Clegg v. Conk*, 507 F.2d 1351, 1361-62 (10th Cir. 1974) ("scienter or conscious fault"), *cert. denied*, 422 U.S. 1007 (1975); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 (2d Cir. 1973) ("willful or reckless disregard" for truth). But negligent conduct has seldom been involved in decisions announcing that some form of negligence suffices for civil liability under section 10(b) and Rule 10b-5. *Smallwood v. Pearl Brewing Co.*, 489 F.2d 579, 606 (5th Cir.), *cert. denied*, 419 U.S. 873 (1974); *Kohn v. American Metal Climax, Inc.*, 458 F.2d 255, 286 (3d Cir.) (Adams, J., concurring and dissenting in part), *cert. denied*, 409 U.S. 874 (1972); *see Bueklo, Scienter and Rule 10b-5*, 67 Nw. U.L. REV. 562, 568-70 (1972). In *Ernst*, the Court stated that "the term scienter refers to a mental state embracing intent to deceive, manipulate, or defraud." *Ernst*, 425 U.S. at 194 n.12. The Court did not address the question whether, in some circumstances, reckless behavior is sufficient for civil liability under section 10(b) and Rule 10b-5 nor did it consider the question whether scienter is a necessary element in an action for injunctive relief under section 10(b) and Rule 10b-5. *Id.*; *cf. SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963) ("Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit' upon a client, did not intend to require proof of intent to injure and actual injury to the client").

36. This is evidenced by an explanation of the provision that became section 10(b) by a spokesman for the drafters, Thomas G. Corcoran:

Of course subsection (c) [referring to § 9(c) of H.R. 7852 which would become section 10(b)] is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices.

*Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934).

This explanation of section 10(b) has been the basis for judicial determinations regarding the scienter requirement:

The section was described rightly as a "catchall" clause to enable the Commission "to deal with new manipulative [or cunning] devices." It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions.

*Ernst*, 425 U.S. at 203 (footnote omitted).

37.

An estimated 20,000 or so "unlisted" securities are traded solely in the "over-the-counter" or "OTC" market. The OTC market has no physical location, and has historically been characterized by virtually complete freedom of entry. There are no formal procedures for commencing or terminating trading in a particular security. Any broker-dealer registered with the SEC can act as a dealer (buying and selling to others as principal) or broker (buying or selling for others as their agent) or both in any

securities on national securities exchanges.<sup>38</sup>

The crux of the prohibition of insider trading is the "disclose or refrain" rule.<sup>39</sup> This rule asserts that persons in possession of material nonpublic information must either disclose that information or refrain from using such information as the basis for their trading.<sup>40</sup>

The classification<sup>41</sup> of the party in question is a crucial factor in

OTC security. Market-making in OTC stocks ranges from sporadic activities of individual dealers in inactive local stocks to continuous competition among thirty or more dealers in the largest, most active issues.

Prior to 1971, the only formalized means of communication of quotations in the OTC market was through the publication of daily "sheets", listing the bid and asked prices of each dealer in each stock at the close of the previous day. On February 8, 1971, the National Association of Securities Dealers (NASD) put into operation an automated quotation system—NASDAQ—by which continuously updated price quotations are displayed on a real-time basis on cathode ray terminals located in subscribers' offices.

NASDAQ is at present only a quotation system. After obtaining a quotation, a subscriber must consummate the transaction by telephone communication with the market-maker. Nor does the NASDAQ system provide reports of transactions, although suggestions have been made that NASDAQ could serve as the nucleus of an automated system for the execution and clearance of securities transactions . . . . NASDAQ is presently furnishing to over 800 subscribers, with approximately 60,000 terminals, quotations of over 394 marketmakers in approximately 3,000 securities which meet NASD requirements for inclusion in the system.

SECURITIES REGULATION, *supra* note 26, at 5-6.

38. Rule 12g-1, promulgated under the Securities Exchange Act of 1934, provides that listing of securities on a national securities exchange is no longer a prerequisite to the registration requirement.

An issuer shall be exempt from the requirement to register any class of equity securities pursuant to section 12(g)(1) if on the last day of its most recent fiscal year the issuer had total assets not exceeding \$3,000,000 and, with respect to a foreign private issuer, such securities were not quoted in an automated interdealer quotation system.

17 C.F.R. § 240.12g-1 (1985); *see Ernst*, 425 U.S. at 195; *Sargent v. Genesco, Inc.*, 492 F.2d 750, 760 (5th Cir. 1974) ("[t]he basic intent of section 10(b) and Rule 10b-5 and indeed, of the Exchange Act, is to protect investors and instill confidence in the securities markets by penalizing unfair dealings"); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 235 (2d Cir. 1974).

39. *See Langevoort*, *supra* note 30, at 1 n.1 (referring to "disclose or refrain" rule as "abstain-or-disclose" rule); *Brudney*, *supra* note 6, at 1-2; *An Outsider Looks at Insider Trading*, *supra* note 30, at 778-79; *cf. Kardon v. National Gypsum Co.*, 73 F. Supp. 798, 803 (E.D. Pa. 1947) ("well known and well established equitable principles governing fiduciary relationships" must control).

40. *See GOLDBERG*, *supra* note 26, at 7. "A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *Capital Gains*, 375 U.S. at 186 (emphasis in original).

41. In this regard, "classification" refers to categories such as corporate di-

determining whether there exists a duty to disclose material nonpublic information under the disclose or refrain rule.<sup>42</sup> One group subject to the rule, as a matter of both legislative history and traditional law, is the issuer's insiders, i.e., directors, officers, and executive employees.<sup>43</sup> Their fiduciary duty to their corporation and to the corporation's security holders prohibits these insiders from trading on material nonpublic information.<sup>44</sup> One commentator has noted that to allow such individuals to profit despite their fiduciary duty would be both inequitable<sup>45</sup> and unfair.<sup>46</sup>

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rectors, corporate officers, employees, outsiders, or others standing in some relationship with the firm. See generally Langevoort, *supra* note 30, at 19-21.

42. See *supra* note 39 and accompanying text.

43. See *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961) (corporate insiders, e.g., officers, directors and controlling stockholders, traditionally held to have special obligation for protection of others). For a further discussion of *Cady, Roberts*, see *infra* notes 74-81 and accompanying text.

44. See Langevoort, *supra* note 30, at 19-20.

[T]he affirmative disclosure rule established in these cases is best seen as the legal judgment that a person in a position of responsibility for the property or welfare of another should act in that capacity solely for the best interest of the beneficiary—in other words, a rule derived from the fiduciary's duty of loyalty.

Langevoort, *supra* note 30, at 5. See generally Scott, *The Fiduciary Principle*, 37 CALIF. L. REV. 539 (1949) [hereinafter cited as Scott]. The fiduciary relationship has been held to apply even where the parties do not trust each other. See *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786 (1938); Langevoort, *supra* note 30, at 20 (insiders acting as agent with corporation as principal have fiduciary duty to corporation and derivatively to its shareholders).

45. *An Outsider Looks at Insider Trading*, *supra* note 30, at 785. Other commentators have agreed:

Here, the basis in equity for the open-market abstain-or-disclose rule is plain. When an insider buys immediately before the announcement of good news or sells just before bad, his profit arises by virtue of his fiduciary status and the resulting access to the nonpublic information that created the opportunity for low-risk wealth. Requiring public disclosure by the insider in the open-market situation furthers a significant objective underlying the fiduciary disclosure rule—that of preventing unjust enrichment.

Langevoort, *supra* note 30, at 19; see also Brudney, *Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws*, 93 HARV. L. REV. 322, 344 (1979) (“[t]here is no reason for them to be entitled to trade for their own benefit on the basis of such information, particularly when, as we have noted, permission to do so will enable, if not indeed tempt, them to disserve the corporation and all its stockholders”) (emphasis in original) [hereinafter cited as *Insiders, Outsiders, and Informational Advantages*].

46. *An Outsider Looks at Insider Trading*, *supra* note 30, at 785; *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 344. The concept of fiduciary duty is of particular significance in the context of leveraged buyout, management buyout, and going private transactions which are discussed *infra* notes 135-208 and accompanying text. See Note, *Corporate Morality and Management*

Although the federal securities laws do not distinguish between various types of material nonpublic information,<sup>47</sup> several commentators have drawn a distinction between two particular types: corporate [issuer] information and market information.<sup>48</sup> Corporate information is information that emerges from within the corporation or that affects the price of the issuer's securities because of its reflection of the corporation's expected earnings or assets.<sup>49</sup> Examples of corporate information include the imminent reduction of dividends,<sup>50</sup> the discovery of a potential mineral deposit,<sup>51</sup> or the report of a decline in earnings for a particular period.<sup>52</sup> Market information, which emerges from outside the corporation, has been defined several

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*Buyouts*, 41 WASH. & LEE L. REV. 1015, 1017 (1984) [hereinafter cited as *Corporate Morality*] (management buyout transactions may violate the fiduciary obligation of management to administer corporate affairs exclusively for the benefit of the corporation's shareholders and the corporation itself).

47. See *Frigitemp Corp. v. Financial Dynamics Fund, Inc.*, 524 F.2d 275, 281-83 (2d Cir. 1975); see also *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 331-32 ("[t]he antifraud provisions by their terms and by their history do not distinguish between noncorporate and corporate information or outsiders and insiders" (footnotes omitted)).

48. See, e.g., *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 329 (corporate information comes from within corporation or affects price of corporate stock; market information concerns transactions in corporation's securities that will impact on their future price); *Langevoort*, *supra* note 30, at 42 (corporate information relates to intrinsic value of the issuer, primarily its business and operations; market information may include information coming from bidder in planned tender offer).

49. See *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 329; *Langevoort*, *supra* note 30, at 42 ("[c]orporate information concerns 'information relating to the intrinsic value of the issuer, primarily its business and operations . . .'").

50. See *Cady, Roberts*, 40 S.E.C. 907 (1961) (discussed *infra* notes 72-79 and accompanying text).

51. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969) (discussed *infra* notes 80-87 and accompanying text).

52. See *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974) (prospective managing underwriter and its directors, officers and employees divulged materially adverse inside information regarding decline in issuer's earnings).

Examples of corporate information include knowledge of a significant discovery of natural resources, a research and development breakthrough, a rush of new orders, or a potential merger, any of which can be expected to cause a rise in the price of a corporation's stock upon public disclosure. Corporate information can also be adverse, such as knowledge of cancelled orders, nonacceptance of new products, a newly computed decline in earnings, the passing of a dividend, or the writeoff of a failed venture. In the latter cases, the corporation's stock price can be expected to decline once the news reaches the market.

*Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 329 n.31.

ways, with some commentators giving it a macroeconomic character while others give it a more narrow and rigid interpretation.<sup>53</sup>

Regardless of whether the nonpublic information is corporate or market, the information must be material<sup>54</sup> for there to be a violation of the antifraud provisions of the federal securities laws.<sup>55</sup> Materiality, in the context of the federal securities laws, often has been defined in major cases and in legal commentaries.<sup>56</sup> In general, information is considered material if a reasonable person would attach importance to it or if the information is likely to have substantial market impact.<sup>57</sup> Reliance may be presumed if the information is shown to be material.<sup>58</sup>

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53. Compare Langevoort, *supra* note 30, at 42 (“‘market’ information (a residual category of noncorporate information)”) with *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 329 (“[m]arket information concerns transactions in a corporation’s securities that will have an impact on their future price quite apart from expected changes in the corporation’s earnings or assets”).

54. See, e.g., *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 444 (1976) (“[s]o long as the misstatement or omission was material, the causal relation between violation and injury is sufficiently established . . .”); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848-52 (2d Cir. 1968) (en banc) (“[a]n insider’s duty to disclose information or his duty to abstain from dealing in his company’s securities arises only in ‘those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed’.” (quoting Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 VA. L. REV. 1271, 1289 (1965)), *cert. denied*, 394 U.S. 976 (1969)).

55. See *supra* notes 33-34 and accompanying text.

56. See *infra* note 57 and accompanying text.

57. GOLDBERG, *supra* note 26, at 4; see *Texas Gulf Sulphur*, 401 F.2d at 849 (“[t]he basic test of materiality . . . is whether a reasonable man would attach importance [to the information] . . . in determining his choice of action in the transaction in question”) (emphasis in original) (citing *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965)); *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 571 (E.D.N.Y. 1971) (“a fact is proved to be material when it is more probable than not that a significant number of traders would have wanted to know it before deciding to deal in the security at the time and price in question”); *In re Investors Management Co.*, 44 S.E.C. 633, 642 (1971) (“[a]mong the factors to be considered in determining whether information is material . . . are the degree of its specificity, the extent to which it differs from information previously publicly disseminated, and its reliability in light of its nature and source and the circumstances under which it was received”).

58. See Langevoort, *supra* note 30, at 43 (“[u]sually the information is sufficiently material that the insider’s reliance can be presumed” (footnote omitted)); Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 HARV. L. REV. 584, 587 (1975); *An Outsider Looks at Insider Trading*, *supra* note 30, at 784. *But see* GOLDBERG, *supra* note 26, at 5 (“plaintiff’s harm must take the form of pecuniary losses, before liability will be imposed”). In this regard, “nonpublic” information “refers to information that investors may not lawfully acquire without the consent of the source. It also includes information which, although it may lawfully be disseminated, is not yet generally available.” *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 322 n.2.

## B. Section 16(b) and Short-swing Profits

Section 16(b) of the Securities Exchange Act of 1934 is closely related to Rule 10b-5.<sup>59</sup> Section 16(b) is a rather technical provision authorizing an issuer, or any of its security holders suing derivatively, to recapture profits that arise from short-swing trading<sup>60</sup> by certain insiders in the issuer's equity securities.<sup>61</sup> Although both Rule 10b-5 and section 16(b) "are directed at the informational advantage inherent in insider status,"<sup>62</sup> a major difference exists between the two provisions. Rule 10b-5 imposes liability where the actual misuse of material inside information is proved.<sup>63</sup> Section 16(b), however, is applied mechanically without inquiry as to whether inside information was used.<sup>64</sup>

Section 16(b) applies to officers, directors, and shareholders owning more than ten percent of a class of registered equity securities.<sup>65</sup> It

59. Section 16(b) of the Securities Exchange Act of 1934 provides in relevant part:

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months.

15 U.S.C. § 78p(b) (1982).

60. Section 16(b) specifies a short-swing trading period to be "any period of less than six months." 15 U.S.C. § 78p(b) (1976). A period of less than six months is usually defined as six calendar months less one full period from midnight to midnight. For example, "if securities purchased on January 1st are sold on June 30th, the sale is not considered to be made within a period of less than six months from the purchase." See GOLDBERG, *supra* note 26, at 14.

61. GOLDBERG, *supra* note 26, at 13; Langevoort, *supra* note 30, at 3 n.7 ("[s]ection 16(b) of the Securities Exchange Act . . . prohibits short-swing profits by certain insiders, a rule designed to reach certain insider trading practices").

62. See GOLDBERG, *supra* note 26, at 14.

63. See *supra* notes 34, 56-58 and accompanying text.

64. See *Smolowe v. Delendo Corp.*, 136 F.2d 231, 235 (2d Cir.) (rejecting defendant's contention that liability results only for profits from a proven unfair use of inside information), *cert. denied*, 320 U.S. 751 (1943); GOLDBERG, *supra* note 26, at 14 ("Section 16(b) is designed to apply irrespective of whether misuse of material inside information can be shown"); Langevoort, *supra* note 30, at 3 n.7 ("[l]iability does not depend on any showing that the insider actually possessed any material nonpublic information").

65. *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 591 n.21 (1973); see GOLDBERG, *supra* note 26, at 14.

provides a cause of action for recovery of profits realized from a purchase and sale or a sale and purchase of the issuer's equity securities<sup>66</sup> within a period of less than six months.<sup>67</sup> Those having a cause of action under section 16(b) include the issuer and, if the issuer fails or refuses to sue, the security holders suing derivatively.<sup>68</sup> Since its scope is relatively narrow, section 16(b) does not provide a complete or effective remedy for all insider trading abuses.<sup>69</sup> It does, however, "evidence a congressional policy against insider trading."<sup>70</sup> The application of section 16(b) is limited due to difficulties of proof, not because of a judgment permitting trading that is not expressly covered.<sup>71</sup>

### C. Major Developments in Insider Trading Case Law

Although many cases have dealt with insider trading, including early common law cases,<sup>72</sup> several decisions are at the forefront of

66. "Purchases and sales of convertible securities will always be matched with purchases and sales of securities into which the convertible securities can be converted." GOLDBERG, *supra* note 26, at 18.

67. *See id.* at 14.

68. 15 U.S.C. § 78p(b) (1982). It is significant to note that the SEC has no powers of enforcement under section 16(b). *See id.* Liability may only be asserted in a suit brought by a security holder suing on behalf of the issuer or by the issuer itself. *Id.*

It is well settled that purchases resulting in a person's ownership of more than 10% of a class of equity securities and sales reducing a person's holdings below 10% are considered purchases and sales within the meaning of Section 16(b). In other words, if Mr. X, who already owns 5% of a class of registered equity securities, purchases an additional 6% in June, raising his holdings above 10%, and then sells 4% of his holdings in July, reducing his holdings below 10%, Mr. X will be treated as a principal shareholder both at the time of purchase and sale; and any profits realized by Mr. X as a result of the transactions will have to be disgorged.

GOLDBERG, *supra* note 26, at 17.

69. *See Langevoort, supra* note 30, at 3 n.7.

70. *See id.*

71. *Id.*; *see also Kern*, 411 U.S. at 594 n.26 ("[b]y far the greater weight of authority is to the effect that a 'pragmatic' approach to § 16(b) will best serve the statutory goals" (citations omitted)).

72. *See An Outsider Looks at Insider Trading, supra* note 30, at 791; *see, e.g., Strong v. Repide*, 213 U.S. 419 (1909) (defendant fraudulently concealed from plaintiff's agent facts affecting value of stock sold and delivered); *Goodwin v. Agassiz*, 283 Mass. 358, 186 N.E. 659 (1933) (no actionable wrong by defendant buyer in not disclosing to plaintiff seller that geologist's report was promising and thus stock price would likely rise); *Hotchkiss v. Fischer*, 136 Kan. 530, 16 P.2d 531 (1932) (action by former owner of corporate shares to recover damages from president of corporation for breach of duty of loyalty to shareholder because president purchased shares for much less than their value without making full

the history of insider trading.<sup>73</sup> Some of these cases, which are most germane to the topic of this Note, will be reviewed.

1. *In re Cady, Roberts & Co.*

In *In re Cady, Roberts & Co.*<sup>74</sup> the Securities and Exchange Commission (SEC) addressed the duties a broker has after he receives nonpublic information concerning a company's dividend action from a director employed by the same brokerage firm.<sup>75</sup> The decision was particularly significant because the SEC based its holding on statutory rather than common law.<sup>76</sup> In this case, a brokerage firm partner received a message from a director of Curtiss-Wright that the dividend was to be cut pursuant to a vote of the board of directors.<sup>77</sup> Without hesitation, the broker placed orders to sell Curtiss-Wright stock on behalf of some of his customers; these sales were consummated before news of the dividend cut was available to the general public.<sup>78</sup> The SEC noted that although the broker, based on the facts, was not a corporate insider,<sup>79</sup> the antifraud provisions still applied because these provisions are "not [meant] to be circumscribed by fine distinctions and rigid classifications."<sup>80</sup> The SEC held:

[T]he obligation rests on two principal elements; first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such in-

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disclosure of facts pertinent to transaction). For analyses of these cases, see Brudney, *Insider Securities Dealings During Corporate Crises*, 61 MICH. L. REV. 1 (1962); Conant, *Duties of Disclosure of Corporate Insiders Who Purchase Shares*, 46 CORNELL L.Q. 53 (1960); Comment, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120 (1950) [hereinafter cited as *Prospects for Rule X-10b-5*].

73. See *infra* notes 74-125 and accompanying text.

74. 40 S.E.C. 907 (1961).

75. *Id.*

76. The Commission noted that "[t]his is a case of first impression and one of signal importance in our administration of the Federal securities acts." *Id.*

77. *Id.* at 908-10.

78. *Id.* at 909. For a detailed discussion of the "disclose or refrain rule," see *supra* notes 39-44 and accompanying text.

79. The Commission defined "corporate insiders" as "officers, directors, and controlling stockholders." *Cady, Roberts*, 40 S.E.C. at 912.

80. *Id.* (footnote omitted); see *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 436 (2d Cir. 1943) (securities legislation does not fail for vagueness), *cert. denied*, 321 U.S. 786 (1944); *The Prospects for Rule X-10b-5*, *supra* note 72, at 1145 ("[t]he purpose of the Securities Acts is to protect investors generally").



formation knowing it is unavailable to those with whom he is dealing.<sup>81</sup>

## 2. *SEC v. Texas Gulf Sulphur Co.*

The prohibition against insider trading continued in *SEC v. Texas Gulf Sulphur Co.*,<sup>82</sup> where materiality was the key element in determining liability.<sup>83</sup> Officers of Texas Gulf Sulphur Co. engaged in extensive purchases of its securities<sup>84</sup> after learning that one of the company's properties showed potential for abundant ore discovery.<sup>85</sup> The Supreme Court held that "[w]hether predicated on traditional fiduciary concepts . . . or on the 'special facts' doctrine, . . . [Rule 10b-5] is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information."<sup>86</sup> The Court established the basic test of materiality as being "whether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question"<sup>87</sup> and added that "[t]his, of course, encompasses any fact ' . . . which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities . . . .'"<sup>88</sup> The Court ordered the defendants to disgorge their ill-gained profits to a court-supervised fund.<sup>89</sup>

81. 40 S.E.C. at 912 (footnote omitted).

82. 401 F.2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969).

83. *See supra* notes 56-58 and accompanying text.

84. Between November 12, 1963 and March 31, 1964, acquisitions totaled 7,100 shares of Texas Gulf Sulphur stock and 12,300 call options to purchase such stock. The price per share ranged from 17.75 to 25. *Texas Gulf Sulphur*, 401 F.2d at 843-44; *see* GOLDBERG, *supra* note 26, at 85-86.

85. On November 12, 1963, a drill core of 655 feet was extracted for analysis. *Texas Gulf Sulphur*, 401 F.2d at 843. A chief geologist for the company (who was later to be a defendant in the action) examined the core. *Id.* It was eventually assayed as containing an average metal content of 1.18% copper, 8.26% zinc, and 3.94% ounces of silver per ton over the length of the core which was 602 feet. *Id.* These results were so remarkable that none of the five expert witnesses "had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit." *Id.* The trial court concluded that there was "no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it." *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262, 282 (S.D.N.Y. 1966), *rev'd*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

86. *Texas Gulf Sulphur*, 401 F.2d at 848 (citations omitted).

87. *Id.* at 849 (emphasis in original) (quoting *List v. Fashion Park, Inc.*, 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965)).

88. *Id.* (emphasis in original); *List*, 340 F.2d at 462 (quoting *Kohler v. Kohler Co.*, 319 F.2d 634, 642 (7th Cir. 1963)).

89. *See SEC v. Texas Gulf Sulphur Co.*, 446 F.2d 1301 (2d Cir.), *cert. denied*, 404 U.S. 1005 (1971); Langevoort, *supra* note 30, at 9 (discussing fraud on mar-

### 3. *In re Investors Management Co.*

In *In re Investors Management Co.*,<sup>90</sup> another major case evidencing the prohibition of insider trading, an aircraft manufacturer obtained the services of a broker-dealer who was acting as the principal underwriter for the manufacturer's proposed debenture issue.<sup>91</sup> After a forecast of the manufacturer's earnings for the current year were made public, the manufacturer disclosed to the broker-dealer that the actual figures were substantially less.<sup>92</sup> The broker-dealer's underwriting department made this disclosure known to members of its sales department who then informed agents of major institutional clients of the discrepancy.<sup>93</sup> Before the revised earnings estimate was generally made available to the public, the institutions sold large amounts of the manufacturer's stock.<sup>94</sup> The SEC held that, on such facts, the appropriate test for determining liability is "whether the recipient knew or had reason to know that the information was non-public and had been obtained improperly by selective revelation or otherwise."<sup>95</sup> If such information is material,

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ketplace). It has been suggested that the antifraud provisions obligate a corporation to disclose information regarding its affairs at some point in time, notwithstanding the fact that the mandated system does not require the disclosure of that information at that time and the firm is not contemplating any securities transactions. *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 336; see *Financial Indus. Fund v. McDonnell-Douglas Corp.*, 474 F.2d 514, 521 (10th Cir.) (dictum), *cert. denied*, 414 U.S. 874 (1973); *Mitchell v. Texas Gulf Sulphur Co.*, 446 F.2d 90, 100-02 (10th Cir.) (dictum), *cert. denied*, 404 U.S. 1004 (1971); *Texas Gulf Sulphur*, 401 F.2d at 850 n.12; *Heit v. Weitzen*, 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); *Bauman, Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935, 937 (1979). *But see* *Goldberg v. Meridor*, 567 F.2d 209, 221 n.10 (1977) (expressly refusing to decide whether such disclosure is required), *cert. denied*, 434 U.S. 1069 (1978). As pointed out by Judge Friendly in *Texas Gulf Sulphur*, scienter may be the appropriate test in order to establish a defendant's culpability for violation of this disclosure obligation. See *Texas Gulf Sulphur*, 401 F.2d at 866-68; *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 337 n.58.

90. 44 S.E.C. 633 (1971).

91. *Id.* at 635-36.

92. *Id.*

93. *Id.* at 636.

94. *Id.* Between June 21, 1966 and June 23, 1966, respondents sold a total of 133,400 shares of Douglas stock from existing long positions, which constituted virtually all of their holdings of Douglas stock, and sold about 21,100 shares, for an aggregate price of more than \$13,300,000. *Id.* On June 22, 1966, the price of Douglas stock reached a high of 90.50, but, by October it declined to a low of 30. *Id.*

95. *Id.* at 643. The SEC specifically rejected the following claim:

[N]o violation can be found unless it is shown that the recipient himself occupied a special relationship with the issuer or insider corporate source

one who obtains such information falls within the restraints of section 10(b) and Rule 10b-5.<sup>96</sup>

Thus, in *Investors Management*, as in *Cady, Roberts* and *Texas Gulf Sulphur*, the persons who effected the transactions, as well as those who participated in the transactions by passing information to those effecting the transactions, were held to have violated Rule 10b-5.<sup>97</sup>

#### 4. *Chiarella v. United States*

The law on insider trading, as evidenced by *Cady, Roberts, Texas Gulf Sulphur*, and *Investors Management*, underwent a formidable revamping when the United States Supreme Court decided *Chiarella v. United States*.<sup>98</sup> In *Chiarella*, a financial printing firm employee ascertained the identities of companies that were the targets of contemplated tender offers and purchased stock in those companies.<sup>99</sup> He then awaited the public announcement of the takeover attempts and sold the stock immediately thereafter, harvesting a substantial profit.<sup>100</sup> He was convicted of a criminal violation<sup>101</sup> of section 10(b) and Rule 10b-5.<sup>102</sup> The Court of Appeals for the Second Circuit upheld the conviction based upon the "disclose or refrain rule."<sup>103</sup>

giving him access to non-public information, or, in the absence of such relationship, that he had actual knowledge that the information was disclosed in a breach of fiduciary duty not to reveal it.

*Id.*

96. *Id.* at 644. The SEC stated that "one who obtains possession of material, non-public corporate information, which he has reason to know emanates from a corporate source, and which by itself places him in a position superior to other investors, thereby acquires a relationship with respect to that information within the purview and restraints of the antifraud provisions." *Id.*

97. See *supra* notes 72-94 and accompanying text. See generally J. BOLAND, WALL STREET'S INSIDERS (1985) (discussing general case law in insider trading context); *An Outsider Looks at Insider Trading*, *supra* note 30 (detailed discussion of insider trading cases).

98. 445 U.S. 222 (1980).

99. *Id.* at 224.

100. *Id.* *Chiarella* realized a gain of slightly more than \$30,000 in the course of 14 months. Subsequently, the SEC began an investigation of his trading activities. *Id.*

101. SEC v. *Chiarella*, 450 F. Supp. 95 (S.D.N.Y. 1978); see Langevoort, *supra* note 30, at 11 n.40. See generally Morrison, *Silence is Golden: Trading on Nonpublic Market Information*, 8 SEC. REG. L.J. 211 (1980) (discussing *Chiarella* in detail).

102. For the complete text of section 10(b) and Rule 10b-5, see *supra* notes 33-34.

103. United States v. *Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978), *rev'd*, 445 U.S. 222 (1980). The court ruled that "[a]nyone—corporate insider or not—who regularly receives material nonpublic information may not use that information to

The Supreme Court reversed the conviction on the ground that Chiarella had no fiduciary duty to the sellers of the securities.<sup>104</sup> The Court set out that liability under section 10(b) must be "premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction."<sup>105</sup> Due to Chiarella's situation of employment, the Court concluded that his use of the nonpublic information could not be considered a fraud under section 10(b).<sup>106</sup>

### 5. *Dirks v. SEC*

The revamping of insider trading law continued in *Dirks v. SEC*<sup>107</sup> which involved disclosures of material nonpublic information by a former officer of Equity Funding of America (Equity Funding) to a broker-dealer.<sup>108</sup> The broker-dealer provided investment and portfolio analysis of insurance companies' securities to institutional investors.<sup>109</sup> The broker-dealer investigated Equity Funding and, in accordance with information he had been given, found its corporate assets to be severely overstated.<sup>110</sup>

During this time, the price of Equity Funding stock fell drastically, and the firm subsequently went into receivership.<sup>111</sup> Before this occurred, however, several of Dirks' clients and institutional investors sold their Equity Funding shares based on their conversations with Dirks, thereby averting substantial financial losses.<sup>112</sup>

Noting the holding of *Chiarella*, that a duty to disclose or refrain may not be found unless a fiduciary or other special relationship exists between the parties to a transaction<sup>113</sup> or unless the inside information has been made available *improperly*,<sup>114</sup> the United States Supreme Court held:

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trade in securities without incurring an affirmative duty to disclose. And if he cannot disclose, he must abstain from buying or selling." *Id.* (footnote omitted) (emphasis in original). For a detailed discussion of the "disclose or refrain rule," see *supra* notes 30-32, 39-46 and accompanying text.

104. *Chiarella*, 445 U.S. at 230. For a detailed discussion of *Chiarella*, see Langevoort, *supra* note 30, at 11-16.

105. *Chiarella*, 445 U.S. at 230.

106. *Id.* at 233.

107. 463 U.S. 646 (1983).

108. *Id.* at 648-49.

109. *Id.* at 648.

110. *Id.* at 649.

111. *Id.* at 650.

112. *Id.* at 649.

113. *Id.* at 654-55.

114. *Id.* at 660.

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information *only* when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.<sup>115</sup>

The Court defined the test for such a breach as "whether the insider personally will benefit, directly or indirectly, from his disclosure."<sup>116</sup> It follows that, absent a breach by the insider, there is no derivative breach.<sup>117</sup> Hence, the Court concluded that Dirks did not violate the provisions of section 10(b) or Rule 10b-5.<sup>118</sup>

## 6. *United States v. Newman*

After *Chiarella* was decided by the United States Supreme Court in 1980,<sup>119</sup> the Second Circuit, in *United States v. Newman*,<sup>120</sup> upheld the prosecution of a trader for aiding and abetting Rule 10b-5 violations by brokerage house employees who had profited from insider knowledge of mergers and takeovers.<sup>121</sup>

Newman, the defendant stocktrader, acquired confidential information regarding proposed mergers and acquisitions.<sup>122</sup> He then conveyed the information to two confederates, who in turn purchased stock in the merger and takeover targets, and thereby reaped substantial gains.<sup>123</sup> *Newman* held that a duty to disclose or refrain from trading may be found absent a special relationship between the parties to the transaction.<sup>124</sup> In dicta, the court specifically rejected the theory that it is a requisite element under the securities laws that fraud be perpetrated upon purchasers or sellers of securities.<sup>125</sup>

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115. *Id.* (emphasis added).

116. *Id.* at 662.

117. *Id.* "Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach." *Id.*

118. *Id.* at 665-67.

119. For a discussion of *Chiarella*, see *supra* notes 98-106 and accompanying text.

120. 664 F.2d 12 (2d Cir. 1981), *cert. denied*, 464 U.S. 863 (1983).

121. *Id.* at 20.

122. *Id.* at 15.

123. *Id.*

124. *Newman*, 664 F.2d at 20. *But see Dirks*, 463 U.S. at 654-55; *Chiarella*, 445 U.S. at 230.

125. *Newman*, 664 F.2d at 17. Similarly, in his concurring opinion in *Chiarella*, Justice Stevens stated that "a legitimate argument could be made that [*Chiarella's*] actions constituted 'a fraud or a deceit' upon those companies 'in connection with

#### D. Positive Aspects of Insider Trading

One commentator has noted that the arguments in favor of insider trading fall into one of two categories: (1) no one is harmed by insider trading and there are inherent benefits in such activity; and (2) the inadequacy of the present structure prohibiting insider trading mandates that a reorganization of the current system be undertaken.<sup>126</sup>

Arguments falling into the first category contend that there is "no causal connection between insider trading and outsiders' losses."<sup>127</sup> One commentator suggests that, for this argument to stand, an individual investor would have had to participate in a particular trade irrespective of the insider's activity.<sup>128</sup>

Depending upon whether the underlying goal of securities regulation is thought of in terms of investor protection or market efficiency, insider trading may be either a nemesis or a blessing.<sup>129</sup> If insider trading is allowed, the action of insiders in the market will move prices to their natural equilibrium.<sup>130</sup> Therefore, insider trading

the purchase or sale of any security' . . . . [I]t could also be argued that no actionable violation of Rule 10b-5 had occurred." 445 U.S. at 238 (Stevens, J., concurring) (citations omitted). According to the *Newman* decision, the dissent in *United States v. Chiarella* is primarily based "upon the absence of a special relationship between Chiarella and the sellers of the stock, the point which the Supreme Court held to be determinative." *Newman*, 664 F.2d at 16 n.2. *But see Chiarella*, 588 F.2d at 1373-74 ("[t]he majority terms 'irrelevant' the fact that Chiarella was neither an insider of the companies whose securities he purchased, nor the tippee of an insider. . . . 'The essential purpose of Rule 10b-5, as we have stated time and again, is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders'.") (Meskill, J., dissenting) (quoting *Radiation Dynamics, Inc. v. Goldmuntz*, 464 F.2d 876, 890 (2d Cir. 1972)).

126. See *An Outsider Looks at Insider Trading*, *supra* note 30, at 789. See generally H. MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966) (prohibition against insider trading ignores goals of allocative market efficiency).

127. Dooley, *Enforcement of Insider Trading Restrictions*, 66 VA. L. REV. 1, 33 (1980) [hereinafter cited as Dooley]; see also *Fridrich v. Bradford*, 542 F.2d 307 (6th Cir. 1976) (finding no causal connection between the defendant's purchases and the plaintiff's lost opportunity in selling before favorable news), *cert. denied*, 429 U.S. 1053 (1977).

128. See Branson, *Discourse on the Supreme Court Approach to SEC Rule 10b-5 and Insider Trading*, 30 EMORY L.J. 263, 295-96 (1981) [hereinafter cited as Branson].

129. See *Insiders, Outsiders, and Informational Advantages*, *supra* note 45, at 336.

130. See Branson, *supra* note 128, at 292.

For example, a corporation developing a new product which is subject to governmental approval may receive advance notice that such approval will be denied, a decision that would adversely affect the price of the corporation's securities when made public. By permitting corporate insiders to sell their stock based on such information, the securities markets

arguably may increase the efficiency of capital markets.<sup>131</sup> Moreover, it has also been argued that removing prohibitions against insider trading will act as an incentive for an issuer's officers to achieve trading conditions for the issuer's securities which, as investors, they can then exploit.<sup>132</sup>

The argument in the second category favoring insider trading is that attempts to regulate insider trading have been grossly inadequate.<sup>133</sup> One commentator asserts that the problem lies in "the futility of the SEC's goal of providing meaningful information equally to all investors under a scheme of mandatory, standardized disclosure."<sup>134</sup>

### III. Leveraged Buyout, Management Buyout, and Going Private Transactions

In the world of high finance, the once obscure transaction known as the leveraged buyout is now storming the market.<sup>135</sup> In this transaction, corporate officers turn publicly-held firms into private operations that are free from unwanted attention of corporate raiders and from demands of short-term investors.<sup>136</sup> In addition, many corporate officers are making huge profits for themselves and for shareholders.<sup>137</sup>

#### A. The Structure of the Transaction

The actual mechanics of going private are varied.<sup>138</sup> A leveraged

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would begin to incorporate the adverse decision by setting a lower, more accurate stock price. Potential investors in the corporation may be dissuaded from purchasing the stock as a result of the price movement initiated by the insider trading.

*An Outsider Looks at Insider Trading*, *supra* note 30, at 790 (footnote omitted).

131. See *supra* notes 130 and accompanying text.

132. Branson, *supra* note 128, at 291-92.

133. See *id.* at 293; Dooley, *supra* note 127, at 72; Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1059 (1977) [hereinafter cited as *The Efficient Capital Market Hypothesis*].

134. *The Efficient Capital Market Hypothesis*, *supra* note 133, at 1059.

135. See *infra* notes 147-52 and accompanying text.

136. Greenwald, *supra* note 5, at 54. For a discussion of leveraged buyouts as a defense tactic against hostile takeovers, see *infra* notes 159-61 and accompanying text.

137. Greenwald, *supra* note 5, at 54. For an example of profits made by officers, see *infra* notes 155-58 and accompanying text.

138. Greenwald, *supra* note 5, at 54-55. For a discussion of several variations of leveraged buyout structures, see *infra* notes 138-46 and accompanying text.

buyout involves leveraging, that is, borrowing from a financier to acquire the target company.<sup>139</sup> The funds obtained through borrowing

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139. See DIAMOND, *supra* note 4, at 11; Greenwald, *supra* note 5, at 55. Leveraged buyouts normally involve the purchase of either corporate assets or stock. Stock acquisitions take on several structures including stock purchases, cash mergers, redemptions, and tender offers. The following is an example of a stock purchase of a subsidiary:

[A] lender (Lender) makes an unsecured loan to a newly formed holding company (Holding) established for the purpose of entering into a stock purchase agreement with the existing owner(s) (Seller) of the stock of the target company (Target). Proceeds of Lender's initial loan are used by Holding to purchase the stock of Target. Immediately after the closing of the stock purchase, Lender makes a second loan, this time to Target. The proceeds of this second loan are upstreamed to Holding (by dividend, loan, or other distribution), and Holding uses the funds to repay the first loan to Lender. The second loan is secured by liens on the assets of Target.

DIAMOND, *supra* note 4, at 120-21.

In a cash merger . . . an investing group forms Holding, which in turn forms a wholly owned subsidiary (Acquisition Sub). Acquisition Sub and Target enter into a merger agreement, following approval of their respective boards of directors providing for (1) the merger of Acquisition Sub into Target (Target being the survivor in the merger) and (2) the conversion of the outstanding shares of stock of Target into the right to receive cash at a specified dollar amount per share . . . . Immediately following the consummation of the merger (which normally will require shareholder approval *before* consummation can occur), Lender makes a secured loan to Target in an amount at least sufficient to enable Target to satisfy its obligations to its "former" shareholders under the merger agreement to exchange their stock for cash. Following the merger, Target becomes a wholly owned subsidiary of Holding; and often, in order to achieve various tax benefits (e.g., a step-up in basis of the Target's fixed assets for future depreciation deductions), the Target will be either wholly or partially liquidated into Holding. This merger technique is often used by investing groups to take publicly held corporations private.

*Id.* at 122 (emphasis in original).

In a typical redemption . . . Lender makes a secured loan to Target to enable Target to redeem the stock of one or more of Target's shareholders . . . . [T]he redemption vehicle is most often employed by closely held corporations to purchase the stock of one or more of their shareholders. Following the redemption, the redeemed stock is either held in the corporate treasury or canceled, thereby increasing the percentage of outstanding stock of Target held by each of Target's remaining shareholders.

*Id.* at 123.

In a typical tender offer,

[t]he investing group establishes Holding, which in turn forms Acquisition Sub. Acquisition Sub makes a public tender offer for the stock of Target. The offer provides that the obligation of Acquisition Sub to pay for the tendered stock is conditioned upon (1) the tender of at least 80 percent of Target's stock and (2) the posttender consummation of a cash merger of Target with Acquisition Sub (Target being the survivor).

The tender offer further provides that after the tender offer but *before* Acquisition Sub pays for the tendered shares, Acquisition Sub has the



are used to pay the seller.<sup>140</sup> Internal cash flow generated by the target and/or redeployment of the target's assets are used to retire the debt.<sup>141</sup> The buyers and sellers of target companies can also be varied in their motives and their approaches.<sup>142</sup>

Basically, the techniques used in recent attempts to go private fall into two categories: (1) a "one-step acquisition" of publicly held securities,<sup>143</sup> typically through a merger;<sup>144</sup> and (2) a "two-step acquisition,"<sup>145</sup> which usually involves a tender offer followed by, if

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right to vote the tendered shares in favor of the merger. If less than 80 percent of Target's voting stock is tendered or if for any reason the merger of Acquisition Sub into Target is not consummated by a date certain, the shares are required to be returned to the tendering shareholders. This structure enhances the ability of the investing group to "freeze out" the 20 percent minority interest in Target and to permit Lender to determine whether Acquisition Sub's tender offer is successful *before* Lender's loan is made. In this structure Lender does not make its secured loan to Target until *after* the merger takes place.

*Id.* at 123-24 (emphasis in original).

Asset acquisitions, on the other hand, usually involve a much less complicated structure. See *supra* note 4 for a discussion of asset acquisitions. For a detailed discussion of asset acquisition structures including the legal problems which they may generate, see DIAMOND, *supra* note 4, at 124-25.

140. DIAMOND, *supra* note 4, at 11.

141. *Id.*

142. See *Going Private*, *supra* note 6, at 905-09; see also DIAMOND, *supra* note 4, at 11 (priorities must include determining quality and size of potential firm for purchase, matching a deal with target screen, locating the seller, determining the seller's goal, and demonstrating to the seller the mutual beneficiality of the deal).

143. The "one-step" merger is less complex than its "two-step" counterpart. As an illustration of a "one-step" merger, one commentator offers the following scenario: assume Firm A is seeking to go private by merging into Firm B, which owns 44 percent of Firm A's stock. Firm B is owned in its entirety by a group of officers and directors of Firm A. In accordance with the terms of the proposed merger, as determined by the common directors of A and B, only Firm A's shareholders will receive cash, and Firm B, as the surviving corporation, will change its name to Firm A. *Going Private*, *supra* note 6, at 909-10 (pointing out that pursuant to Delaware law, merger must be approved for each merging corporation by a majority of that corporation's voting stock, but, since Firm B owns 44 percent of Firm A's stock, approval can be expected). See *supra* notes 138-42 and accompanying text and *infra* notes 144-46 and accompanying text for a discussion of various acquisition structures.

144. See *supra* note 143.

145. A "two-step" method that begins with a tender offer by a corporation to its public shareholders, followed by a "mop-up" of any remaining publicly held shares, is the more common method of going private. See *Going Private*, *supra* note 6, at 910. "Tender offers . . . require no approval by shareholders as a group. Instead, their success is dependent upon the decision of individual shareholders; and to overcome shareholder inertia companies have regularly fixed the tender price above, and sometimes as much as double, that obtainable in the market immediately before the tender offer was announced." *Id.* (footnotes omitted). For a discussion

necessary, one of several "mop-up" devices.<sup>146</sup>

The propensity for leveraged buyout, management buyout, and going private transactions undoubtedly is rising consistently.<sup>147</sup> The forecast "that managerial buy-outs will increase in direct proportion to the rate of takeover activity" is supported by empirical evidence.<sup>148</sup> Leveraged buyouts represent a significant percentage of all corporate acquisitions.<sup>149</sup> Some estimates indicate that leveraged buyouts may have comprised fifty percent of all corporate acquisitions completed in 1983.<sup>150</sup> These predictions and estimates are not far off the mark. For example, a record \$10.8 billion was spent to take publicly-held

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of various acquisition structures, see *supra* notes 138-44 and accompanying text and *infra* note 146 and accompanying text.

146. If a tender offer does not prove to be completely successful, corporate officers who are anxious to take the company private have several "mop-up" techniques at their disposal. One such technique is a "reverse stock split" whereby the company issues one new share, for example, in exchange for every 1000 old ones. See *Going Private*, *supra* note 6, at 910. This results in all shareholders with less than 1000 shares, or some multiple of 1000, holding fractional amounts of stock in the corporation and since a corporation can usually buy out fractional shares unilaterally, reverse stock splits can effectively eliminate remaining minority interests. *Id.* A second "mop-up" technique is for majority shareholders to "freeze out" the remaining minority through a merger. *Id.* at 911. If the majority controls almost all of the outstanding stock, it may take advantage of popular short-form merger statutes. *Id.* In a short-form merger, the majority sets up a new corporation as the parent of the corporation going private and merges the latter into the former; however, short-form mergers do not require shareholder approval. *Id.*

"Freeze-out" has been defined as follows:

In its broadest sense, it might be taken to describe any action by those in control of the corporation which results in the termination of a stockholder's interest in the enterprise . . . . The term has come to imply a *purpose* to force a liquidation or sale of the stockholder's shares, not incident to some other wholesome business goal.

Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1192-93 (1964) (emphasis in original) (citing O'NEAL & DERWIN, *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES* 3 (1961)).

147. See Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1197 (1984) [hereinafter cited as Coffee]; Greenwald, *supra* note 5, at 54-55.

148. See Coffee, *supra* note 147, at 1197. See *infra* notes 149-52 and accompanying text for a discussion of estimated figures for leveraged buyouts.

149. A report by W.T. Grimm & Co. states that of the 694 divestitures that took place during the first three quarters of 1983, "104—or 15 percent—were leveraged buyouts." *Legal Times*, Nov. 7, 1983, at 8, col. 1.

150. See Coffee, *supra* note 147, at 1197. The managing director of Merrill Lynch Capital Markets predicted that leveraged buyouts would account "for up to 50% of all corporate acquisitions in 1983, compared with 15% to 20% in 1982." *Id.* at 1197 n.149; see Hill & Williams, *Buyout Boom: Leveraged Purchases of Firms Keep Gaining Despite Rising Risks*, *Wall St. J.*, Dec. 29, 1983, at 1, col. 6.

firms private in 1984, versus just \$636 million in 1979.<sup>151</sup> The 1985 pace was even more furious.<sup>152</sup>

The factors for the attractiveness of leveraged buyouts are even more diverse than the techniques employed to structure them.<sup>153</sup> The most compelling factor is the potential for profit.<sup>154</sup> For example, in 1982, a group of investors led by then Treasury Secretary William Simon invested \$1 million of personal capital and borrowed \$79 million to buy the Gibson greeting card company from RCA.<sup>155</sup> The Simon group turned Gibson into a private corporation and reorganized its operations.<sup>156</sup> Then, only 18 months later, the Simon group sold \$290 million worth of the firm's stock to the public.<sup>157</sup> William Simon alone earned more than \$15 million and found himself holding shares in Gibson worth about \$50 million.<sup>158</sup>

Leveraged/management buyouts often have been used as a weapon to defend against hostile takeovers.<sup>159</sup> As one commentator points out, "[t]he enhanced danger of ouster under a regime of frequent takeovers threatens the senior management group with the potential

151. See Greenwald, *supra* note 5, at 54. Some leveraged buyouts, either completed or being negotiated at the time of the writing of this Note include:

COMPANY	TRANSACTION DATE	VALUE IN BILLIONS
Beatrice	Apr. '86	\$4.91
R.H. Macy	July '86	\$3.58
Continental Group	Nov. '84	\$2.75
Storer Communications	Dec. '85	\$2.5
Union Texas Petroleum (50%)	July '85	\$1.7
Levi Strauss	Aug. '85	\$1.48
Northwest Industries	July '85	\$1.37
City Investing (3 subs.)	Dec. '84	\$1.25

*Id.*

152. *Id.*

153. *Id.*; see *Going Private*, *supra* note 6, at 905-09.

154. Greenwald, *supra* note 5, at 54; see HAMILTON, *supra* note 11, at 611; Buxbaum, *Corporate Legitimacy, Economic Theory, and Legal Doctrine*, 45 OHIO ST. L.J. 515, 533 (1984) [hereinafter cited as Buxbaum]; Easterbrook & Fischel, *supra* note 6, at 706.

155. Greenwald, *supra* note 5, at 55.

156. *Id.*

157. *Id.*

158. *Id.* One commentator argues that buyouts of this type "invariably increase the value of the stock that executives had before the deal." *Id.* After this type of buyout, the management generally holds a great deal more of the private company than it did of the public one and thus it can collect a greater percentage of dividends distributed by the company. *Id.* Moreover, as was the case with William Simon, the owners can reap heavy gains if they later decide to sell stock to the public again, assuming the public is willing to buy. See *supra* notes 155-57 and accompanying text.

159. See Coffee, *supra* note 147, at 1195-99.

loss of what they predictably see as their legitimate entitlement to share in the future earnings and stock appreciation of the firm."<sup>160</sup> Thus, target management may be able to preempt the potential contest for control by taking the firm private.<sup>161</sup>

There are other formidable business reasons for taking a company private.<sup>162</sup> Free from the ever-pressing need to satisfy impatient Wall Street stock market analysts and short-term shareholders who often demand increasing profits each quarter, corporate management can focus on long-term goals.<sup>163</sup> By doing this, a firm's future investment can be used to speculate on long-term market trends and fluctuations.<sup>164</sup>

Finally, going private transactions are encouraged by United States tax laws.<sup>165</sup> The Internal Revenue Code permits investors to deduct the interest on their debts.<sup>166</sup> This makes substantial borrowing extremely attractive because an interest expenditure generates a corresponding decrease in taxable income and the government thereby shares the cost of the borrowing.<sup>167</sup>

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160. *Id.* at 1196.

161. *Id.*

162. *See infra* notes 163-67 and accompanying text.

163. *See* Greenwald, *supra* note 5, at 55. "Going private gives us the opportunity to get out of the fishbowl and to make marketing decisions in a longer time frame than a public company has. Sometimes you need to invest in the future, and sometimes the future is more than 90 days away." *Id.* (quoting Dean Meadors, spokesman for Mary Kay Cosmetics).

164. *See id.*

165. *See infra* notes 166-67 and accompanying text.

166. I.R.C. § 163(a) (1985).

167. *See* Greenwald, *supra* note 5, at 55. As a case in point, the recent activity of Goldome may be examined. Goldome has 17 dealmakers who specialize in leveraged buyouts mainly for tax reasons. *N.Y. Times*, Nov. 10, 1985 § 3 (Business), at F9, col. 1. Goldome is such a partner. *Id.* In the last 18 months, Goldome participated in 20 such deals. *Id.* The targets are companies with annual sales of between \$70 million and \$140 million. *Id.*

Goldome sets up subsidiaries that make highly leveraged equity investments in the target companies . . . . [T]he bank could ultimately earn \$100 million on a \$1 million investment. Under a typical transaction, in return for its equity investment, 90 percent of the company's profits are allocated to Goldome for the first five years, and 10 percent for the next 25 years. But in the first five years, Goldome receives no cash, although it can include the allocated profits in the bank's net income. It need not pay taxes on that income, however, because it can charge those profits against Goldome losses from previous years.

*Id.* Ten million dollars of such profits were included in Goldome's net income in 1984, and that figure was expected to double in 1985 and reach \$35 million in 1986. *Id.*

## B. Fiduciary Duty and the Equal Treatment of Security Holders

It is an accepted tenet that corporate directors and other managers are fiduciaries, and therefore, must behave in an upright manner toward the beneficiaries of fiduciary duties.<sup>168</sup> Fiduciary principles restrict the ability of corporate managers to line their own pockets at the security holders' expense.<sup>169</sup> They also encompass anti-theft directives and constraints on conflicts of interest.<sup>170</sup> It is argued that management buyout transactions "may violate management's fiduciary obligation to administer corporate affairs for the exclusive benefit of the corporation and the corporation's shareholders."<sup>171</sup>

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168. See *Singer v. Magnavox Co.*, 380 A.2d 969, 976-77 (Del. 1977), *overruled on other grounds*, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983). See generally *Brudney*, *supra* note 6, at 1114 ("investors have reason to expect equal treatment in distributions or reorganizations which are simply internal reshuffles, it would take a powerful case of net social gain to justify denying such treatment"); *Brudney*, *A Note on Going Private*, 61 VA. L. REV. 1019, 1021 (1975) (fiduciary strictures governing behavior of management and controlling stockholders apply to going private transactions) [hereinafter cited as *A Note on Going Private*]; *Coffee*, *supra* note 147, at 1150 ("fiduciary duties are typically enforced through derivative actions . . ."); *Easterbrook & Fischel*, *supra* note 6, at 700 ("[c]orporate directors and other managers are said to be fiduciaries, who must behave in certain upright ways toward the beneficiaries of fiduciary duties"); *Going Private*, *supra* note 6, at 914 ("[a]n insider's fiduciary duty prevents him from exercising corporate powers, no matter how absolute on the surface they are, if the effect is simply to enrich himself at the expense of the minority").

169. *Easterbrook & Fischel*, *supra* note 6, at 700.

Fiduciary principles govern agency relationships. An agency relationship is an agreement in which one or more persons (the principal) delegates authority to another person (the agent) to perform some service on the principal's behalf. The entire corporate structure is a web of agency relationships. Investors delegate authority to directors, who subdelegate to upper managers, and so on.

*Id.*

170. *Id.* at 702.

171. *Corporate Morality*, *supra* note 46, at 1017 (footnote omitted); see *United States v. Byrum*, 408 U.S. 125, 137-38 (1972) (majority shareholders and corporate directors owe fiduciary duty to all shareholders not to misuse power by promoting personal interests); *Manufacturers Trust Co. v. Becker*, 338 U.S. 304, 312 (1949) (standard of loyalty that will prevent conflict of interest from arising must be applied by courts to corporate fiduciaries); *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943) (Court insists on "scrupulous observance" of management's fiduciary obligations). State law generally governs the fiduciary obligations of officers of corporations. See *Hausman v. Buckley*, 299 F.2d 696, 702-03 (2d Cir.) (court refers to laws of state of incorporation to determine fiduciary obligations), *cert. denied*, 369 U.S. 885 (1962). States have strictly construed statutes mandating management's fiduciary duty to the corporation and the corporation's shareholders. See, e.g., *Herald Co. v. Seawell*, 472 F.2d 1081, 1094 (10th Cir. 1972) (under Colorado law, corporate officers function as agents of corporation and thereby stand in quasi-fiduciary relation to shareholders); *Talbot v. James*, 259 S.C. 73, 82, 190 S.E.2d 759, 764 (1972)

The argument stands for the proposition that even if the best interests of the corporation's security holders are served by going private, the dual role of buyer and seller which management plays is suspect because there is a conflict between management's obligation to obtain the highest price available for public shareholders and the interest of management in acquiring the corporation for the lowest price available.<sup>172</sup> The greatest possible conflict arises when management unilaterally sets the price of sale and repurchase.<sup>173</sup> Nevertheless, serious questions regarding the propriety of the management buyout process have been raised.<sup>174</sup> Judge Easterbrook and Professor Fischel suggest a large scope in determining to whom the fiduciary duty is owed.<sup>175</sup> They urge that corporate fiduciaries should seek to maximize shareholder wealth generally and not just to maximize the returns to their specific shareholders.<sup>176</sup> The breadth of fiduciary duty that such an argument calls for would create a situation where corporate directors could not pursue a gain if its realization would impose greater costs upon society.<sup>177</sup> Thus, one can see why "[t]his line of argument quickly converts the corporate director into an unelected and unaccountable public servant."<sup>178</sup>

One aspect of fiduciary duty is the equal treatment of investors, and both statutory law and case law undoubtedly mandate that equal

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(corporate officers stand in fiduciary relationship to shareholders); *Shermer v. Baker*, 2 Wash. App. 845, 851, 472 P.2d 589, 593-94 (1970) (fiduciary duty of corporate officers requires utmost good faith and undivided loyalty to corporation and every shareholder).

172. See *A Note on "Going Private," supra* note 168, at 1029-30; *Corporate Morality, supra* note 46, at 1017-18.

173. This is the case of "one-step" and "two-step" mergers. One and two step mergers that eliminate public shareholders are referred to as either "takeout mergers" or "freezeouts" since these transactions give management the ability to compel minority shareholders to accept cash rather than an equity interest in the newly formed corporation. See *Corporate Morality, supra* note 46, at 1019-20. For a further discussion of "one-step" and "two-step" merger transactions, see *supra* notes 143-46 and accompanying text.

174. See *supra* notes 17-19 and accompanying text.

175. See *Easterbrook & Fischel, supra* note 6, at 711-15 (fiduciary duty is owed to market generally). *But see Coffee, supra* note 147, at 1216-21 (the logic underlying proposed radical reformulation of fiduciary duties is flawed).

176. See *Easterbrook & Fischel, supra* note 6, at 708-15. *But see Chiarella*, 445 U.S. at 230 (violations of section 10(b) must be "premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction"). For a further discussion of *Chiarella*, see *supra* notes 98-106 and accompanying text.

177. See *Coffee, supra* note 147, at 1217. "Such a rule, if intended, might also deny directors the ability to close or relocate an industrial plant if the private gains were less than the social loss." *Id.*

178. *Id.*

amounts or values be distributed, per share, to security holders of a single class upon dissolution of the enterprise.<sup>179</sup> The form of the argument is in three steps: (1) "fiduciary principles require fair conduct;" (2) "equal treatment is fair conduct; hence," (3) "fiduciary principles require equal treatment."<sup>180</sup> The conclusion, however, does not follow.<sup>181</sup>

[I]f the terms under which the directors obtain control of the firm call for them to maximize the wealth of the investors, their duty is to select the highest-paying venture and, following that, to abide by the rules of distribution. If unequal distribution is necessary to make the stakes higher, then duty requires inequality.<sup>182</sup>

In a leveraged/management buyout transaction, it is argued that "[f]air treatment of the displaced stockholders requires not only that

179. See *Brudney*, *supra* note 6, at 1079; see, e.g., N.Y. BUS. CORP. LAW § 502(b) (McKinney 1963) (requiring a "ratable" payment of preferred shares in liquidation); *Kellogg v. Georgia-Pacific Paper Corp.*, 227 F. Supp. 719, 722 (W.D. Ark. 1964) (after providing for corporate debts and liabilities, remaining assets should be distributed in cash or in kind to former stockholders in proportion to their stock ownership); *Zimmermann v. Tide Water Associated Oil Co.*, 61 Cal. App. 2d 585, 143 P.2d 409, 412 (1943) (legislature, through silence, has decided that minority shareholders cannot be compelled to accept cash for their interests upon voluntary dissolution of corporation); G. SEWARD & W.J. NAUSS, JR., *BASIC CORPORATE PRACTICE* 273 (2d ed. 1977) ("[i]n the majority of jurisdictions, no appraisal remedy is provided in the event of dissolution; and stockholders share proportionately in the net corporate assets remaining after the satisfaction of creditors and liquidation preferences and other rights").

180. See *Easterbrook & Fischel*, *supra* note 6, at 703.

181. *Id.* For example:

A corporation may choose to invest its capital in one of two ventures. Venture 1 will pay \$100, and the returns can be divided equally among the firm's investors. Thus, if there are 10 investors in the firm, the expected value to each investor is \$10. Venture 2 will pay \$150, in contrast, but only if the extra returns are given wholly to five of the ten investors. Thus, five "lucky" investors will receive \$20 apiece, and the unlucky ones \$10. Because each investor has a 50 percent chance of being lucky, each would think Venture 2 to be worth \$15. The directors of the firm should choose Venture 2 over Venture 1 because it has the higher value and because none of the investors is worse off under Venture 2.

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

*Id.* at 703-04.

182. *Id.* at 704. For an example where *ex post* inequality would be both fair and desirable, see *supra* note 181.

they be given the value they are compelled to surrender but also that they be given a share of the increment or of the opportunity which the insiders acquire by forcing them out."<sup>183</sup>

This argument is useful, but ultimately it is misleading. The fiduciary principle provides that gains realized from corporate control transactions need not be shared as long as each investor receives compensation equalling what he had before.<sup>184</sup> Generally, the fiduciary principle is satisfied if investors do not suffer a loss, even though some investors receive a premium over the market price of their securities.<sup>185</sup> Several commentators claim that the fiduciary principle should be interpreted "as *not* permitting insiders unilaterally to condemn the stock of public investors . . . no matter how high the condemnation price."<sup>186</sup> These same commentators, however, offer no specific explanation as to why security holders should be forced to hold onto their securities when they can realize financial gains as a result of a value-increasing going private corporate control transaction.<sup>187</sup>

### C. Rule 13e-3

Rule 13e-3,<sup>188</sup> which has been adopted by the SEC, addresses the going private, leveraged buyout, and management buyout phenomena.<sup>189</sup> As originally proposed, the Rule would have required that a going private transaction be procedurally and substantively fair to minority shareholders.<sup>190</sup> The substantive aspect of this regulation

183. See *A Note on Going Private*, *supra* note 168, at 1025; *cf.* *Ervin v. Oregon Ry. & Navigation Co.*, 27 F. 625, 632 (S.D.N.Y. 1886) (minority stockholders "may justly complain because the majority, while occupying a fiduciary relation towards the minority, have exercised their powers in a way to buy the property for themselves, and exclude the minority from a fair participation in the fruits of the sale"), *appeal dismissed*, 136 U.S. 645 (1890); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Take Overs*, 88 HARV. L. REV. 297, 298 (1974) ("the parent stands in a fiduciary relationship to the subsidiary's public stockholders, which creates a special obligation to deal fairly with them when acquiring their interest"). *But cf.* *Christiana Sec. Co.*, SEC Investment Co. Act Release No. 8615, [1974-75 Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 80,054 (Dec. 13, 1974).

184. See Easterbrook & Fischel, *supra* note 6, at 731.

185. See *id.*

186. Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1367 (1978) (emphasis in original).

187. See Easterbrook & Fischel, *supra* note 6, at 730.

188. 17 C.F.R. § 240.13e-3 (1985).

189. *Id.*

190. The proposed rule stated: "It shall be unlawful . . . to engage . . . in a Rule 13e-3 transaction unless . . . the Rule 13e-3 transaction is fair to unaffiliated



was greatly criticized because it exceeded the rulemaking authority of the SEC.<sup>191</sup> When Rule 13e-3 was adopted in August, 1979, the purely substantive requirement that the transaction be "fair" was eliminated;<sup>192</sup> however, Rule 13e-3, as adopted, requires "the issuer to disclose whether it reasonably believes the transaction is fair or unfair to minority shareholders."<sup>193</sup>

In disclosing its reasonable belief, an issuer must also disclose, "in reasonable detail," the "material factors" upon which the belief

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security-holders. . . ." SEC Exchange Act Release No. 34-14185, 42 Fed. Reg. 60,090 (1977).

191. See 44 Fed. Reg. 46,736 (1979); HAMILTON, *supra* note 11, at 613; Note, *Regulating Going Private Transactions: SEC Rule 13e-3*, 80 COLUM. L. REV. 782, 783 (1980) [hereinafter cited as *Regulating Going Private*].

192. SEC Exchange Act Release No. 34-16075, 44 Fed. Reg. 46,736 (1979), reprinted in 17 SEC Docket 1449 (Aug. 2, 1979); see *Regulating Going Private*, *supra* note 191, at 783.

193. Schedule 13E-3, item 8(a), 44 Fed. Reg. 46,745 (1979), reprinted in 17 SEC Docket 1466 (Aug. 2, 1979). The disclosure requirements of Rule 13e-3 relating to the fairness of the transaction have been summarized as follows:

2. Substantial information concerning the transaction and those who propose it is also required. This includes the material terms of the transaction and any term or arrangement relating to any security holder of the issuer which is not identical to that relating to other security holders of the same class. The plans or proposals of the issuer or affiliate regarding certain subsequent activities are also required . . .

3. The source and amount of funds or other considerations to be used must be disclosed, along with a statement of all expenses incurred or expected to be incurred, and the disclosure of the provisions of any loan or financing arrangements with respect to the funds to be used as consideration for the transaction. A statement of the purposes of the transaction must be made as well as a discussion of any alternative means which the issuer or affiliate may have considered and the reasons for their rejection. There must be a statement of the reasons for the structure of the transaction and its timing, as well as the effects of the transaction on the issuer, its affiliates and unaffiliated security holders, including federal tax consequences. There is a specific requirement for detailed discussion of the benefits and detriments of the transaction to the various interested parties, with quantification to the extent possible.

4. The fairness of the transaction must be discussed in detail. After receipt of negative comments on earlier Commission proposals that would require that the transaction be fair, the Commission fell back upon its unquestioned right to demand disclosure of material factors pertaining to a proposed transaction, and concluded that fairness was such a factor. Accordingly, the issuer or affiliate must state whether it believes that the transaction is fair or unfair to unaffiliated security holders. Information concerning dissents or abstentions by any director in making this determination must be indicated. Material aspects of the transaction upon which the belief as to fairness is based must be given, including the weight assigned to each such aspect. Various aspects which may be considered include: current market price, historical market prices, net book value, going concern value, liquidation value, the purchase price

is based and the weight assigned to each factor.<sup>194</sup> However, a fairness opinion from an independent financial institution, reflecting a presumption of good faith pursuant to the business judgment standard, serves the fiduciary's purpose of justifying the fairness of the transaction and the fiduciary's conduct in its execution.<sup>195</sup>

Skeptics of Rule 13e-3 have questioned whether it actually protects minority security holders.<sup>196</sup> Several scholars assert that the Rule does not promote the welfare of security holders.<sup>197</sup> One commentator

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paid in previous purchases, any report, opinion or appraisal, and any firm offers for acquisitions by unaffiliated parties. (A proposed amendment would limit this additional detail to transactions which are believed by the issuer or affiliate to be fair to unaffiliated security holders. It would also inquire as to whether or not the issuer has furnished such projections during the preceding eighteen months to a person who has made a loan described in the schedule or to a person who has filed a report, opinion or appraisal described in the schedule, including identification of a person to whom such projections were furnished, a brief description of the reason for furnishing them to the person and the uses to which they were put, and a fair and accurate summary of the projections. If adopted, copies of the projections would be required to be filed as an exhibit to the schedule.)

5. If a report, opinion or appraisal from an outside party has been obtained, disclosure must be made and described, along with any material relationship of the outside party to the issuer or its affiliates. If the report deals with fairness of the consideration, a statement must be made as to whether the issuer or affiliate determined the amount of consideration to be paid or whether the outside party recommended it. A fairly detailed summary of the report must be given. And the report itself must be made available for inspection and copying by any interested equity security holder or his representative.

*Guidelines on Going Private*, *supra* note 12, at 329-30 (Appendix A) (emphasis in original) (footnote omitted).

194. Schedule 13E-3, item 8(b).

Requiring the issuer to disclose the weight assigned to the various factors it considered in arriving at its belief of fairness seems to place a heavy burden on the issuer with little benefit to the shareholder. In many cases it will be impossible to gauge the weight assigned in the decision making process to the various factors, and even if it were possible it seems unlikely that disclosure of the relative importance of the factors to the issuer will aid the shareholders in their own decisionmaking.

*Regulating Going Private*, *supra* note 191, at 785 n.30.

195. See *Corporate Morality*, *supra* note 46, at 1036.

196. See HAMILTON, *supra* note 11, at 614; Easterbrook & Fischel, *supra* note 6, at 729 n.83; *Corporate Morality*, *supra* note 46, at 1035.

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The rule "requires either a statement that the transaction is unfair (which will lead to an injunction under *Singer*) or a statement that the transaction is fair, which can be challenged in federal court as a material and untrue statement. The damned-if-you-do-and-damned-if-you-don't quality of the Rule makes it an obstacle to the achievement of shareholders' welfare."

goes so far as to argue that the broad scope of Rule 13e-3 is not authorized by any statute.<sup>198</sup>

#### **D. Leveraged Buyout, Management Buyout, and Going Private Transactions: The Risks Involved**

As with almost any financial transaction, leveraged buyout, management buyout, and going private transactions involve a certain degree of risk.<sup>199</sup> In the case of management buyouts, management has an incentive to exploit its superior access to information and to purchase its own firm at a bargain price, even when a takeover is not imminent.<sup>200</sup> However, if a hostile takeover is not imminent, management often restrains from engaging in such a buyout because of the enormous financial risk associated with holding an undiversified portfolio which is severely over-invested in a single investment.<sup>201</sup> Moreover, the recent increase in buyouts, in direct correspondence to an increase in takeover threats, suggests that economically attractive opportunities to go private based on material inside information<sup>202</sup> have not been previously exploited by managements.<sup>203</sup>

To explain management buyout transactions by saying that management is acting on inside information has a certain conspiratorial appeal; however, it ignores the fact that inside information can also be a negative factor if future prospects are bleak.<sup>204</sup> In addition, the inside information-conspiracy theory completely overlooks several formidable considerations. First, to arrange the intricate financing, prepare the necessary proxy material and consummate the transaction may take as long as a year.<sup>205</sup> It would be extremely difficult to

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Easterbrook & Fischel, *supra* note 6, at 729 n.83; see *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. 1977), *overruled on other grounds*, *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (going private transactions must meet an "entire fairness" standard and serve valid business purpose) (dictum). The business purpose requirement enunciated in *Singer* has been eliminated. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983).

198. See *Regulating Going Private*, *supra* note 191, at 788-98.

199. See Easterbrook & Fischel, *supra* note 6, at 728 ("[w]hat if the merger results in a loss rather than a gain?").

200. See Coffee, *supra* note 147, at 1196.

201. *Id.* at 1197.

202. See *supra* notes 56-58 and accompanying text.

203. See Coffee, *supra* note 147, at 1197, n.148. For a discussion of the recent increase in buyouts including those whose purpose is to defend against hostile takeovers, see *supra* notes 147-61 and accompanying text.

204. See Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 296 (1983) [hereinafter cited as Lowenstein].

205. *Id.* at 296-97.

keep clandestine any but the most long-term expectations—which are, at best, speculative.<sup>206</sup> Second, the inside information theory ignores the fact that as the rewards of taking a firm private became more and more apparent, institutional investors and major banking firms were drawn in as buyers.<sup>207</sup> One commentator notes that “[t]his fact, increasing institutionalization, and exacting disclosure regulations were simply not conducive to the planning and financing of large company acquisitions by conspiracy.”<sup>208</sup>

#### IV. Recommendations

Although this Note argues that insider trading<sup>209</sup> is an unlikely explanation for the propensity of buyers to engage in leveraged buyout, management buyout, and going private transactions,<sup>210</sup> there are those who disagree.<sup>211</sup> Moreover, there is disagreement as to how such transactions should be treated.<sup>212</sup>

##### A. The Pros and Cons of Leveraged Buyout, Management Buyout, and Going Private Transactions

It has been suggested that current rules be replaced with doctrines of equitable sharing or even absolute bans on the allocation of opportunities to parent corporations or corporate managers.<sup>213</sup> In

206. *Id.* “Indeed, if it consisted of news relating not to the corporation specifically but to the industry as a whole, as is often the case, it would already have made the rounds.” *Id.*

207. *See id.* For an example of exacting disclosure regulations, see the discussion of Rule 13e-3 *supra* notes 188-98 and accompanying text.

208. Lowenstein, *supra* note 204, at 297. “In any event, the businesses that go private generally have dependable cash flows on which debt repayment can be confidently built. They are almost uniformly prosaic businesses rather than ones in which major discoveries or new advantages, other than those achieved by close attention to operations, are likely.” *Id.*

209. For a discussion of the history of insider trading, including pertinent case law as well as arguments that insider trading may be economically beneficial, see *supra* notes 26-134 and accompanying text.

210. *See supra* notes 202-08 and accompanying text.

211. *See, e.g.,* Brudney, *supra* note 6, at 1094 n.60 (“[t]he misuse of inside information in going private transactions is most likely to occur in the case of the smaller companies for which going private is most feasible . . .”); Buxbaum, *supra* note 154, at 533 (“[w]hat remains, other than an explanation suggesting the presence of an organizational surplus which had not previously been reflected in share prices, and which now is used by management to buy out the outside ownership interest?”). *But see* Lowenstein, *supra* note 204, at 296-97 (“the inside information-conspiracy explanation overlooks several considerations”).

212. *See infra* notes 213-18 and accompanying text.

213. *See* Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 679-83 (1974).

fact, several scholars claim that the possibility that management will overreach is so great that only complete prohibition can protect the interests of security holders.<sup>214</sup> Such proposals, however, will deter the undertaking of some value-increasing ventures, or, alternatively, cause them to be undertaken inefficiently.<sup>215</sup>

Conversely, there are those who recommend that the structure of leveraged buyout, management buyout, and going private transactions be left undisturbed.<sup>216</sup> They argue that "the fiduciary principle should incorporate a wealth maximization standard, that an unequal division of gains from corporate control transactions facilitates wealth maximization, and that corporation law almost never requires gain sharing."<sup>217</sup>

There is also one commentator who advocates a more moderate approach. This commentator recommends that leveraged buyout, management buyout, and going private transactions should continue, provided that state courts invoke a test of intrinsic fairness notwithstanding the absence of financial proof of self-dealing by the purchaser.<sup>218</sup>

## B. An Alternative Proposal

In a transaction involving corporate control, certain minimum payments must be given to those investors who are affected by the transaction.<sup>219</sup> Pursuant to these appraisal rights, the investors must receive the equivalent of what they give up, but they should not receive any share of the gain obtained from the change in control.<sup>220</sup> Moreover, the judicial process of financial examination and valuation cannot be guaranteed to produce accurate appraisals.<sup>221</sup>

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214. See Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1023 (1981); see also Easterbrook & Fischel, *supra* note 6, at 733.

215. Easterbrook & Fischel, *supra* note 6, at 733.

216. See *id.* at 698 (those producing gain should be allowed to keep it).

217. *Id.* at 737. "In general, the law is congruent with shareholders' interests in this regard; 'fairness' plays little role in the fiduciary principle, and perhaps it should play none." *Id.*

218. See *Corporate Morality*, *supra* note 46, at 1042 ("[s]ince buyout transactions present a clear potential for self-dealing, state courts should be willing to invoke the intrinsic fairness standard without financial proof of self-dealing to the detriment of minority shareholders").

219. Easterbrook & Fischel, *supra* note 6, at 731.

220. See, e.g., DEL. CODE ANN. tit. 8, § 262(h) (1981) (providing that courts "shall appraise the shares, determining their fair value *exclusive* of any element of value arising from the accomplishment or expectation" of the event giving rise to the appraisal) (emphasis added).

221. See *Corporate Morality*, *supra* note 46, at 1041-42.

Instead, the control group should be allowed to make its offer, which usually will be at a premium over market price.<sup>222</sup> Minority shareholders should be allowed to engage private financial analysts to calculate what they consider to be a fair price while taking into consideration a potential increase in value resulting from the transaction. Both prices may then be submitted to arbitration,<sup>223</sup> with the stipulation that the arbitrator, who would be chosen by both the control group and the minority shareholders, must choose one of the two proffered prices, that is, a figure representing a compromise would be unacceptable. In addition, an arbitrator would be employed only at the request of the minority shareholders, who would have to agree to a ten percent deduction from the control group's original offer should the arbitrator select the control group's figure.

The threat of a ten percent deduction will deter the minority shareholders from seeking arbitration with any figure that is unreasonable or grossly inaccurate. The possibility that an arbitrator may choose a considerably higher figure submitted by the minority shareholders will deter the control group from making any unreasonably low initial offer. The result will be "fairness" without the prohibition of potentially value-increasing transactions.

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222. See Easterbrook & Fischel, *supra* note 6, at 728-31 ("[a] freezeout price above the current market price is no less beneficial to shareholders because the price was once higher, and the person paying the above-market price cannot hope to profit unless the transaction is value-increasing").

223. Under the United States Arbitration Act (Arbitration Act), 9 U.S.C. §§ 1-14 (1982), agreements to arbitrate future disputes are, in general, specifically enforceable. Katsoris, *The Securities Arbitrators' Nightmare*, 14 *FORDHAM URB. L.J.*, 3, 4 (1986) [hereinafter cited as Katsoris]. Arbitration provides the needed advantage of speedy dispute resolution by persons knowledgeable in the area, without excessive costs. See *id.* at 3. In *Wilko v. Swann*, 346 U.S. 427 (1953), the United States Supreme Court concluded that the nonwaiver provision of section 14 of the Securities Act of 1933, in conjunction with the special rights provision of section 12 and the special process and forum provisions of section 22, implicitly repealed the Arbitration Act with regard to securities claims arising under the 1933 Act. *Wilko*, 346 U.S. at 438; Katsoris, *supra* at 6. However, the United States Supreme Court has yet to decide whether the *Wilko* prohibition as to 1933 Act claims also applies to the far more numerous claims by the public under the Securities Exchange Act of 1934. See Katsoris, *supra* at 8. One scholar, in addition to the author of this Note, argues that *Wilko* should not apply to the 1934 Act. *Id.*

Securities arbitration provides a forum for the fair, inexpensive and speedy resolution of disputes. *Id.* at 15. Perhaps it should be the foremost method of settling securities disputes. As one scholar notes, "[i]f that requires some adjustments by the securities industry—so be it." *Id.*

### V. Conclusion

Certainly, leveraged buyout, management buyout, and going private transactions are hallmarks of our modern entrepreneurial system. Banning such transactions because of the risk of exploitation of inside information would be not only irrational, but a solution far worse than the problem.<sup>224</sup> By affording minority security holders a remedy should they feel they are being grossly exploited,<sup>225</sup> value-increasing leveraged buyout, management buyout, and going private transactions will be perpetuated while the principle of fiduciary duty<sup>226</sup> remains untarnished.

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224. See Easterbrook & Fischel, *supra* note 6, at 731.

225. See *supra* notes 219-23 and accompanying text.

226. See *supra* notes 168-87 and accompanying text.