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Sale of Controlling Interest: A Financial Economic Analysis of the Governing Law in the United States and Canada*

*Joshua Ronen***

INTRODUCTION

The major issue addressed in this article is whether a shareholder, holding a controlling interest¹ in a corporation, can sell his ownership to a third party at a premium without the obligation to have the same premium offered to minority shareholders.

“Sale of control” transactions can arise in different situations. These situations are described in detail in an article by Robert Hamilton.²

In essence, the transaction involves a shareowner with de facto control³ of the corporation who agrees to sell his shares to an outsider for an above-market price. Generally, the opportunity to sell is not extended to public shareholders. Typically, the sale agreement additionally provides

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Generally, in the United States purchasers of a controlling stock interest do not have an obligation to offer (nor must sellers secure) the same premium price to minority shareholders of the corporation. In some situations in Canada, such an obligation exists. This Article examines the economic efficiency of these two approaches. The author concludes that notwithstanding some notable deviations in American case law from what is normatively desirable, the American approach comes close to being economically efficient.

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¹ A “controlling interest” is the amount of corporate stock held by the dominant shareholder. The Securities and Exchange Commission defines control as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.” 17 C.F.R. § 230.405(f) (1986). However, determination of who the controlling person is does not depend upon the ownership of any specific percentage of shares and may be highly factual. T. HAZEN, THE LAW OF SECURITIES REGULATION 147 (1985).

² See Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 13 CAN.-U.S. L.J. 229 (1988).

³ De facto control refers to the existence of control in actual fact although not by official recognition.

that the directors designated by the seller are to resign and be replaced by designees of the purchasers. Variations on this framework abound within a wide spectrum of "sale of control" contracts.⁴ However, these variations do not sufficiently alter the basic features of a control transaction to require a change in the mode of analysis presented here. Hence, the analysis will focus on whether, from the standpoint of economic efficiency, the opportunity to sell at a premium made available to a controlling shareholder should be extended to all other shareholders.

A controlling shareholder, by virtue of his voting control, has the ability to install his own designees as directors and officers and thus has control over the operational and informational decisions of the corporation. In other words, the presumption is that he can avail himself of nonpecuniary benefits.⁵

Section I briefly summarizes the governing law in the United States and Canada.⁶ Section II provides the economic perspective underlying the analysis of the transaction as well as the conclusions of the analysis. The primary conclusion is that American case law comes close to being economically efficient.⁷ Section III examines some notable deviations in American case law from what is normatively desirable.⁸ Theories that are used to justify present legal doctrines in the United States and Canada are briefly addressed in Section IV.⁹ With some measure of "poetic license," I speculate in Section V on the possible genesis of the doctrine of "fairness" which seems to lie at the core of the legislative requirements in Canada and essentially require a purchaser to offer the same opportunity to sell shares at a premium above market price to all other shareholders. Section VI concludes the commentary.¹⁰

I. THE LAW GOVERNING "SALE OF CONTROL" TRANSACTIONS IN THE UNITED STATES AND CANADA

Although details of the relevant legal norms are provided by Hamilton¹¹ as well as by Bailey and Crawford,¹² a brief sketch based on their surveys may be useful. In the United States, the general rule is that po-

⁴ See generally Bailey & Crawford, *Constraints and Obligations Relating to the Sale of Control: The Canadian Approach* 13 CAN.-U.S. L.J. 197 (1988) (for such a description of the rich menu in use in Canada); Hamilton, *supra* note 2 (for such a description of the American menu).

⁵ Such nonpecuniary benefits include the prestige of office, personal relations with employees, direction of charitable contributions and use of facilities. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312 (1976).

⁶ See *infra* text accompanying notes 11-27.

⁷ See *infra* text accompanying notes 29-80. An efficient distribution of fixed total quantities of goods is one in which it is not possible through any change in the distribution to benefit one person without making some other person worse off. P. SAMUELSON, *ECONOMICS* 461-62 (10th ed. 1976).

⁸ See *infra* text accompanying notes 80-93.

⁹ See *infra* text accompanying notes 94-102.

¹⁰ See *infra* text accompanying notes 103-04.

¹¹ See generally Hamilton, *supra* note 2.

¹² See generally Bailey & Crawford, *supra* note 4.

tential purchasers of a controlling ownership interest in a corporation may offer whatever price they please for shares and that the controlling shareholders may sell their interest for whatever price they can obtain. Such a transaction can not be attacked on grounds of inherent illegality, discrimination, or impropriety of multiple price structure.¹³ However, liability may be imposed on a seller who turns the control of a corporation over to purchasers who loot the corporation's assets, and so causes losses to the remaining shareholders and creditors. This liability can be more readily imposed if the corporation's assets are readily salable and can be avoided if the seller makes a reasonable investigation of the purchaser.¹⁴

In Canada, common law generally has not imposed any fiduciary duty on majority shareholders or directors of corporations as to minority shareholders, when they "sell control" of the corporation at a premium not generally available to other shareholders.¹⁵ But the Securities Act of 1978 (Ontario)¹⁶ requires a purchaser of a large block of shares in a public company to make an offer to purchase the shares of the corporation's remaining shareholders at equivalent value consideration.¹⁷ The Act triggers the follow-up obligation upon the acquisition of such number of the outstanding voting securities of the target corporation since, when combined with voting securities then owned by the offeror¹⁸ and its associates¹⁹ and by persons acting in concert with the offeror, that number will equal twenty percent or more of the outstanding voting securities in the target corporation.²⁰ A further condition of the obligation is that the price paid be greater than fifteen percent of the average closing prices

¹³ See *Treadway Companies, Inc. v. Care Corp.*, 638 F.2d 357, 376 (2d Cir. 1980); *Essex Universal Corp. v. Yates*, 305 F.2d 572, 576 (2d Cir. 1962).

¹⁴ *Kaster v. Modification Systems, Inc.*, 731 F.2d 1014, 1020 (2d Cir. 1984); *Estate of Hooper v. Government of Virgin Islands*, 427 F.2d 45, 47 (3d Cir. 1970); *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969). See O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. PITT. L. REV. 9, 16-23 (1976); Note, *Jones v. Ahmanson: The Fiduciary Obligation of Majority Shareholders*, 70 COLUM. L. REV. 1079, 1086 (1970).

¹⁵ See F. IACOBUCCI, M. PILKINGTON & S. PRICHARD, *CANADIAN BUSINESS CORPORATIONS* 457-58 (1977).

¹⁶ The Securities Act, 1978, ONT. REV. STAT. ch. 466 (1980).

¹⁷ *Id.* at § 91(1).

¹⁸ "Offeror" means a person or company other than an agent, who makes a take-over bid or an issuer bid and where two or more persons or companies make offers,

(i) jointly or in concert, or

(ii) intending to exercise jointly or in concert any voting rights attaching to the securities acquired through the offers, then each of them shall be deemed to be an offeror if the offer made by any of them is a take-over bid.

Id. at § 88(1)(h).

¹⁹ In general, an "associate" is: (1) any company or person of which such person owns voting securities with more than ten percent of the voting rights of the company, (2) "any partner of that person or company," (3) any trust or estate in which such person or company has a substantial beneficial interest or to which serves as trustee, or (4) any relative of such person who has the same home as such person. *Id.* at § 1(1) ¶ 2.

²⁰ *Id.* at §§ 88(1)(k), 91.

available on the ten business days preceding the purchase plus the transaction costs.²¹ The Securities Act (Quebec), enacted in 1982, contains general takeover bid provisions similar to those in the Ontario legislation.²² Amendments to the 1978 Securities Act, which reflect a consensus reached among the securities administrators of Alberta, British Columbia, Ontario and Quebec and which are based on the Quebec Securities Act, have been proposed and are now under consideration. The primary effect of the proposals will be the adoption of uniform legislation among the provinces. The modifications suggested in these proposals, however, do not alter the basic feature of the Canadian rule for dealing with the control premium: a party acquiring controlling interest must make a similar offer to all public shareholders.²³

Ohio and Pennsylvania have enacted statutes directed at tender offers which also may affect control transactions.²⁴ These statutes make it more difficult to sell controlling interests at a premium without some form of compensation to other shareholders.²⁵ Despite these exceptions, the general rule which allows freedom of transaction without an obligation to offer the same terms to remaining shareholders appears to be widely accepted in the United States.²⁶

Thus, we encounter a contrast between the case law prevalent in the United States and the statutory law applicable in Canada: potential sellers and purchasers of controlling interests in Canada are required to offer

²¹ ONT. REV. REGS. § 163(3) (1980).

²² Securities Act of Dec. 1982, QUE. REV. STAT. ch. 48, § 130-31 (1982). See generally R. FORBES & D. JOHNSTON, CANADIAN COMPANIES AND THE STOCK EXCHANGES § 4000 (1980).

²³ See generally SECURITIES INDUSTRY COMMITTEE ON TAKE-OVER BIDS, THE REGULATION OF TAKE-OVER BIDS IN CANADA: PREMIUM PRIVATE AGREEMENT TRANSACTIONS (1983); SUB-COMMITTEE ON CANADIAN SECURITIES LAWS, CANADIAN SECURITIES LEGISLATION AND THE SALE OF CONTROL (Report to the State Regulation of Securities Committee on the Section on Corporation, Banking and Business Law of the American Bar Association) (1982).

²⁴ See OHIO REV. CODE ANN. § 1701.83 (Baldwin 1985); PA. STAT. ANN. tit. 15, § 1910(G) (Purdon Supp. 1986). The Ohio Control Share Acquisition Act was held unconstitutional in *Fleet Aerospace Corp. v. Aeronca*, 796 F.2d 135 (6th Cir. 1986). My analysis is unaffected by this holding.

²⁵ The Ohio statute, under certain circumstances, allowed shareholders (other than the prospective buyer) to vote on whether to allow the sale of control transaction to proceed. A majority of shares not owned by the buyer would defeat the transaction. OHIO REV. CODE ANN. § 1701.831(E) (Baldwin 1985). According to Hamilton, the statute "may serve to compel the sharing of premiums in control share transactions." See Hamilton, *supra* note 2, at 259.

The Pennsylvania provision requires, in some instances, a controlling shareholder whose voting shares exceed 30% to offer to purchase the shares of other shareholders at a fair price. PA. STAT. ANN. tit. 15, § 1910(G) (Purdon Supp. 1986). For a discussion of this statute, see Hamilton, *supra* note 2, at 260.

²⁶ See, e.g., a report by the Securities and Exchange Commission ("SEC") Advisory Committee on Tender Offers that recommends prohibiting, except under certain circumstances, private sales of control at a premium when the transaction involves more than 20% of the public corporation's voting shares. Reprinted in Fed. Sec. L. Rep. (CCH) ¶ 83,511 (Mar. 28, 1984). According to Professor Hamilton, the recommendation is not likely to be adopted since the SEC has expressed reservations about its desirability. See Hamilton, *supra* note 2, at 258 n.107.

an equal opportunity to the remaining shareholders of the target corporation. In the United States, with the exception of cases of consequent looting,²⁷ sellers and purchasers are free from such encumbrances. It is beyond the scope of this paper to explain this major difference. Undoubtedly, alignments of interest groups and the distribution of power among them were factors responsible for setting in motion a political process that culminated in the Canadian legislation. Instead, primary focus is directed to analysis of the relative economic efficiency of the two rules. A foundation for a normative perspective is set out below.

II. FINANCIAL ECONOMIC ANALYSIS OF THE "SALE OF CONTROL" TRANSACTION

The following analysis of the sale of control transaction assumes a scenario whereby a shareholder with a controlling interest is free to sell his ownership to a purchaser for whatever price he can get, without any legal liability. This scenario is analyzed with respect to both economic efficiency (in the sense of resource allocation) and distribution of wealth among different groups of shareholders. I then consider the potential impact on economic efficiency and wealth distribution of legislation, such as now exists in Canada, which imposes on the purchaser and the seller of the controlling interest an obligation to offer to all other shareholders the same opportunity to sell their shares at the agreed upon price. Finally, I consider the desirability of imposing liability on the seller for losses to remaining shareholders suffered as a result of the looting of corporate assets by the purchaser.

The discussion of both scenarios will proceed in two stages. In the first stage, I examine the genesis of the corporate form of organization when an entrepreneur decides to incorporate and raise capital by issuance of equity securities. In the second stage, I assume that the corporation has matured into a stable equilibrium and examine what happens when a dominant shareholder identifies a purchaser who would potentially offer him a premium above market price in consideration for his ownership interest.

While the second stage is the focus of the analysis, it is important to consider the first stage because both the original entrepreneur and the initial financiers of the corporation's activities are expected to anticipate such a second stage, whereby the dominant shareholder (either the original entrepreneur or his ultimate replacement) sells his interest to an outsider. Because of the existence of such rational expectations, it is important to consider the impact of anticipated sale of control transactions on the pricing of securities issued by the entrepreneur at the first stage as well as on the incentives of the entrepreneur to embark on his venture, which is assumed to have positive net present social value. Thus, after consideration of the first and second stages, attention returns

²⁷ See *infra* text accompanying note 80.

to the first stage to examine the anticipatory incentive effects of the second stage on the first, the formation and financing of the corporation.

The analysis of the first stage below—conducted within a scenario where there is no liability for consequent losses that encumbers the potential sale of control transaction—will draw on Jensen and Meckling's analysis of agency costs.²⁸ However, a different mode of analysis of the scenario is presented whereby one of their major (unrealistic) assumptions is relaxed. Consequently, this analysis points to different conclusions with respect to a manager's incentives to engage in monitoring and bonding activities. The difference between my conclusion and theirs is crucial for the analysis of the potential impacts of sale of control transactions.

A. *The Original Formation and Financing of the Corporation: An Agency Framework*²⁹

Unlike Jensen and Meckling,³⁰ I argue that agency costs will not always be borne by the manager and, therefore, while the manager still has incentives to reduce his share of the agency costs, he will not be motivated to reduce the share borne by the owners. As a result, the monitoring and bonding contracts into which the manager enters will not necessarily give rise to such information flow as would be expected when agency costs are borne totally by the manager.

One of the requirements in Jensen and Meckling's analysis of agency costs borne by the manager is that the market anticipates the agency cost effects.³¹ In other words, prospective minority shareholders and bondholders should be aware that the owner-manager's interests will diverge from theirs. The price they are willing to pay for the shares will reflect the monitoring costs and the effect of the divergence between the manager's interests and theirs. Specifically, if we consider as an example the case of outside equity, the equity holders are assumed to be aware that the owner will increase his nonpecuniary consumption when his ownership share is reduced. But equity holders are not only required to be cognizant of the consequent nonpecuniary consumption—they must also know the owner-manager's response to the change in his ownership.³² Jensen and Meckling do not explain what mechanism will produce such unbiased estimates; what sources, if any, will supply information on the manager's tastes for nonpecuniary benefits; and if there are such sources

²⁸ See generally Jensen & Meckling, *supra* note 5.

²⁹ This subsection is based primarily on material included in Ronen, *The Dual Role of Accounting: A Financial Economic Perspective*, in HANDBOOK OF FINANCIAL ECONOMICS 415 (Bicksler, ed. 1979).

³⁰ See Jensen & Meckling, *supra* note 5, at 319 (“*the decline in the total value of the firm . . . is entirely imposed on the owner-manager*”) (italics in original).

³¹ *Id.* at 313.

³² *Id.* at 318.

of information, whether competitive or monopolistic, what price this information commands.

Indeed, if the equity market holds rational (i.e. unbiased) estimates of the manager's response to reduction of ownership, and if the estimation errors are independent across firms, Jensen and Meckling are justified in concluding that the risk inherent in whatever uncertainties introduced by imperfect knowledge of the owner-manager's response function is diversifiable and that, as a result, equilibrium prices will equal the expected values.³³ A critical issue is, then, how are such unbiased estimates obtained?

Information on the owner-manager's taste for nonpecuniary benefits, and thus on his response to a reduced share in the firm's ownership, can only come from two sources: (1) the manager himself, or (2) observations of the manager's behavior over time and his past responses to reductions in his ownership share. Such observations must be made possible through some kind of monitoring scheme that requires the gathering of information. This can be quite costly, especially if the owner-manager does not cooperate in providing information.

Will the owner-manager, pursuing his own interest, have an incentive to provide correct information on his response function? Arguably, the cost of obtaining information on the owner-manager's response function will reduce the value of the firm and thus increase agency costs to the manager, thereby motivating him to voluntarily provide correct information regarding his response function. But what is encountered in this instance is a moral hazard situation characterized by information asymmetry similar to the one analyzed by Akerlof.³⁴ This asymmetry will cause minority equity owners to bear some of the agency cost.

To illustrate how the agency cost will be shared between the owner-manager and equity holders, consider Figure 1.³⁵

As in Jensen and Meckling's analysis, the F axis reflects the current market value of the stream of manager's expenditures on nonpecuniary benefits and the V axis represents the value of the firm. Line VF represents the constraint which an owner-manager faces in deciding how much nonpecuniary income he will extract from the firm. \bar{OV} is the value of the firm when the amount of nonpecuniary income consumed is zero. The slope of VF is -1 to indicate that one dollar of current value of nonpecuniary benefits withdrawn from the firm by the manager reduces the market value of the firm by one dollar. The convex indifference curves³⁶ (U_1 , U_2 and U_3) represent possibilities of the "true" tradeoff

³³ *Id.*

³⁴ See Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 490-92 (1970). See also *infra* note 64 and accompanying text.

³⁵ See Ronen, *supra* note 29, at 421 (original version of this graph).

³⁶ Generally, the indifference curve is a graphic representation of the various combinations of two goods which yield the same level of satisfaction to the consumer. See P. SAMUELSON, *supra* note 7, at 443-44. In this context the indifference curves represent the combinations of the value of the

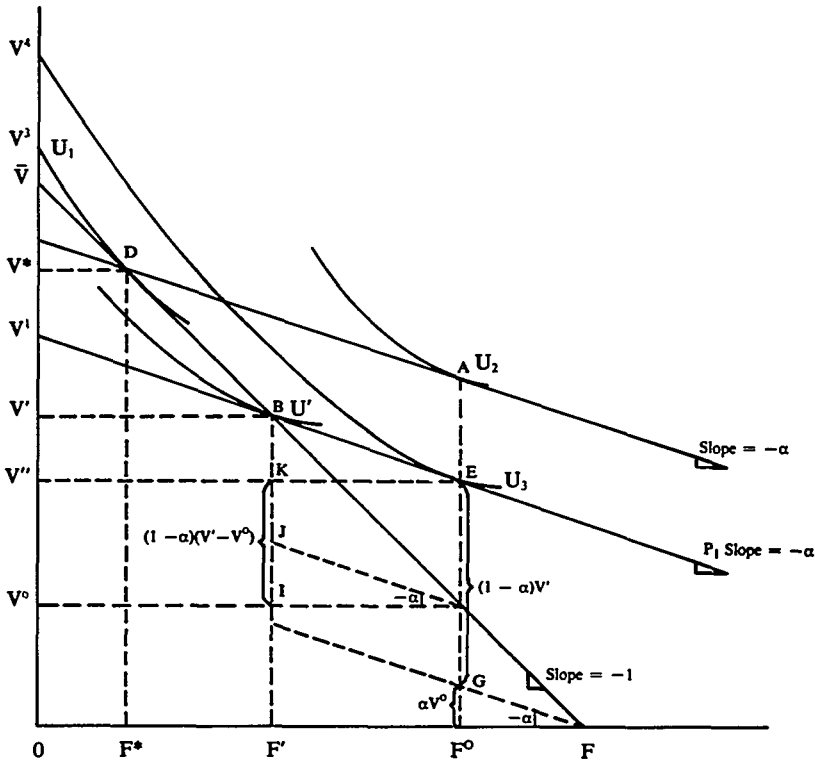


FIGURE 1. The value of the firm (V) and the level of nonpecuniary benefits consumed (F) when the fraction of outside equity is $(1 - \alpha)V$. U curves represent owner's indifference curves between wealth and nonpecuniary benefit.

between pecuniary (firm value) and nonpecuniary benefits—known only to the owner-manager himself.

Assume that U' belongs to the map of indifference curves of which U_1 is also a member, erroneously attributed to the owner-manager by the equity holders. Thus, equity holders, attributing to the owner-manager preferences that differ from his "true" tastes, will derive a biased estimate of the change in F triggered by a reduction in the owner's share of the firm.

When the manager is the sole owner, the value of the firm is V^* and the level of nonpecuniary benefits consumed is F^* . Now, suppose the owner-manager (in need of cash to invest in a lucrative newly discovered opportunity or to diversify) sells a fraction $(1 - \alpha)$ of the firm ($0 \leq \alpha \leq 1$) to an outsider and retains for himself the share α .³⁷ The cost to the

firm (V) and the level of nonpecuniary benefits consumed (F) which yield the same level of satisfaction to the controlling shareholder.

³⁷ " α " represents the percentage of shares held by a shareholder, represented in decimal form.

owner-manager of consuming one dollar of nonpecuniary benefits is now $\alpha \times \$1$.

It is easy to show that the new equilibrium will be at point B, where the indifference curve U' , believed by equity owners to characterize the owner-manager's taste for nonpecuniary benefits, is tangent to the line V_1P_1 with slope $-\alpha$, such that B lies on the budget line³⁸ $\bar{V}F$. Equity-holders will agree to pay $(1 - \alpha)V'$, where V' corresponds to the point B. The owner-manager is assumed to know that equity-holders attribute to him indifference curve U' . Therefore, if the tangency point is to the left of B on $\bar{V}F$, he will demand more than $(1 - \alpha)V'$ and, if the tangency point is to the right of B, the equity-holders will want to pay less than $(1 - \alpha)V'$.

Based on the adverse selection and information asymmetry argument, however, the owner-manager's consumption of nonpecuniary benefits will be at the point F^0 , corresponding to the value V^0 , where $V' \geq V^0$. The total agency cost is thus $V^* - V^0$; however, the owner-manager's share of the agency cost will be only $V^* - [\alpha V^0 + (1 - \alpha)V']$. The owner-manager's share is represented by the distance $V^* - V''$ where OV'' is composed of the segment $F^0G = \alpha V^0$ and the segment $GE = (1 - \alpha)V'$. The outside equity-holders will now bear a portion of the agency cost amounting to $(1 - \alpha)(V' - V^0)$. This share is represented by the distance $V'' - V^0 = IK = JB$. Actually, in this particular illustration, in spite of the residual loss to the owner-manager of $V^* - V''$, he gains a net increment in welfare as reflected in the distance $V^4 - V^3$, the difference between the intercepts on the y-axis of the two indifference curves U_3 and U_1 . The fact that the owner-manager experiences a net gain in welfare in spite of his pecuniary residual loss is due to the increase in his consumption of nonpecuniary benefits ($F^0 - F^*$).

The situation illustrated in Figure 1 represents an adverse selection potential.³⁹ It is easy to draw an analogy with Akerlof's analysis of the market for "lemons."⁴⁰ Owner-managers would not have an incentive to

³⁸ The budget line represents and identifies all of the possible options from which can be chosen the value of the firm (V) in relation to the level of nonpecuniary benefits (F) to be consumed.

³⁹ Adverse selection is defined here as the process by which a manager of a firm will strive for personal economic efficiency and will base his decisions for the firm on these personal goals.

⁴⁰ In Akerlof's model, he imagines that there are just four kinds of cars: new or used and good or bad. The individuals in the market buy a new car without knowing it will be good or a "lemon" (bad). The individuals know with probability q it is a good car and with probability $(1-q)$ it is a lemon (q is the proportion of good cars and $(1-q)$ is the proportion of lemons). After owning the car for a period of time, the owner has a good idea about the quality of the car and thus can assign a new probability to whether his car is a lemon. This estimate is more accurate than the initial estimate. An asymmetry in information has developed because the sellers now have more knowledge about the quality of a car than the buyers. But, because buyers cannot tell the difference in quality, good cars and bad cars must sell at the same price.

It is apparent that a used car cannot have the same valuation as a new car—if it did have the same valuation, it would clearly be advantageous to trade a lemon at the price of a new car, and buy another new car, at a higher probability of being good and a lower probability of being bad.

provide correct information about their tastes to potential purchasers of the firm's equity securities. The owner-manager will act like the seller of used cars in Akerlof's model: since potential buyers do not have the information on the manager's tastes for nonpecuniary benefits, the owner-manager has an incentive to sell poor quality securities because the return for good quality securities accrues mainly to the entire group and not to the individual seller. In other words, the manager with a greater taste for nonpecuniary benefits will be selling an inferior security—a "lemon"—to a potential investor uninformed about this particular manager's tastes. As a result, the average quality of securities sold in the market will decrease as will the size of the market for securities.

To see how the analogy with Akerlof's analysis holds, one need merely substitute securities for used cars. The security of a company whose manager has little taste for nonpecuniary benefits would resemble the "good car"; the security of a company whose manager has a great taste for nonpecuniary benefits would resemble the "bad car" or "lemon". Groups in society are characterized by a utility that is a function of the quality of the securities. It is only necessary to add the plausible assumption that utility functions of different groups in society differ in the weight attached to security quality and Akerlof's conclusions automatically follow. Clearly, there are arrangements in the American capital market that minimize the adverse selection bias. As I argue below, one such arrangement is the regulation of the securities market by the Securities and Exchange Commission ("SEC") and the mandatory disclosure and filing requirements imposed on managers of publicly held corporations.

If equity holders were able to estimate unbiasedly the manager's response function, there would be a situation in which the information is symmetrical and the anomalies encountered in the case of information asymmetry would not arise. The analysis of information asymmetry therefore leads to the conclusion that trades may not occur in spite of the fact that there are given prices at which some owner-managers would be willing to issue securities and at which there would be buyers willing to purchase them. This happens due to the existence of poor quality securities that drive the price below that at which the high quality security suppliers are willing to sell. These adverse effects on trade may well have been one of the underlying factors behind the establishment of the securities law and the regulation of information disclosure. The arguments underlying the disclosure rules and securities regulations typically cite facilitation of trade and the building of public confidence in the securities market.⁴¹

Akerlof, *supra* note 34, at 489.

Thus, the owner of a good car is locked in; he cannot receive the true value of his car, nor can he obtain the expected value of a new car. Thus, there is a market for lemons! *Id.*

⁴¹ President Franklin D. Roosevelt remarked about the Securities Act of 1933:

It [the Securities Act] puts the burden of telling the whole truth on the seller. It should

Will private institutions come into being in an unregulated market to limit or even eliminate the adverse selection element inherent in the agency relationship? We have seen that the cost of adverse selection (or the cost of dishonesty) lies not only in the potential amount by which a given purchaser is cheated, but also in driving legitimate businesses out of existence. As in Akerlof's "lemons" model, the presence of owner-managers who are willing to offer inferior goods "represents the major cost of dishonesty."⁴² The purchaser's problem is to identify the quality of the securities, that is, the earning streams underlying those securities. In the agency costs case, the purchaser's task is to identify the manager's response function to a reduction of his share in the ownership of the company.

One might expect private institutions to counter these adverse selection effects. Such efforts would be consistent with the lobbying for monitoring legislation, such as that which was included in the Securities Acts of 1933 and 1934, and for the establishment of a government agency such as the SEC that mandates specific categories of disclosure. In the market for goods, Akerlof mentions some private institutions such as prior guarantees, brand names, nationwide chains and licensing practices.⁴³

In the corporate securities market, similar institutions exist to ameliorate selection imperfections. One is the audit institution. Managers with little taste for perquisites will want to advertise this fact to potential shareholders in order to enhance the value of the shares they issue. They will want neutrally objective auditors to guarantee the truth of these assertions, especially at the expense of false claims by rival corporate spendthrifts. Self-interest rather than mandatory rules drives this hiring of auditors.

Purchasers must be assured of the value of these attestations. Branding (differentiating one's service through training and other activities that build reputation), establishing professional associations with the threat of revocation of the membership, granting licenses which can be

give impetus to honest dealing in securities and thereby bring back public confidence. The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business. This is but one step in our broad purpose of protecting investors and depositors.

H.R. REP. NO. 85, 73d Cong., 1st Sess., at 1-2 (1933).

⁴² See Akerlof, *supra* note 34, at 495-96.

The presence of people in the market who are willing to offer inferior goods tends to drive the market out of existence—as in the case of our automobile "lemons." It is this possibility that represents the major cost of dishonesty—for dishonest dealings tend to drive honest dealings out of the market. . . . The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.

Id. at 495.

⁴³ Akerlof, *supra* note 34, at 499-500. Examples of nationwide chains are hotel and restaurant chains. Licensing practices include the licensing of such groups as doctors, lawyers and barbers. *Id.* at 500.

withdrawn, and setting standards, noncompliance with which would trigger review and rebuke, all represent arrangements designed to enhance credibility in the audit process. Without such arrangements, the auditors' pursuits of their own self-interests may induce them to collaborate with the "poor quality" management.

Management must also consider the litigation costs associated with potential suits brought by stockholders, regulatory authorities and others. For these penalties to be effective, however, the threat of their enforcement must be real. The enforcement arm of the SEC is now entrusted with this enforcement task. This particular regulatory function, therefore, may have been created to buttress the private, self-regulatory institutions spawned by the market's need to minimize the costs of adverse selection.

In addition to the hiring of auditors, a manager might attempt to signal credibility through such mechanisms as increasing debt,⁴⁴ or voluntary bonding through private contracts (such as a commitment to pay up to specified amounts to the corporation if the manager does not perform in accordance with his promises). The first signaling mode is costly, however, because of the increased agency cost of debt. The second may not be sufficient to induce honest promises and adequate performance (contractually specified penalties are bound by personal endowment, including human capital). Hence, signaling may not be as effective an arrangement for mitigating adverse selection as regulatory functions.

The market for professional managers, which monitors their performance record to evaluate their skill and integrity for potential future employments, has been cited as yet another effective mechanism for weeding out the incompetent and the cheat.⁴⁵ Will the anticipation of ex post settling up in the market for managers be a sufficiently credible deterrent to mitigate adverse selective effects?⁴⁶ Probably not. There is an abundance of managers with short-term horizons or who, anticipating retirement from professional management (and seeking haven in other countries!), may find that their diversion of corporate assets more than offsets the long-term impact of their reputation loss. The anticipation of such possibilities by investors may militate against the elimination of adverse selection effects.

To ensure the efficient operation of the private institutions that emerge to minimize the adverse selection effects, enforcement procedures are necessary. The particular set of required procedures depends on the setting and the relative costs and benefits. Optimal procedures may vary

⁴⁴ See Ross, *The Determination of Financial Structure: The Incentive-Signaling Approach*, 8 BELL J. ECON. 23, 26 (1977).

⁴⁵ See Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 292-95 (1980).

⁴⁶ See *id.* at 297-98.

from country to country, depending upon economic, cultural, and other societal characteristics. Peer pressure and withdrawal of recognition may suffice in some countries, but regulation may be necessary in others. Careful cost-benefit analysis is required before imposing a regulatory enforcement procedure. Regulatory rule setting may not be the most efficient social arrangement to mitigate a particular market failure such as adverse selection in the issuance of securities. Economic analysts and other theorists continue to search for more efficient social arrangements.

A normatively sensible and relatively efficient rule of law that is to govern the sale of control transaction should be subjected to these same efficiency criteria. The fiduciary duty principle of corporate law and the liabilities that can be imposed under the rules and regulations promulgated by the SEC upon evidence of impropriety, dishonesty or "misleading" reporting can themselves be considered social arrangements created to minimize adverse selection costs. I argue that the freedom to sell controlling interest to a third person by a dominant shareholder potentially creates an adverse selection problem similar to the one introduced by the combination of a passion for the consumption of nonpecuniary benefits and informative asymmetry in the market for first issues of securities.⁴⁷

At this point, it is useful to note how relaxing the assumption of information symmetry in the Jensen and Meckling analysis produces an importantly different characterization of the behavior of the system. Under their analysis, *every* manager engages in an "efficient" consumption of nonpecuniary benefits and of monitoring and bonding activities, consistent with his preferences and the pricing of the securities he issues.⁴⁸ Under my analysis, there are managers who would transfer wealth to themselves from potential stockholders due to information asymmetry. The market would respond to this possibility by setting deterrents that drive such "bad" managers out of the market. The need for such deterrents is consistent with the corporate and securities rules of law that we observe today.

The second stage of analysis which involves the impact of sale of control introduces a change of terminology and a broadening of the scope of the adverse selection phenomenon. First, the manager's skills, i.e., his competence to do the job, should be introduced. The simplest way to do this is to redefine the horizontal axis of Figure 1 to include the combined outcome to be measured in terms of current value of benefits withdrawn from the firm by the manager consuming the nonpecuniary benefits and the level of skill the manager applies to his task. Thus, V is redefined to be the maximum value of the firm consistent with zero consumption of nonpecuniary benefits and the maximum possible level of skill. As we move to the right on the horizontal axis, the consumption of nonpecuniary benefits increases or the skill level decreases. Any point on

⁴⁷ See *supra* notes 31-32 and accompanying text.

⁴⁸ Jensen & Meckling, *supra* note 5, at 319.

the x-axis thus will reflect a unique combination of skill level and consumption of nonpecuniary benefits. Recognizing that (1) in addition to possessing superior information about their preferences for nonpecuniary benefits, managers also possess superior information about their skill level, and (2) managers lie on a continuum with respect to the combined outcome of a decrement in the value of the firm as a result of the combinations of skill and preference for nonpecuniary benefits that characterize them, the results of the analysis with respect to the creation of adverse selection follow in their entirety without modification.

Second, at the cost of linguistic inaccuracy, I shall refer to the combined outcome of skill and consumption of nonpecuniary benefits as "looting." This term is used by the pertinent case law⁴⁹ and consistency of usage will help elucidate the development of a "normative" rule of law. Thus, the x-axis of Figure 1 will be understood to measure the extent of "looting" (denoted by L). Note that loss of value due to incompetence is subsumed under "looting" even though the loss does not result from any "evil" intentions on the part of the manager. Any decrement of firm value, whether resulting from incompetence or from consumption of nonpecuniary benefits, will be considered as "looting." These modifications set the groundwork for the second stage of the analysis.

B. The Impact of "Sale of Control"

Regardless of whatever market mechanisms came into existence in the first stage, some equilibrium which is contingent on the institutional arrangements will have emerged. A corporation has been created and now exists. We take a leap in time and now consider a mature corporation with a dominant shareholder owning a controlling interest. Whatever combinations of managerial incentives were created by private contracts between owners and the managers designated by the controlling shareholder, whatever the statutory, regulatory or common law penalties imposed on management for impropriety, we expect to observe within this corporation an equilibrium amount of looting (denoted by L^*). Also, contingent on the existing institutional and judicial arrangements, it is plausible to assume that the price at which the corporation stock is traded reflects L^* . Markets are expected to be semi-strong efficient, and prices would reflect whatever information about L^* may become publicly available under existing disclosure rules, liabilities for misrepresentation, audit procedures and other monitoring mechanisms.

As indicated above, this equilibrium amount of looting, L^* , reflects a particular combination of skill level (relative incompetence) and consumption of nonpecuniary benefits. If the dominant shareholder sells his controlling interest to a third party, he simultaneously sells his opportu-

⁴⁹ See *Kaster v. Modification Systems, Inc.*, 731 F.2d 1014, 1020 (2d Cir. 1984); *Doleman v. Meiji Mutual Life Ins. Co.*, 727 F.2d 1480, 1483 (9th Cir. 1984); *Dan River, Inc. v. Icahn*, 701 F.2d 278, 291 (4th Cir. 1983).

nity to loot and commands a premium above market price to reflect the additional utility of consumption of nonpecuniary benefits. Referring to Figure 1, suppose that the "true" indifference map of the dominant controlling shareholder is one that includes U' (that is, assume there is information symmetry between the owners and manager regarding skill and preferences). Then the total utility level of the dominant shareholder will be such that its monetary equivalent equals the intercept of U' with the y-axis. The difference between this intercept and V' will represent the minimum premium the dominant shareholder will demand as consideration for his controlling interest; that is, for his opportunity to loot. He will not be willing to part with his controlling interest at the prevailing market price, which does not reflect the ability to loot and its consequent higher level of utility.

What about the potential purchaser? The premium he will be willing to pay depends on his particular skill and taste for nonpecuniary benefits. In this regard, one must recognize that potential purchasers of "control" differ from each other with respect to both their passion for nonpecuniary benefits and their skill.⁵⁰

A purchaser who is more skillful than the existing management could (but need not necessarily) increase the value of the firm and thus benefit noncontrolling shareholders even when the premium is totally appropriated by the seller of "control." Such a potential purchaser will necessarily improve the lot of noncontrolling shareholders if his utility function is such that he will engage in an amount of looting that is less than or equal to the amount of looting by existing management. Depending on his benefit-preference characteristics and the degree to which his skill exceeds that of existing management, he might even improve the lot of noncontrolling shareholders even if he consumed more nonpecuniary benefits than existing management. Such a potential purchaser will be willing to pay a premium above market price which does not exceed the monetary equivalent of the increment in utility he would enjoy as a result of the joint outcome of the value he can create (due to his superior skill) and his preferred consumption of nonpecuniary benefits. To the extent that the maximum premium the potential purchaser will be willing to pay for a controlling interest exceeds the minimum premium the potential seller will demand, a voluntary, mutually beneficial transaction will emerge. And, to the extent that the purchaser possesses either superior skill or consumes fewer nonpecuniary benefits, so as to create more value for noncontrolling shareholders than existing management, all parties will benefit; there will be no need to demand that the purchaser offer, or the seller secure, the same premium to noncontrolling shareholders.

Some aspects of this analysis have been captured by Easterbrook and Fischel:

⁵⁰ Their skill is the maximum value they can attain for the firm if they were to consume no nonpecuniary benefits.

The sale of a control block of stock, for example, allows the buyer to install his own management team, producing the same gains available from a tender offer for a majority of shares but at lower cost to the buyer. Because such a buyer believes he can manage the assets of a firm more profitably, he is willing to pay a premium over the market price to acquire control. The premium will be some percentage of the anticipated increase in value once the transfer of control is effectuated.⁵¹

But this is only part of the story. The increase in the market value of the firm after the sale of controlling interest may be attributed not only to the superior skill of the purchaser in managing assets more profitably, but also to a lower taste for nonpecuniary benefits (as compared to existing management). To the extent that the potential purchaser consumes fewer nonpecuniary benefits than existing management, the value of the firm will increase and noncontrolling shareholders will benefit even if the purchaser's skill is either equal to (or perhaps less than) that of existing management. Why, however, will a potential purchaser be willing to pay the minimum premium requested by the seller when he, in fact, engages in less "looting" than the seller? It is conceivable that a purchaser with both lower skill and lower preference for nonpecuniary benefits (which decrease firm value) would be willing to pay a premium above market price for a controlling interest, for example, when the mere ability to control or to hold a high executive office by virtue of such control (such as serving as chairman of a prestigious and powerful board of directors) is a direct source of utility enhancement, even without actual consumption of nonpecuniary benefits of the kind that cause a decrement in the value of the firm.

Easterbrook and Fischel seem to recognize this possibility: "In a few instances changes in control may be attributable to self-aggrandizement of buyers rather than to gains in the use of the acquired firms' assets."⁵² However, if the passion for control is what the authors refer to as self-aggrandizement, it need not preclude the production of gains in the use of the acquired firm's assets. Such gains can indeed come about by the consumption of fewer nonpecuniary benefits. And even if the level of nonpecuniary benefits consumed is the same as existing management, noncontrolling shareholders will suffer no loss as a result of the sale transaction.

We also must consider the case of potential buyers who have the same or lower skill than existing management but for whom "control" holds the lure of greater consumption of nonpecuniary benefits than existing management. Such buyers will engage in a higher level of looting than existing management and, hence, be "overlooters" (their L exceeds L*). They also will be willing to pay a premium to the extent that their rate of substitution between nonpecuniary benefits and monetary wealth

⁵¹ Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 705 (1982).

⁵² *Id.* at 707.

yields a level of utility which exceeds the utility foregone by the payment of premium to the seller. Once control is acquired, even one-time overlotters will cause a decrement in the value of the firm and consequent losses to the noncontrolling shareholders. Of course, there are cases where controlling shareholders sell to an overlooter.⁵³ Sale to "overlotters" will cause redistribution of wealth from noncontrolling shareholders to the purchaser and to the seller.⁵⁴ Unlike the case in which securities are first issued by an owner-manager⁵⁵ whereby potential purchasers of the securities can price them appropriately to reflect their (unbiased) estimate of the nonpecuniary benefits the owner-manager will consume after the securities sale (assuming information symmetry between the owner-manager and the purchasers), noncontrolling shareholders are not automatically in a position to recoup their wealth loss through the market mechanism. Since they already own the shares, they cannot avoid the loss suffered as a result of the decrease in the value of such holdings. Easterbrook and Fischel argue:

At least for publicly-traded firms, the market offers information that distinguishes value-increasing control transactions from others in which looting and mismanagement may be in store. The information is contained in the price of a firm's shares. If the control change is associated with an increase in price, the investors apparently do not fear looting or other harm to the firm. If a syndicate acquires a control bloc of shares, and the price of the remaining shares *rises*, relative to the market as a whole, then the shareholders are betting on the basis of available information that the new controller will be better for their interests than the old.⁵⁶

There are two problems with this argument. First, the price of the stock at the time of the control change will only reflect information publicly available at that time and the assessments as of that date of the character and ability of the purchaser. But a potential overlooter, who hides his intentions carefully, will not be "betrayed" in the stock price until the first news of his looting leaks into the marketplace. Second, even if prices accurately reflect the intentions and future actions of the looter, noncontrolling shareholders will have suffered the loss, regardless of how accurately reflected in market prices, at the time of the sale of control.

The key question is whether such a sale should be prevented or whether a requirement should be imposed that the premium offered to the seller be shared by noncontrolling shareholders. We have seen that

⁵³ See, e.g., *DeBaun v. First Western Bank and Trust Co.*, 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975).

⁵⁴ The redistribution will be to the extent that the premium paid exceeds the equivalent of the increment of utility the seller enjoyed prior to the sale, above the utility of the market value of the shares.

⁵⁵ See *supra* note 31 and accompanying text.

⁵⁶ Easterbrook & Fischel, *supra* note 51, at 707 (italics in original).

overlooters may pay a premium above market price, in light of the utility from overlooting they expect to derive, and that noncontrolling shareholders can suffer a loss *ex post*. However, we must consider the situation *ex ante*.

1. A Scenario of Information Symmetry

Consider the situation where no information is available in advance, either to the potential seller or to the noncontrolling shareholders, regarding the characteristics and skill of the potential purchasers. Under such a scenario of information symmetry (actually, symmetry of ignorance), both the potential seller and the noncontrolling shareholders hold the same prior probability distribution associated with the post-sale equilibrium combination of firm value and looting (the equilibrium points reflect pairs of looting level and the corresponding value of the firm). These equilibria are uniquely determined by the particular combinations of skill and taste for nonpecuniary benefits that characterize the individual purchasers. If one is willing to assume sufficient diversity among potential purchasers along a continuum of combinations of skill and taste for nonpecuniary benefits (that is, looting levels), it is not difficult to see how such a probability distribution is induced. A purchaser could either benefit or harm noncontrolling shareholders depending on his particular looting potential. He may benefit shareholders even if he consumes more nonpecuniary benefits than existing management if he is sufficiently more skillful, and, conversely, when his tendency to consume nonpecuniary benefits more than offsets his superior skill. Similarly, a potential purchaser who is less skillful than existing management could harm noncontrolling shareholders, but he could also benefit them to the extent that his tendency to consume nonpecuniary benefits is sufficiently less than that of the incumbents.

With no specific knowledge of the purchaser's looting potential, consider what happens when the distribution⁵⁷ characterizing the outcomes in terms of the level of looting is symmetrical around a mean which equals L^* , the equilibrium level of looting under the incumbent controlling shareholder. In other words, noncontrolling shareholders stand a fifty percent chance of either losing or benefiting from the sale of control to a purchaser for whom advance knowledge does not exist. Of course, it might be argued that for any particular corporation, the looting level L^* associated with the incumbents would be either below or above the mean of the perceived probability distribution of potential looting levels. But, *ex ante*, and without advance knowledge, L^* has a fifty percent chance of being either above or below this mean so that the "expected" location of L^* will be at the mean of the distribution. Under the assumption of symmetry of information, this is the situation we face *ex ante* when we pon-

⁵⁷ The distribution in this model is perceived identically by potential seller and noncontrolling shareholders.

der the desirability of imposing a sharing rule with respect to the premium.

Assumptions about risk aversion of the noncontrolling shareholders must be made. Assume first that they are risk neutral. The level of their expected utility neither increases nor decreases, *ex ante*, as a result of the sale transaction since they are just as likely to gain as they are to lose. But since a voluntary sale of control by the dominant shareholder to the purchaser necessarily implies that the expected utilities of both the seller and the purchaser would remain the same or increase if we must conclude under this scenario that the sale of control constitutes a Pareto improvement:⁵⁸ noncontrolling shareholders remain as well off, either the purchaser or the seller is strictly better off, and the other remains at least as well off. Any rule that imposes sharing of the premium or that otherwise regulates the sale of control (such as outright prohibition, at the extreme) will stifle and decrease the equilibrium number of such mutually beneficial exchanges, thereby constituting a Pareto inferior state of affairs; overall economic efficiency would be decreased.

This analysis is different from Easterbrook and Fischel's. They seem to assume that sale of controlling blocs would tend to be mostly beneficial:

Sales of controlling blocs of shares provide a good example of transactions in which the movement of control is beneficial. The sale of control may lead to new offers, new plans, and new working arrangements with other firms that reduce agency costs and create other gains from new business relationships. The premium price received by the seller of the control bloc amounts to an unequal distribution of the gains.⁵⁹

They use this premise to justify the conclusion that sales at a premium should be lawful. On the other hand, my analysis indicates that sales of control are not necessarily beneficial to noncontrolling shareholders. Nonetheless, sale at a premium should be lawful without spreading the bounty because, *ex ante*, under the scenario I depicted,⁶⁰ the purchaser is just as likely to be an overlooter ($L > L^*$) as he is to be an underlooter ($L < L^*$). The sale should be lawful even when noncontrolling shareholders are harmed *ex post*. The main point is that, *ex ante*, they are as well off in terms of expected utility and either the seller or purchaser is strictly better off and the other is at least as well off.

My conclusion differs from Easterbrook and Fischel's again as to what should be the proper formulation of a fiduciary principle. They claim: "Investors' welfare is maximized by a legal rule that permits une-

⁵⁸ A Pareto-optimal solution is one of maximum economic efficiency. See P. SAMUELSON, *supra* note 7, at 461-62.

⁵⁹ Easterbrook & Fischel, *supra* note 51, at 715-16.

⁶⁰ Recall, the scenario I depicted is that risk-neutral noncontrolling shareholders, along with the seller, are ignorant about the nature of the purchasers and perceive a distribution of looting potential that is symmetric around L^* under the incumbents.

qual division of gains from corporate control changes, subject to the constraint that no investor be made worse off by the transaction. In essence, this is a straightforward application of the Pareto principle of welfare economics."⁶¹ This principle can only be correct if it is interpreted as applicable *ex ante* and not *ex post*. I would allow sale at a premium without a sharing rule even if, *ex post*, noncontrolling shareholders are made worse off—provided that *ex ante* they are not. But it is difficult to see how, *ex ante*, the courts can verify that the shareholders would be made worse off unless there is advance knowledge regarding the characteristics of the purchaser. Thus, I must conclude that under this first scenario, sale of control at a premium must be lawful. And, as Easterbrook and Fischel observe, any rule restricting or otherwise deterring such sales will stifle mutually beneficial exchanges and reduce efficiency.

But there exists yet another social cost that attends any rule restricting sale of control under these circumstances. Entrepreneur-owners, who embark on a new investment project for which they might require financing from outside minority stockholders and who anticipate that sale of their control would be restricted (or their activities made unprofitable) by a rule that forces them to spread the bounty when they do encounter an opportunity to sell their control, will find the initial investment project less attractive. The rule will decrease the present value of benefits gained from becoming an owner-manager, preserving control, and subsequently selling at a premium. Thus, in equilibrium, the total amount of such initial investments will decline. This amounts to a social cost in that it will decrease the equilibrium volume of entrepreneurial activities with positive net social value.⁶²

Suppose we relax the assumption of risk neutrality of the noncontrolling shareholders. Will this alter the conclusion? No. If noncontrolling shareholders are risk averse, their expected utility, *ex ante*, will decrease with respect to their stockholdings in the corporation if control is sold under the above scenario. However, they can minimize this "unsystematic" risk by holding sufficiently diversified portfolios of securities. Moreover, such an anticipated decrement in expected utility will have been considered in the calculus of costs and benefits that investors engaged in when they initially decided whether to buy the securities. For example, under the Jensen and Meckling analysis,⁶³ upon the first issuance of securities by owner-managers, potential purchasers will discount the anticipated future loss in utility contingent on future sales of control and will bid a price for the securities that will appropriately reflect the present value of expected losses. When the initial owners later sell their securities, the prices at which the securities trade will again reflect the expected decrements in the utility that the buyers anticipate will be suf-

⁶¹ Easterbrook & Fischel, *supra* note 51, at 715.

⁶² This social cost is not mentioned by Easterbrook and Fischel.

⁶³ See *supra* note 31 and accompanying text.

ferred when controlling shareholders sell their interest to third parties. Thus, the prevailing prices of securities will reflect the implications of risk aversion for the loss in expected utility upon sales of control. In other words, prevailing prices of securities are expected to be such that, *ex ante*, there will be no actual loss in expected utility when control is sold: the price already reflects the anticipated loss.

2. A Scenario of Information Asymmetry

So far, we have assumed that both noncontrolling shareholders and the selling dominant shareholder are equally ignorant about characteristics of potential purchasers. But is there room for improvement? For example, can we produce more efficiency by weeding out the overlotters, by attempting to increase the probability that sales of control would only be made to the underlotters (those more skillful or with lesser taste for nonpecuniary benefits)? This could produce a more efficient resource allocation in that assets will eventually be employed by those who are able to employ them most efficiently. But how could we discriminate in advance between the more and the less skillful, between those with a greater tendency to consume nonpecuniary benefits and those with the lesser?

Such discrimination (not necessarily perfect) can only be made if information about potential purchasers is produced. But we face a dilemma: the first individual to know the identity of the potential purchaser is the seller himself. The seller would be unwilling to produce much information about the potential purchaser because information production is costly and does not privately benefit the seller. He will receive the agreed upon premium one way or the other: the information could only benefit the noncontrolling shareholders. We thus have a classical moral hazard situation.⁶⁴ Here, "information production" about the potential purchaser replaces "effort" in the typical relation between a principal and an agent. The potential seller (agent) is averse to the (costly) production of information about the potential purchaser which would benefit noncontrolling shareholders (principal) by decreasing the likelihood of selling control to an overlooter.

However, unlike the typical relation between principal and agent, the relationship between noncontrolling shareholders and the dominant shareholder does not conveniently allow the former to induce the latter to be party to an incentive contract that would minimize disincentives to produce information. In the traditional principal-agent situation, the agent accepts the contract because his minimum required level of ex-

⁶⁴ Such a situation arises when individuals engage in risk sharing "such that their privately taken actions affect the probability distribution of the outcome." This situation will not induce proper incentive for taking correct actions and thus, Pareto-optimal risk sharing is precluded. Instead, only a second-best solution can be achieved by trading off some risk-sharing benefits for provision of incentives. Holstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 74 (1979).

pected utility will be attained as a result of having become a party to the contract. Furthermore, the principal is the one who defines the employment task for the agent.⁶⁵ The relation between noncontrolling shareholders and dominant shareholder is different. Noncontrolling shareholders have nothing to dangle before the dominant shareholder to induce him to be party to an incentive contract that would guarantee a "second best solution" for the decision to produce information about a potential purchaser.⁶⁶ Hence, the dominant shareholder will produce sub-optimal information. The setting does not make possible the (relatively) efficient mechanism of private contracting to reduce moral hazard.

Some information will ultimately be produced, for the seller must ascertain the financial creditworthiness of the potential purchaser to assure collection of the consideration for the "control" he is selling. But this minimal information (probably obtainable at a fairly low cost) will not typically enable discrimination between overlooters and underlooters. Information revealing such distinctions would be both imperfect and costly to obtain.

The dominant shareholder's (agent's) effort in the production of information about the potential purchaser is unobservable by noncontrolling shareholders (principal). The eventual level of looting is a function of this effort and the subsequent decision by the dominant shareholder to sell or not sell, and the characteristics of the potential purchaser (viewed here as uncontrollable or random). Therefore, the condition for a "first best solution" (optimal risk sharing) within a principal-agent context can suggest potential remedies. As discussed below, such potential remedies will not be effective in the case of sale of control.

First, consider the observability of effort. If effort (production of information) were to be made observable, an optimal risk-sharing rule (first best solution)⁶⁷ would become possible. But as we have seen above, this remedy is ruled out by the inability to contract privately.⁶⁸

Another possibility also proves to be ineffective. It may be intuitively appealing to contemplate the shifting of the effort from the dominant shareholder (who does not privately benefit from the effort) to the noncontrolling shareholders (who do benefit from it) and thus "internalize" the information production activity and attain a locally optimal level. Since the starting position is one of information asymmetry (the seller knows first the purchaser's identity and possible financial creditworthiness), the imbalance of this initial information must be corrected before a shifting of incremental information production to noncontrolling shareholders becomes possible.

⁶⁵ See *id.* at 83-85.

⁶⁶ See *id.* at 85-86.

⁶⁷ See Borch, *Equilibrium in a Reinsurance Market*, 30 *ECONOMETRICA* 424 (1962).

⁶⁸ See *supra* text accompanying note 66.

Therefore, visualize a rule whereby before a potential sale, the seller is obligated to disclose all of the information he possesses about the purchaser to the noncontrolling shareholders.⁶⁹ The latter will decide individually or collectively⁷⁰ on the optimal investment in information production (possibly zero), so as to ascertain whether the purchaser is a potential overlooter. As a result of this investigation, they will form an assessment of the purchaser's looting potential. They will then be able to optimally decide whether they are better off deterring the dominant shareholder from selling by offering him the same premium he otherwise could obtain from the purchaser. The noncontrolling shareholders will be willing to offer such a premium if they expect the savings gained by driving away the overlooter will exceed the premium they would have to pay to the seller.

The problem that this potential remedy poses is that it provides an incentive for the seller to collaborate with an overlooter. The seller would agree with the overlooter on a high premium which the latter would not necessarily wish to pay. Also, the seller would provide sufficiently incriminating (and true) information to the noncontrolling shareholders about the purchaser. Upon investigation, the noncontrolling shareholders would correctly assess the purchaser as an overlooter and would be willing to pay the high premium to the seller in order to drive away the "bad" purchaser. The suggested remedy could therefore degenerate into a "get rich" scheme for the dominant shareholder even if he could implement it only once.

Remedies based on a "second best solution,"⁷¹ in terms of the principal-agent model through private contracting, can also be elusive. The function of a second best incentive contract in this case is to induce a second best optimal investigation of a potential purchaser (by the seller) before deciding whether to sell. This second best solution requires a rule whereby the seller's own fortune will vary with the outcome of his sale of control (i.e., the level of looting). Ideally, the contract would reward the seller if the purchaser turns out to be an underlooter, and penalize the seller if the purchaser turns out to be an overlooter. Both rewards and penalties would vary directly with the degree of under- or overlooting. However, contracts must be enforceable to be effective. The fiduciary duty principle of corporate law would have to be replaced by one that facilitates the enforcement of private contracts designed to induce optimal behavior regarding the investigation of a purchaser and the decision to sell. Such private contracts ideally would take several things into ac-

⁶⁹ No market incentives exist which would induce such a disclosure without a specific rule.

⁷⁰ This would work better in a closely-held corporation where the cost of organizing as a group is likely to be low.

⁷¹ The theory of second best is that if one or more of the Pareto-optimal conditions cannot be satisfied, it is not generally desirable to force compliance with the remaining Pareto-optimal conditions. In general, the conditions of Pareto-optimality are not required in order to attain a second best solution. See P. SAMUELSON, *supra* note 7, at 504 n.1., 524 n.1.

count: (1) the dominant shareholder's characteristics as to risk aversion and taste for nonpecuniary benefits; (2) endowment; that is, personal wealth, including human capital; (3) noncontrolling shareholders' preferences and tastes; and (4) potential benefits from—and the opportunities for—selling to an overlooter, which may depend on the nature of the business, the liquidity of assets, and similar things.

However, except for closely-held corporations in which costs of organizing and contracting are apt to be low, the relatively complicated and expensive process necessary to draw agreements between noncontrolling shareholders and the dominant shareholder could make this remedy less attractive. Moreover, under current law, implicit contractual arrangements (fiduciary duties) are left to the interpretation of the courts and not to the parties concerned. Thus, at least for the time being, we have to do without the remedy of private contracting.

Without contractual remedies, this unresolved moral hazard situation, combined with information asymmetry regarding the identity of the purchaser (known to the seller but not to the noncontrolling shareholder), may skew the distribution of potential looting levels as perceived by the noncontrolling shareholders. A higher probability will be attached to overlooting than to underlooting. The seller has no incentive to search for an underlooter whereas any premium could induce him to sell to an overlooter. Thus, with the introduction of the reality of information asymmetry and moral hazard, we find that the distribution of potential looting may no longer be symmetric about L^* , and *ex ante*, noncontrolling shareholders may expect to lose on a sale of control transaction. This *anticipated* redistribution of wealth (from noncontrolling shareholder to purchaser and seller) will cause a loss in economic efficiency. Moreover, the market pricing of the original issue will reflect only an anticipated no-better-than-average willingness to investigate, even if the distribution is perceived to be symmetrical around L^* , and this price will be less than that sought by a seller who is indeed willing to more thoroughly investigate. This manifestation of adverse selection is elaborated below.

3. Adverse Selection Revisited: The "Trickle Down"

The analysis of subsection A must be revisited. That subsection involved initial corporation formation and financing. The information-asymmetry-and-moral-hazard-induced distribution of potential looting will set into motion an adverse selection process that takes place, anticipatively, when the entrepreneur-owner-manager incorporates and attempts to finance his investment project.⁷² A sort of "trickle-down" adverse selection would be operative. Some description of the possible scenario may provide clarity.

Suppose that the potential seller of control is the original entrepre-

⁷² See *supra* note 33 and accompanying text.

neur-owner-manager who wishes to sell securities publicly to finance his investment project. Since entrepreneur-owner-managers are potential sellers of their own control, they could differ in their tendency to investigate potential purchasers and in their eagerness to deter overlotters from purchasing their control. In addition to evaluating the probability of enterprise failure, the potential buyer of securities therefore will not only have to assess the entrepreneur-owner-manager's taste for nonpecuniary benefits and competence (looting potential), but also their degree of willingness to discriminate between overlotters and underlotters and their willingness to refrain from selling to an overlooter. I refer to this willingness in both respects as "fairness."

It is thus plausible to expect the "fairer" entrepreneur-owner-managers to engage in bonding activities so that they can assure the potential purchasers of their securities that they will thoroughly investigate potential purchasers of their controlling interest. Otherwise, they may not be able to sell their securities at a price reflecting such willingness to investigate in the future. Furthermore, as in the case of the market for "lemons,"⁷³ public offerings of securities may diminish and otherwise socially profitable investments would not be undertaken due to lack of financing. Therefore, the "fairer" potential dominant shareholders may be expected to welcome a rule of law facilitating orderly capital markets in which they could sell securities to finance their entrepreneurial projects.

Thus, potential noncontrolling shareholders, cognizant that no liability is imposed on the seller, may be unwilling to purchase securities at a price desired by entrepreneur-owner-managers. As the analysis in Part II.A concluded, adverse selection—here with respect to the "fairness" of the potentially dominant shareholder—will decrease the equilibrium number of socially useful investments.

What rule of law should be installed to mitigate this adverse-selection-trickle-down effect? The general rule underlying the principal-agent incentive contract solution⁷⁴ could be applied. As noted above, noncontrolling shareholders (viewed as the principal) seem precluded from contracting with the dominant shareholder to force optimal investigation in selling decisions.⁷⁵ However, reformulation of the fiduciary duty principle can be used to fill the vacuum and to attain an approximation to a second best solution. The potential seller must share in the negative impact that an overlooter would produce in a fashion analogous to an agent who receives compensation depending on the outcome of his unobservable effort. In our case, a dominant shareholder would be liable for ex post damages or a share thereof, if the purchaser mismanages or otherwise overlots the corporation's assets after the sale of control.

⁷³ See *supra* text accompanying note 40.

⁷⁴ See generally Harris & Raviv, *Optimal Incentive Contracts with Imperfect Information*, 20 J. ECON. THEORY 231 (1979).

⁷⁵ See *supra* text accompanying note 66.

If the seller's liability for overlooting is correctly specified, the dominant shareholder will optimally investigate the potential purchaser and decide whether to sell in the "second best" sense. Of course, the seller's liability for ex post damages will depend on the personal characteristics of the seller as well as the characteristics of noncontrolling shareholders. Because it is impossible to formulate in advance a principle of fiduciary duty that is custom-tailored to every potential seller, a formula would have to be determined on a case-by-case basis.⁷⁶

Further improvement in this rule is possible. Any information that can be obtained at no cost, or relatively low cost, about the agent's effort (investigation of the purchaser by the dominant shareholder) can produce a superior solution from the standpoint of incentives to investigate.⁷⁷ Thus, the rule of law should stipulate that the seller can reduce or eliminate his liability for ex post damages by proving that he reasonably investigated the characteristics of the purchaser before deciding to transfer his controlling interest.

To further drive away overlooters, stiff sanctions could be imposed on the purchaser for some period after the sale of control transaction. Such sanctions could provide an effective deterrent if the overlooting purchaser is sufficiently wealthy⁷⁸ or if the sanctions can erode human capital, including the value of personal freedom (such as imprisonment).

Should noncontrolling shareholders bear part of the risk? Since the actual resolution of any suit brought before the courts by noncontrolling shareholders is uncertain, they will share in some of the risk. Indeed, I believe such risk sharing is preferable so as to induce investigation of their investments. If they were not to share in any of the risk (e.g., by being protected by a rule that requires the purchaser or seller to offer to buy their shares at the same premium), then they essentially would be granted a free ride—free insurance—from errors in identifying good-quality entrepreneurs—which will eliminate their incentives to investigate the soundness of their investments. Further, such protection would induce noncontrolling shareholders to underinvest in their own education and sophistication in financial and business matters.

To summarize, the seller should be totally or partially liable for damages caused by mismanagement or overlooting by the purchaser, perhaps for a specified period of time after the sale. The seller's ability to demonstrate reasonable prior investigation of the purchaser should allow him total or partial relief from liability. Imposing stiff sanctions on the purchaser upon evidence of overlooting may be desirable to deter would-

⁷⁶ Note the difficulty of distinguishing among bad luck, incompetence and self-serving consumption of nonpecuniary benefits.

⁷⁷ See Holstrom, *supra* note 64, at 87 ("any informative signal, regardless of how noisy it is, will have positive value. . . if costlessly obtained . . ."). For a discussion of the effects of information within the principal-agent relationship, see generally Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979).

⁷⁸ Wealth is an effective bond for a risk-averse purchaser.

be overlotters from purchasing control. Noncontrolling shareholders would also be exposed to some risk. While they could bring an action against the sellers upon evidence of overlooting, they would be uncertain of the outcome due to the seller's reasonable investigation defense and the inherent arbitrariness of the judicial system.

Certainly, the Canadian rule,⁷⁹ that any premium agreed upon between seller and purchaser must also be offered to noncontrolling shareholders, is economically inefficient. It deters mutually beneficial control-sale transactions by driving away the underlotters (along with the overlotters) and entrepreneur-owners-managers who would otherwise embark on productive ventures. Such a rule also insures noncontrolling shareholders against any misjudgments when making investments and, thus, will induce them to obtain less information about their investments and to underinvest in their own education and sophistication in matters of finance and investments.

"Welfare-flavored" arguments for protecting the "poor, old and ignorant" men and women against the disasters of bad investment can be more effectively and cheaply dealt with by instituting rich and complete capital markets that offer *secure*, as well as risky, investments. The "ignorant" who *choose* not to be informed about the subtleties of risk and return should avoid hazardous paths. If the emphasis of the argument is on the "poor" rather than the "ignorant," the answer is better found in direct welfare transfers where social cost can be more explicitly measured and considered. Furthermore, legal protection for the poor or the ignorant against bad investments constitutes an indirect subsidy of a magnitude that is largely immeasurable and thus eludes the calculus of social cost and benefit. Potential "free rides" also offer opportunities for political entrepreneurship. If able to effectively organize, actual and potential noncontrolling shareholders would be likely to lobby for the legislation of premium-sharing rules such as those in Canada. Arguments would be phrased in terms of enhancing market confidence and facilitating trade. However, while a premium-sharing rule may indeed facilitate trade and enhance market confidence, the price paid—deterrence of beneficial transactions and entrepreneurial ventures—may well be too high.

The general rule that the seller who conducts adequate prior investigation should be liable for a purchaser's overlooting is normatively desirable and similar to the case law in the United States. In the next section, a few exceptions to this general rule in the American cases are briefly discussed.

III. SOME EXCEPTIONS TO THE NORMATIVE RULE IN AMERICAN CASE LAW

It must be noted that American case law closely approximates the

⁷⁹ See *supra* notes 16-23 and accompanying text.

normative rule. For example, it has been stated: “[I]t has long been settled law that, absent looting of corporate assets, conversion of a corporate opportunity, fraud or other acts of bad faith, a controlling stockholder is free to sell, and a purchaser is free to buy, that controlling interest at a premium price.”⁸⁰ However, there are a few instances of departure from the normative rule.

A. *The Duty of Reasonable Investigation*

A departure from the normative rule occurs in the stipulation that the seller is obligated to investigate the purchaser when there is reason to believe that the purchaser intends to loot or mismanage. This diverges from my conclusion that there should be an implicit obligation to investigate the purchaser, inasmuch as the investigation would serve as a defense to an action for sale to an overlooter. Courts seem to impose an obligation to investigate only if there is reason to suspect the purchaser to be an overlooter. In *Treadway Companies, Inc. v. Care Corp.*, the court stated: “Cowin himself would have had an obligation to investigate Care if, contrary to the findings made in this case, Cowin were selling control of Treadway and there were reason to believe Care intended to loot or mismanage Treadway . . .” (emphasis added).⁸¹

Other cases also seem to make the obligation contingent on prior cause of suspicion. For example, in *DeBaun v. First Western Bank & Trust Co.*, the court held that a controlling stockholder has a good faith duty to conduct a reasonable and adequate investigation of potential buyers, if the stockholder has reason to suspect that the buyer may loot the corporation of its assets to pay for the shares purchased.⁸² The Court developed this argument leaving little doubt that the obligation to investigate is contingent upon prior suspicion-creating information:

Here Bank was the controlling majority shareholder of Corporation. As it was negotiating with Mattison, it became directly aware of facts that would have alerted a prudent person that Mattison was likely to loot the corporation. . . . Armed with knowledge of those facts, Bank owed a duty to Corporation and its minority shareholders to act reasonably with respect to its dealings in the controlling shares with Mattison.⁸³

A rule such as the one I recommend, and which enables a seller to avoid liability for subsequent overlooting upon demonstration that he investigated reasonably, will induce the seller to investigate purchasers

⁸⁰ *Zetlin v. Hanson Holdings, Inc.*, 48 N.Y.2d 684, 685, 397 N.E.2d 387, 388, 421 N.Y.S.2d 877, 878 (1979).

⁸¹ *Treadway Companies v. Care Corp.*, 638 F.2d 357, 377 (2d Cir. 1980). For a similar analysis, see *Delano v. Kitch*, 663 F.2d 990 (10th Cir. 1981).

⁸² *DeBaun v. First West. Bank & Trust Co.*, 46 Cal. App. 3d 696, 699, 120 Cal. Rptr. 354, 360 (1975).

⁸³ *Id.* at 697, 120 Cal. Rptr. at 360. For a similar analysis, see *Clagett v. Hutchison*, 583 F.2d 1259 (4th Cir. 1978); *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955).

more extensively than a rule which imposes on the seller the obligation of thorough investigation and of refraining from sale of his control only upon possession of suspicion-creating information. While in legal practice the two formulations may make little difference except in fringe cases, a proper formulation is likely, in general, to induce more optimal investigation.

Surely, the seller could stumble upon information about looting potential as a by-product of collecting information about the purchaser's creditworthiness. Such indeed were the circumstances in *DeBaun*, in which the court concluded that "in those circumstances the majority shareholder owes a duty of reasonable investigation and due care to the corporation."⁸⁴ A duty of reasonable investigation exists "when [the majority shareholder is] possessed of facts establishing a reasonable likelihood that the purchaser intends to exercise the control to be acquired by him to loot the corporation of its assets."⁸⁵

This case law rule can be counterproductive: the imposition on the seller of a duty of reasonable investigation once he possesses information creating suspicion that the purchaser will be a looter depresses the seller's incentive to produce information. Before producing information about the purchaser, we can assume that an investigation (even the most superficial) will indicate equal likelihood that the potential purchaser is either an overlooter or an underlooter.⁸⁶ Suppose the law imposes a duty to investigate further. Further investigation would entail incurring additional cost, introducing additional uncertainty, and result in the ultimate decision not to sell if the information produced indicates that the purchaser might be an overlooter. This rule reduces the ex ante expected benefits of preliminary information production and thus depresses the incentive to produce such information. Such a duty to investigate when in possession of suspicion-creating information either encourages activities designed to efficiently "hide" private information readily available to the seller, or deters the seller from producing any potentially negative preliminary information. A seller interested in ascertaining a purchaser's creditworthiness will only gather information for that purpose, avoiding accidental discovery of information that could obligate him to incur additional costs through further investigation. Judge Lumbard noted the inadequacy (but not necessarily the undesirability which I emphasized above) of imposing liability on the seller only upon evidence of prior knowledge of the purchaser's looting potential and intentions. As Judge Lumbard stated, "[t]o hold the seller for delinquencies of the new directors only if he knew the purchaser was an intending looter is not a sufficient sanction."⁸⁷

⁸⁴ *Debaun*, 46 Cal. App. 3d at 689, 120 Cal. Rptr. at 355.

⁸⁵ *Id.*

⁸⁶ See *supra* text accompanying note 57.

⁸⁷ *Essex Universal Corp. v. Yates*, 305 F.2d 572, 581 (2d Cir. 1962).

*Perlman v. Feldmann*⁸⁸ may be seen as a departure from the general case law and from the normative rule developed above. However, this case did not seem to impact subsequent cases; thus the general case law prevails.⁸⁹

B. Sale of Office

This economic analysis of the "sale of control" transaction should apply with equal force to the sale of corporate office or management control, even when unaccompanied by sufficient transfer of shares that guarantee voting control. However, contrary to my conclusions, American case law seems to distinguish between sale of control of shares and sale of management control unaccompanied by transfers of shares.

The court in *Essex Universal Corp. v. Yates* stated:

It is established beyond question under New York law that it is illegal to sell corporate office or management control by itself (that is, accompanied by no stock or insufficient stock to carry voting control). . . . The same rule apparently applies in all jurisdictions where the question has arisen. . . . The rationale of the rule is undisputable: persons enjoying management control hold it on behalf of the corporation's stockholders, and therefore may not regard it as their own personal property to dispose of as they wish.⁹⁰

This was also referred to in *Caplan v. Lionel Corporation*, in which the court stated:

The underlying principle is that the management of a corporation is not the subject of trade and cannot be bought apart from actual stock control Where there has been a transfer of the majority of the stock, or even such a percentage as gives working control, a change of directors by resignation and filling of vacancies is proper.⁹¹

Presumably, the premium paid on transactions of transfer of corporate office would not be as high as the premium paid for a sale of controlling ownership interests. Dissatisfied controlling shareholders can eventually wrest control from the purchasers of such corporate office. The price paid by the purchaser of a corporate office will reflect the non-pecuniary benefits associated with the corporate office.⁹² The ability of a manager holding a corporate office to sell such office to his benefit would

⁸⁸ *Perlman v. Feldmann*, 219 F.2d 173 (2d Cir. 1955). In *Perlman*, despite the fact that the dominant shareholder had no reason to believe the purchaser would injure the corporation, the dominant shareholder was held accountable. *Id.* at 178, 179. The court emphasized the high standard of care which the controlling shareholder (who was also president and chairman of the board of directors) owed to the minority shareholders. *Id.* at 174, 178.

⁸⁹ *Id.* at 178 (Swan, J., dissenting) ("I think that both the legal profession and the business world will find the decision confusing and will be unable to foretell the extent of its impact upon customary practices in the sale of stock.")

⁹⁰ *Essex Universal Corp. v. Yates*, 305 F.2d 572, 575.

⁹¹ *Caplan v. Lionel Corp.*, 20 A.D.2d 301, 303, 246 N.Y.S.2d 913, 915 (1964).

⁹² See *supra* note 5.

be relevant in deciding how much nonpecuniary benefit to consume and how much to enhance efficiency of operations. Depriving him of the opportunity to sell his office at a premium decreases his incentive to be efficient. Furthermore, this deprivation decreases the number of mutually beneficial transactions (beneficial to shareholders as well as the purchaser) in which purchasers of corporate office can manage more efficiently than incumbents. The possibility that some purchasers may be overlooters can be countered by the same remedies suggested above for the "sale of control."⁹³ Thus, I believe the analyses of "sale of control" and of "sale of corporate office" are identical and lead to the same conclusion.

IV. SOME LEGAL THEORIES GOVERNING "SALE OF CONTROL" TRANSACTIONS

Two major legal doctrines have emerged to justify imposition of a duty on the purchaser or seller of a controlling interest to offer noncontrolling shareholders a similar premium. The first doctrine is predicated on the theory that "control" is a corporate asset, the sale of which must be paid to the corporate till.⁹⁴ The second doctrine is that of equal opportunity.⁹⁵ Both doctrines preceded the now popular agency theory of the firm.⁹⁶ The two doctrines are addressed in sequence.

A. *The Corporate Asset Theory*

For Bayne, the argument that control is a corporate asset is tantamount to arguing that *all* shareholders should share in the opportunity to sell their shares at the higher price offered to the controlling shareholder.⁹⁷ Since presumably the premium belongs to all the shareholders, the premium implicitly belongs to the corporation. But that in turn implies that the premium is for the office and since the office belongs to the corporation, "control" is a corporate asset.⁹⁸ This theory would assert that powers over corporate affairs can only be exercised for the corporation's benefit, not to be sold for private profit. In other words, powers over corporate affairs are powers held in trust for the corporation.

There are three major problems with this theory. The first is definitional: What does it mean to say that the power associated with an office is a corporate asset? The power to affect corporate affairs, after all, is used to create corporate assets or to enhance their value. Thus, if the power to manage corporate affairs is used judiciously and with acumen,

⁹³ See *supra* notes 74-78 and accompanying text.

⁹⁴ Bayne, *A Philosophy of Corporate Control*, 112 U. PA. L. REV. 22, 48 (1963).

⁹⁵ See Andrews, *The Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965).

⁹⁶ See generally Jensen & Meckling, *supra* note 5.

⁹⁷ Bayne, *supra* note 94, at 67.

⁹⁸ *Id.* at 65.

then additional and more valuable corporate assets such as cash, marketable securities, physical property and goodwill will be created. On the other hand, if the power to manage is misused or not used skillfully, the result would be a dissipation of corporate assets. Thus, power over corporate affairs is merely the authority which is necessary for management to be able to create corporate assets. The power itself cannot be an asset; it is only the means by which management can create, or dissipate, assets.

The second problem involves properly identifying the asset's nature and its owner. The asset is the ability to consume corporate resources in the form of nonpecuniary benefits and it is paid for, initially, by the entrepreneur-owner-manager when issuing securities to the public. As detailed in Part II, the ability to derive utility from consuming nonpecuniary benefits is "paid for" by the owner-manager through receipt of a lower price for the securities issued.⁹⁹ This lower price reflects the discount demanded by investors to compensate them for the anticipated consumption of nonpecuniary benefits. When the entrepreneur-owner-manager then sells his controlling interest, the new controlling shareholder would pay for this asset in the form of a premium and would thus become the new owner of the "controlling interest" and the consequent benefit of the utility derived from consumption of nonpecuniary benefit.

Andrews sensed this difficulty when he reasoned that if control, which initially is a corporate asset, was bought, the new owner should be able to resell the asset he paid for at whatever price he is able to obtain.¹⁰⁰ The analysis of Part II shows why this dilemma arose. It demonstrates how control never becomes a corporate asset to begin with: the initial entrepreneur-owner owns the asset, which he paid for by receiving fewer proceeds than he would have if he yielded his control. To view control as a corporate asset for which noncontrolling shareholders should be paid when the asset is sold amounts to the controlling shareholder paying twice for the same "asset."

To demonstrate the third difficulty, assume that control is indeed a corporate asset. Control should be reflected in prevailing market prices since, within a semi-strong efficient market, any information on the power to control corporate affairs would be expected to be known and thus impounded in market prices. Under this interpretation, the premium paid to a controlling shareholder for the sale of his control would not reflect this corporate asset (whose value is already impounded in market prices), but some other possibly hidden asset, the existence of which is known only by the selling shareholder and the purchaser who agree on the premium to be paid for it. But, in this case, the premium would reflect an asset that already existed in the corporation. Knowledge of this asset would eventually come to light, thus inducing an in-

⁹⁹ See *supra* notes 31-32 and accompanying text.

¹⁰⁰ Andrews, *supra* note 95, at 538-39.

crease in the market price of the corporation's shares (including those owned by noncontrolling shareholders).

In this case, noncontrolling shareholders will benefit from this hidden asset once it is revealed. In fact, the sale of control transaction itself will make the asset's existence come to light sooner and will thus increase the market price of the corporation's shares. Viewed in this fashion, the sale of control is a trigger that flushes out "inside" knowledge about the hidden assets. This, in turn, benefits noncontrolling shareholders.

B. The Equal Opportunity Doctrine

As presented by Andrews, the equal opportunity doctrine is based on the view that all holders of shares in a corporation are in some sense equal and therefore should be provided equal opportunity to sell shares (or a pro rata part thereof) on substantially the same terms as a controlling shareholder.¹⁰¹

Easterbrook and Fischel skillfully disposed of this argument.¹⁰² Their counterargument: a rule that obligates seller or purchaser to offer the same opportunity to sell at a premium to noncontrolling shareholders may provide equal opportunity *ex post* but it would be *unfair ex ante*. Due to such a rule, either the seller or the purchaser is likely to find it unattractive to consummate the transaction, thus depriving noncontrolling shareholders of potential benefits. Thus, the *ex post* inequality of distribution becomes both fair and desirable because without it, the beneficial transaction would not occur.

I wish to add only one observation. The *ex ante* rule advanced by Easterbrook and Fischel is the appropriate one. However, it should be applied much earlier than when the "lottery" created by the "sale of control" transaction is being considered. Even if the lottery were to result in a negative expected value to noncontrolling shareholders, the "ex post" possibility of such a lottery taking place would have been considered "ex ante" when noncontrolling shareholders first acquired their shares knowing that controlling interest could be sold to a new team.

As the analysis in Part II indicates, the whole distribution of such lotteries would be anticipated before shareholders agree to finance the entrepreneur-owner-manager's enterprise. At that earlier point in time, the shareholders had an equal *opportunity* to become entrepreneur-owner-managers or passive shareholders. Choice of the former could hold promise for large rewards, challenge, initiative, and entrepreneurial risk (the threat of entrepreneurial bankruptcy in the sense of not being able to survive as entrepreneurs); choice of the latter would offer the more modest return but also the lower entrepreneurial risk. When noncontrolling shareholders were only potential investors they had the equal opportunity to choose between controlling and influencing, or becoming

¹⁰¹ *Id.* at 515.

¹⁰² Easterbrook & Fischel, *supra* note 51, at 708-11.

residual claimants with neither control nor influence. Just as any individual has the free choice to become an entrepreneur or a laborer, preferences, endowments and constraints will determine the selection.

V. SOME SPECULATIONS ON THE CONCEPT OF "FAIRNESS"

A concept of "fairness" is often cited to justify the equal opportunity doctrine, which has led in Canada to the legislation that the opportunity to sell should be offered to all shareholders and not only to the dominant shareholder. Despite wide exposure to the development of American case law, we thus see a divergent course taken by the Canadian legal community. Doubtless, a political process is in motion; active lobbying by interest-groups of all kinds has been underway. But why do we not witness the same process in the United States? Legislation in Ohio and Pennsylvania seem to be the only exceptions. My analysis in Part II indicates that the Canadian rule is economically inefficient. Can there be a socio-economic "rationale" for the Canadian rule which can make it economically efficient in a broader sense? Over the longer term? I doubt this is possible, but a speculation or two is too tempting to resist.

If long-term stability of the community is the ultimate objective, then the relatively more homogeneous make-up of Canadian society could be considered a factor. Consider also the relatively smaller size of communal concentrations in Canada when compared to the United States. With an admittedly large margin of error, historical developments may shed some light on such a hazardous attempt to compare, in cross-section, two societies or cultures. Historically, where economic activity took place within a small isolated community, the transactions that took place—barter and borrowings of all kinds—would be repeated among individuals who knew each other and were possibly members of the same extended family. Each individual knew that he was transacting with a party with whom he would have to transact repeatedly in the future. Penalties—loss of opportunities for future transacting—would be imposed on the individual cheating in the current transaction. Mutual trust, intimacy, and friendship had to evolve so that trading and other economic opportunities could continue to take place. Importantly, this development of mutual trust and intimacy was possible because of the relatively small size of the community and its homogeneity. Both were necessary before literacy could make possible the communication among geographically dispersed transactors and among people with different linguistic heritages. With the development of the fast transport and communication technology, transacting—and cheating—among relative strangers separated from each other both geographically or culturally became possible. With transactions with any particular individual becoming less likely to be repeated, lesser penalties would be anticipated. Exchanges producing large increments in the wealth of one party but not the other—which could conceivably be economically efficient but consid-

ered "unfair"—could be effected with greater immunity. In the ancient societies of Egypt and Mesopotamia, ostracization of an individual from the community to which he belonged was a penalty considered to be of the utmost gravity. In modern times, ostracization and societal rejection can still be effective deterrants in homogeneous communities. Thus, in societies endowed with a common tradition, honorable conduct becomes legal tender; it facilitates transacting and preserves communal stability.

But why would economically efficient changes of wealth be considered unfair? Why would a dominant shareholder becoming wealthier (as a result of selling his "control") than noncontrolling shareholders be "resented" even though the absolute wealth of noncontrolling shareholders did not decrease (and possibly increased)? An answer to this question may provide a socio-economic explanation for the institution of envy. If we are willing to entertain the notion, variously suggested by a number of economists, that individuals' utility decreases with the enhanced wealth of others, then we can view envy as the manifestation of that decrement in utility. Further, we would expect individuals who suffer such adversity to engage in actions designed to restore their prior state of felicity. Gambling rather than bursts of creativity, crime, and revolutions become attractive; aversion to greater wealth of others can explain gambling and crime. Communal stability or survival would be threatened. The institution of charity, in the context of a free-market mechanism, was instrumental historically in redistribution of wealth from the rich to the poor; the rich would avoid retributions from the poor by virtue of their "charitable character." In our days, legal doctrines based on a concept of fairness may partially do the job.

It is not my intention to pretend that these factors offer an explanation as to why Canada but not the United States has a rule of premium sharing when sale of control transactions occur. But if any socio-economic rationale exists for the legislation of such a rule in Canada, it probably would be found among the explanations I speculatively offered above. Admittedly, however, I doubt that any of these explanations were on the mind of the legislators and regulators who were promoting interests of their various constituencies.

VI. CONCLUDING REMARKS

This paper addressed the issue of whether a controlling shareholder should be free to sell his controlling interest at a premium without a legal obligation to secure the offer of the premium to noncontrolling shareholders. The analysis was conducted with the background of a contrast between the case law in the United States and the statutory law in Canada. While, in Canada, potential purchasers of a controlling interest are encumbered by the obligation to offer the same opportunity to noncontrolling shareholders of the target corporation, in the United States—

with the exception of cases of consequent looting—potential purchasers and sellers of controlling interests are free from such encumbrances.

The bulk of the paper was devoted to an economic analysis of the sale of control transaction. Pointing out how the sale of control can set an adverse selection process in motion, I concluded that the rule of American case law is, with some exceptions, economically efficient:¹⁰³ the dominant shareholder is free to sell his controlling interest at a premium, but he should be held liable for damages caused by consequent looting of the purchaser.

My interpretation of the appropriate fiduciary duty principle differs from the case law in that I conclude that the seller should be offered relief if he demonstrates reasonable investigation of the purchaser in the case of consequent looting. Under existing case law, he is obligated to reasonably investigate *if* he already possesses information that indicates the likelihood of the purchaser being an overlooter. Once he has investigated, he should refrain from selling his controlling interest if the investigation of the purchaser indicates that the purchaser will overloot.

Existing legal doctrines offered in support of an obligation to provide an opportunity to noncontrolling shareholders to sell at the same terms as the dominant shareholders were reviewed and found lacking.

A speculative section—the sole excursion into the descriptive—was devoted to an attempt to elucidate the concept of “fairness.” This section may have served no purpose other than satisfying my passion for intellectual venturesomeness.¹⁰⁴

¹⁰³ Bailey and Crawford accept the conclusion, but discount its significance. They state: Economists and legal commentators who oppose the regulation of private acquisition of control essentially argue that shares are a form of private property which should be freely transferable without regulatory restraints to protect minority shareholders. The theoretical rationale of those who support this point of view is that economic efficiency will be facilitated if there are no regulatory restraints since corporate control transactions are beneficial not only to the subject corporation but also to the economy in general.

Bailey & Crawford, *supra* note 4, at 5-6.

Later in their analysis, Bailey and Crawford take issue with the import of this efficiency and state that they are “unpersuaded by economic arguments that a control premium should not be shared with minority shareholders in order to facilitate economic efficiency. Indeed, in Canada, an equal treatment rule appears to be necessary to maintain investor confidence in the public markets.” *Id.* at 65.

¹⁰⁴ See generally Bailey & Crawford, *supra* note 4.