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MANAGEMENT BUYOUTS, EFFICIENT MARKETS, FAIR VALUE, AND SOFT INFORMATION

JAMES R. REPETTI†

Leveraged buyouts, particularly by a corporation's management, provide unique opportunities for investors to realize extraordinary profits. In his Article, Professor Repetti examines the potential harm to shareholder interests when management effects a corporate buyout or bailout, and analyzes the effectiveness of current regulatory and common-law protection against that harm. Professor Repetti concludes that the existing regulatory and common law schemes do not adequately protect shareholder interests and proposes as a solution that the Securities and Exchange Commission promulgate rules requiring enhanced disclosure in management buyouts.

I. INTRODUCTION

Public attention has focused recently on leveraged buyouts because of the extraordinary profits investors have realized in such transactions.[1] Indeed, some of the reported profits would raise the eyebrows of the most skilled financier. For example, in mid-1984 Metromedia was taken private by its chairperson and controlling stockholder for $1.1 billion.[2] Within two years, they sold several of Metromedia's assets piecemeal for $5.5 billion, a 500% increase.[3] Similarly, in 1985 the chairperson of the board of SFN, Inc. took SFN private for $450 million.[4] One year after he acquired control, assets of the company were sold for $944 million.[5] In light of the great profit potential, it is not surprising that the volume of leveraged buyouts has exploded from less than $1 billion in 1980 to over $40 billion in 1986.[6] Moreover, while leveraged buyouts accounted for only 4.6% of all merger transactions in 1981, they accounted for 21.5% of all

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1. *See, e.g.*, Hector, *Are Shareholders Cheated By LBO's?*, FORTUNE, Jan. 19, 1987, at 98; Lowenstein, *No More Cozy Management Buyouts*, HARV. BUS. REV., Jan.-Feb. 1986, at 147; Spragins, *Leveraged Buyouts Aren't Just For Daredevils Anymore*, BUS. WK., Aug. 11, 1986, at 50; Stein, *Going Private Is Unethical*, FORTUNE, Nov. 11, 1985, at 169; Stein, *Leveraged Buyouts: On the Level?*, N.Y. Times, Jan. 17, 1988, § 6 (Magazine), at 40.

2. Hector, *supra* note 1, at 99.

3. Hector, *supra* note 1, at 99.

4. Hector, *supra* note 1, at 104.

5. Hector, *supra* note 1, at 104.

6. *Merger, Acquisition, and LBO Completions 1986 v. 1985*, MERGERS AND ACQUISITIONS, May-June 1987, at 57.

merger transactions in 1986.[7]

The term, leveraged buyout, arises from the fact that a large portion of the price paid for the corporation is derived from debt which is secured by the assets of the business.[8] The profit from a leveraged buyout is usually realized by selling assets of the business in a piecemeal manner or by selling stock in the business back to the public at a later date for a total price greater than the original price paid.

One of the major beneficiaries of the large profits offered by leveraged buyouts has been management. Leveraged buyouts provide management with the opportunity, through the use of debt, to acquire ownership of the corporation and to make large profits.[9] The potential for profits is increased if management can avoid paying fair value to the public stockholders for the corporation by taking advantage of its superior knowledge of the corporation.

The opportunity for management to profit at the expense of stockholders has prompted a great deal of controversy about the proper role of management and directors in management buyouts.[10] Although management owes a fiduciary duty to stockholders and the corporation to manage the corporation for the benefit of the stockholders,[11] management buyouts potentially jeopardize management's duty of undivided loyalty by placing it in a situation in which it can benefit at the expense of public stockholders by paying the lowest possible amount for their stock.[12] This potential is increased by the participation of other investors in the management buyout, such as investment banks, leveraged buyout funds and lenders, whose objectives of maximizing profits are unfettered by fiduciary duties owed to the selling stockholders.[13] Indeed, such investors usually purchase a majority of the corporation's stock with management obtaining less than a controlling share.[14]

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7. Nash, *Company Buyouts Assailed In Study*, N.Y. Times, Jan. 31, 1988, § 1, at 31, col. 1.

8. S. DIAMOND, LEVERAGED BUYOUTS 3 (1985).

9. *See* Sacha, *Why Leveraged Buyouts Are Getting So Hot*, BUS. WK., June 27, 1983, at 86 (great expectations prompt management buyout attempts); Wantuck, *When Managers Become Owners*, NATION'S BUS., Aug. 1983, at 60 (leveraged buyouts are attractive to investors because of opportunity for quick profit). Interestingly, management is increasingly able to purchase significant portions of the equity with minimal personal investment. *See* Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 734 (1985).

10. *See, e.g.*, Brudney, *A Note on Going Private*, 61 VA. L. REV. 1019, 1019 (1975); Brudney & Chirelstein, *A Restatement of Corporate Freeze-outs*, 87 YALE L.J. 1354, 1366-68 (1978); DeAngelo, DeAngelo & Rice, *Going Private: Minority Freeze-outs and Stockholder Wealth*, 27 J.L. & ECON. 367, 371-74 (1984); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 705-08 (1982); Wolfson, *A Critique of Corporate Law*, 34 U. MIAMI L. REV. 959, 978-80 (1980).

11. *See, e.g.*, Smith v. Van Gorkum, 488 A.2d 858, 872 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

12. *See* Borden, *Going Private—Old Tort, New Tort or No Tort*, 49 N.Y.U. L. REV. 987, 1017-18 (1974); Brudney, *supra* note 10, at 1029-30; Note, *Corporate Morality and Management Buyouts*, 41 WASH. & LEE L. REV. 1015, 1017 (1984); Longstreth, *Fairness of Management Buyouts Needs Evaluation*, Legal Times of Washington, Oct. 10, 1983, at 15, col. 3.

13. Coffee, *Shareholders Versus Managers: The Strain In the Corporate Web*, 85 MICH. L. REV. 1, 86-87 (1986); Steingold, *Wall St. Buys Into the Action*, N.Y. Times, June 19, 1986, at D1, col. 3. *But see* Clarke, *The Fiduciary Obligations of Lenders in Leveraged Buyouts*, 54 MISS. L.J. 423, 424 (1984) (discussing whether creditors in leveraged buyouts owe fiduciary duties to other parties, including stockholders).

14. Comment, *The Leveraged Buyout and Appraisal Rights: Balancing The Interest of Majority*

Because of management's conflict of interest and the obvious disparity of knowledge between management and public stockholders pertaining to the corporation, Professors Brudney and Chirelstein have suggested that management buyouts should be prohibited.[15] Similarly, the Securities and Exchange Commission (SEC) initially proposed that management buyouts be forbidden unless the public shareholders received "fair value."[16] However, partly because of a great deal of criticism, the SEC in the final version of rule 13e-3[17] only required management to state that it has a "reasonable belief" the purchase price offered to the public stockholders is "fair."[18] In contrast to Professors Brudney and Chirelstein, Judge Easterbrook and Professor Fischel have argued that buyouts and the creation of a market for control should be encouraged because they help achieve the most efficient use of resources.[19] They also assert that no further regulation of buyouts is required since current insider trading prohibitions are adequate to protect stockholders against management's exploitation of information about the corporation which the public stockholders do not possess.[20]

This Article proposes a new approach. Rather than flatly prohibit management buyouts or permit them under current legal rules, this Article proposes that management buyouts require a new form of disclosure. Contrary to Fischel and Easterbrook's assumption, current insider trading prohibitions are not adequate to protect stockholders against management's exploitation of some very important information which management possesses and stockholders do not—asset appraisals and income projections of the corporation. This disparity of information prevents an efficient allocation of resources from being achieved in a market for control since the market lacks the conditions necessary for a perfectly competitive market. A perfectly competitive market requires the presence of several buyers and sellers who possess perfect knowledge. Because stockholders are not aware of the asset values and income projections of the corporation, they lack the knowledge necessary to approximate the conditions for a perfect market. Moreover, because that information is not publicly available, the number of potential buyers is depressed below an optimal level since buyers other than

and Minority Shareholders, 21 WILLAMETTE L. REV. 123, 125 (1985); *see* Lowenstein, *supra* note 9, at 737.

15. Brudney, *supra* note 10, at 1052-53; Brudney & Chirelstein, *supra* note 10, at 1367; *cf.* Brudney, *Efficient Markets and Fair Values in Parent-Subsidiary Mergers*, 4 J. CORP. L. 63, 68-70 (1978) (distinguishing parent-subsidiary mergers from management buyouts). *But cf.* Greene, *Corporate Freeze-outs Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487, 489 n.7 (1976) (suggesting that management buyouts should be severely regulated).

16. Proposed Rule 13e-3, Securities Act Release No. 5567 [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,104 (Feb. 6, 1975).

17. 17 C.F.R. §§ 240.13e-3(e)(2), -100(8) (1986).

18. Going Private Transactions by Public Companies or Their Affiliates-Proposals; Securities Act Release No. 5884 [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,366 (Nov. 17, 1977); *see* Lowenstein, *supra* note 9, at 734 n.14. Item 8 of Schedule 13E-3, 17 C.F.R. § 240.13e-100, requires management to state whether it reasonably believes that the Rule 13e-3 transaction is fair or unfair to unaffiliated stockholders, and to further discuss "in reasonable detail the material facts upon which" this belief is based.

19. *See generally* Easterbrook & Fischel, *supra* note 10 (arguing that control transactions produce cost-reducing economies and lower agency costs).

20. Easterbrook & Fischel, *supra* note 10, at 730-31.

management cannot accurately value the corporation and, as a result, may not view the corporation as an attractive investment.

Consequently, this Article suggests that asset appraisals and income projections, hereinafter referred to as "soft information," should be disclosed in management buyout situations. The Article further suggests that the SEC, not the courts, is the appropriate authority for imposing that requirement, since the courts are hindered by the narrow scope of the statutory and regulatory language available to them to formulate a rule. The courts would have to interpret the term "material fact" broadly in order to require the disclosure of soft information. Such an interpretation, however, cannot properly distinguish the situations in which the disclosure of soft information would benefit society from the situations in which disclosure would harm society. Thus, the SEC should promulgate rules requiring the disclosure of soft information in certain situations, but should also limit the requirement to those situations in which the benefit to stockholders from disclosing soft information will exceed the harm to the competitiveness of the corporation.

II. The Problem with Management Buyouts and a Proposed Solution

Management buyouts are usually implemented in the same manner as a going-private transaction. That is, management and other investors will form a new corporation (Newco) which it then proposes to merge with the publicly held corporation (target).[21] Rather than receive stock in Newco, the stockholders receive cash in exchange for their stock in the target. If management and its coinvestors do not possess an interest in the target sufficient to approve the merger, the proposal for a merger may be preceded by a tender offer by Newco for the target's stock or by a redemption by the target of its stock in order to increase the percentage of outstanding stock owned by management.[22]

The large profits that management can realize in buyouts may be attributed to several sources. First, as illustrated by managements' successes in the buyouts of Metromedia and SFN, the value of the corporation's assets measured on a piecemeal basis may exceed the value which investors place on the corporation as a going concern. Hence, if the business is sold on a piecemeal basis, a large profit can be realized.

Second, the mere use of a large amount of debt can result in significant gains. This concept is called leverage. For example, consider a business that management and other investors purchased for $100 million, $90 million of the

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21. *See* 1 M. Lipton & E. Steinberger, Takeovers and Freezeouts § 9.03(5), at 9-15 (1987); Booth, *Management Buyouts, Shareholder Welfare, and the Limits of Fiduciary Duty*, 60 N.Y.U. L. Rev. 630, 630-31 (1985); Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 Calif. L. Rev. 1072, 1091-92 (1983); Note, *supra* note 12, at 1015, 1018-19. For additional details regarding the various methods of implementing management buyouts, see *infra* text accompanying notes 110-31.

22. 1 M. Lipton & E. Steinberger, *supra* note 21, § 9.02(2), at 9-8 to -9.

purchase price being financed with debt and the other $10 million with equity.[23] The investors decided to pay $100 million by valuing the corporation at seven times its cash flow of $14.285 million. If the corporation continued to generate a cash flow of $14.285 million per year before debt service, it would be able to repay completely the $90 million of debt in approximately ten years, assuming a ten percent interest rate. If, at that time, the corporation is valued at seven times its cash flow, the investor's equity would have increased from $10 million to $100 million in ten years. Note that if the corporation were valued at a higher multiple of cash flow, as may occur in a "bull" market, the investors would have an even higher return.

Obviously, cash flow and its relation to debt is the crucial element in using leverage.[24] If, in the foregoing example, management had been able to double the cash flow of the business to $28.6 million per year, the debt could have been reduced to zero in just five years. Alternatively, if management had been able to convince lenders that it would be able to increase cash flow, investors could have borrowed a larger percentage of the purchase price, thereby reducing the amount of their initial investment and increasing their return.

Several potential methods exist for increasing cash flow. First, management might be able to increase the productivity of operations by devising new manufacturing or marketing methods which reduce expenses. Management may also be able to identify new product applications or opportunities which increase revenues. The skillful utilization of tax benefits that become available as a result of the acquisition may further increase cash flow by reducing the corporation's tax burden.[25] Management's ability to identify and sell assets which may have a high market value but contribute poorly to cash flow will increase cash flow when such assets are sold.

Other methods for management to realize large gains in management buyouts are not as innocuous as the use of leverage or as apparently innocuous as increasing cash flow. Management may actively depress the price of the shares prior to the management buyout in order to reduce the price they have to pay. Management may accomplish this by reducing dividends, overfunding employee benefit plans, channeling investments into long-term projects which will not provide short-term returns, and utilizing conservative accounting methods which will help reduce the amount of reported income.[26] The large profits may

23. This hypothetical is a modified version of a hypothetical buyout described in Donnelly, *Valuing LBOs Takes Analysis of Distinct Kind*, Wall St. J., Apr. 2, 1987, at 31, col. 3.

24. *See* Ross, *How the Champs Do Leveraged Buyouts*, FORTUNE, Jan. 23, 1984, at 70. It is also obvious that debt increases the risk of the investment in the business. R. BREALY & S. MYERS, PRINCIPLES OF CORPORATE FINANCE 392 (3d ed. 1988).

25. *See* Lowenstein, *supra* note 9, at 759-61.

26. Lowenstein, *supra* note 9, at 740; *see also* Brudney, *supra* note 15, at 69-72 (describing various managment actions which affect stock prices); Brudney & Chirelstein, *supra* note 10, at 1366 (suggesting that since management controls the timing of the buyout, it will initiate the transaction when stock prices are depressed); Easterbrook & Fischel, *supra* note 10, at 707 (suggesting management might attempt to loot a potentially profitable corporate opportunity); Greene, *supra* note 15, at 497 n.37 (discussing fact patterns of cases in which management and majority stockholders used various methods to depress stock prices).

also be achieved if management can avoid paying full value for the corporation by not disclosing the true value of the corporation to stockholders.

Despite the potential for conflicts of interest, management buyouts have not been prohibited, and the zeal displayed by management and other investors for buyouts does not seem to have been even slightly impaired by the rule 13e-3's requirement that management state that it has a reasonable belief that the purchase price offered to the stockholders is fair. Consequently, management buyouts have sparked a great deal of controversy with some commentators extolling their virtues and others proposing that they be prohibited.

Brudney and Chirelstein, the principal opponents of management buyouts, disfavor buyouts for several reasons. First, they perceive the transactions as providing an opportunity for management to benefit at the expense of stockholders.[27] Their concern is based on the belief that management will attempt to purchase the corporation when the stock market does not adequately reflect the value of the corporation because the market does not possess all the information that management has pertaining to the corporation's future prospects.[28] Moreover, they assert that to the extent that the buyout will permit the corporation to achieve new gains by virtue of the buyout, the public stockholders should be permitted to participate in those gains.[29] Brudney and Chirelstein further reason that the appraisal remedy—the principal method for stockholders to receive a value for their stock which reflects management's nonpublic information and the stockholders' share of postbuyout gains—is inadequate because of the delay of litigation[30] and because the courts are not capable of determining the corporation's true value.[31] Thus, they conclude that management buyouts should be prohibited.[32]

In contrast, proponents of management buyouts, principally Fischel and Easterbrook, assert that buyouts result in a net increase of society's welfare.[33] They first argue that buyouts are beneficial because they eliminate or minimize the monitoring costs associated with the separation of ownership from management in a public corporation.[34] Thus, they suggest that buyouts help to minimize the costs, such as accounting and legal expenses, that stockholders incur to monitor management. Moreover, they assert that the avoidance of disclosure

27. Brudney, *supra* note 10, at 1019-20; Brudney & Chirelstein, *supra* note 10, at 1366.

28. Brudney & Chirelstein, *supra* note 10, at 1366, 1368.

29. Brudney & Chirelstein, *supra* note 10, at 1366, 1368.

30. Brudney, *supra* note 10, at 1024. For articles describing some of the difficulties of utilizing the appraisal process, see Kerr & Letts, *Appraisal Procedures for Dissenting Delaware Stockholders*, 20 BUS. LAW. 1083, 1085-95 (1965); Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962); Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189 (1964); Comment, *supra* note 14, at 133. A thoughtful discussion of the goals of appraisal statutes and the efficacy of achieving those goals is contained in Kanda & Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429 (1985).

31. *See* Brudney, *supra* note 10, at 1024-25.

32. *See* Brudney, *supra* note 10, at 1021; Brudney, *supra* note 21, at 1096-98.

33. *See generally* Easterbrook & Fischel, *supra* note 10 (asserting that buyouts produce more efficient corporations).

34. Easterbrook & Fischel, *supra* note 10, at 706.

requirements imposed on public firms may provide a competitive advantage to a company which has been taken private.[35] They also point out that management buyouts will result in a more efficient use of resources since management possessing a larger stake in the business will be better motivated to manage the firm effectively.[36] Lastly, the proponents argue that the current insider trading prohibitions are adequate to protect stockholders against management's exploitation of inside information.[37]

The reduction of monitoring costs may not in fact be substantial in a management buyout because of the presence of other investors in addition to management who will desire to monitor management. Moreover, as Brudney and Chirelstein point out, saving legal and accounting expenses associated with a public corporation is an inadequate justification for a buyout in light of the relatively small amount of these expenses.[38] However, society will clearly benefit when assets are used efficiently as is likely to be the case when management has a large stake in the business and has much to gain from a buyout.

Therefore, the question whether buyouts should be permitted is really about whether the deprivation of a "fair price" from stockholders is justified by the benefits identified by Easterbrook and Fischel. Such a speculative balancing process is not necessary, however, because a market mechanism can be used to allocate resources between management and stockholders in a manner which achieves a societally optimal solution. Indeed, Congress, in enacting the Securities Exchange Act of 1934, envisioned that fair prices for securities would be established by an open, competitive market. The Senate Report stated:

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price.[39]

Under general economic principles, maximum welfare is achieved where assets are allocated in conditions approaching a perfect market.[40] In a perfect market for securities, the nation's capital resources are allocated among compet-

35. Easterbrook & Fischel, *supra* note 10, at 706; *see* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 326-27, 333; Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371, 382-87 (1980); Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683 (1980).

36. Easterbrook & Fischel, *supra* note 10, at 705, 707.

37. Easterbrook & Fischel, *supra* note 10, at 730 (stating shareholders are also protected by independent valuation of corporate assets by financial and commodities markets and by likelihood of buyout plans leaking to media).

38. *See* Brudney & Chirelstein, *supra* note 10, at 1366 (authors state that saving legal and accounting expenses associated with a public firm is an inadequate justification in light of the relatively small amount of these expenses and add that in "many instances [they] would doubt its sincerity"); *see also* Lowenstein, *supra* note 9, at 743 ("The old explanations seem feeble. Surely a billion dollar company does not go private in order to save legal fees and the other routine expenses of having publicly traded securities.").

39. S. REP. NO. 792, 73d Cong., 2d Sess. 11 (1937).

40. Professor Fischel has explained allocational efficiency as follows: "Allocational efficiency, generally considered the most important economic goal achieved by securities markets, refers to the ability of those markets to maintain equivalent rates of return or costs of financing on comparable

ing uses based on the relative risk and returns associated with the uses.[41] Consequently, the amount which stockholders receive in a management buyout should approximate the amount they would receive in a perfect market. In that situation, societal welfare will have been maximized.

Before discussing the best way to achieve a perfect market in a management control transaction, it is important to first note that in a variety of circumstances it has been recognized that control of a corporation has separate value.[42] One way of describing this difference would be to state that the market for securities of a corporation operates in two tiers. The first tier is the usual market for securities and exists where securities are viewed as commodities[43] or residual claims to the corporation.[44] In this tier of the market, securities represent nothing more than discrete rights to portions of the net cash flow of the corporation.[45] The securities holders do not view themselves as having any significant impact on the deployment of assets of the corporation which would result in an enhancement of the cash flow.[46]

The second tier, in contrast, is a market for the control of the corporation which can be obtained if a sufficient amount of the corporation's equity securities are purchased. In this second market tier, a security represents not only a discrete right to a portion of the cash flow of a corporation, but also a right to

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investments with equivalent risk." Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 4-5 (1978).

When an economy achieves allocational efficiency, assets are presumed to be used in their most efficient manner. William J. Zaremba stated:

> The markets for stocks and bonds perform many essential and useful functions in the United States economy. One of the most important is the influence which this market, along with other financial and non-financial institutions, exerts in allocating the nation's capital resources among numerous competing uses for these resources.
>
> The efficiency with which this allocative functional is performed determines in large part the overall growth and efficiency of the economy itself. Thus, the government has from time to time passed legislation aimed at improving the performance and efficiency of the stock market.

Zaremba, *Foreward* to W. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY at vii (1965); *see also*, Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 707 (1987) (bargaining results in Pareto efficiency).

41. T. COPELAND & J. WESTON, FINANCIAL THEORY AND CORPORATE POLICY 285-86 (2d ed. 1983). The authors stated,

> Thus a market is said to be *allocationally efficient* when prices are determined in a way which equates the *marginal* rates of return (adjusted for risk) for all producers and savers. In an allocationally efficient market, scarce savings are optimally allocated to productive investments in a way which benefits everyone.

Id. at 286.

42. *See, e.g.*, Haddock, Macey & McChesney, *supra* note 40, at 708 (distinguishing market for shares from market for control); Lowenstein, *supra* note 9, at 751-53 (distinguishing the market for shares from the market for corporations as a whole); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-14 (1965) (establishing that a market for control exists and analyzing the various methods for obtaining control). *See generally* Jensen & Ruback, *The Market For Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983) (discussing market for control).

43. *See* J. KEYNES, THE GENERAL THEORY OF EMPLOYMENT INTEREST AND MONEY 147-64 (1936).

44. Fama & Jensen, *Separation of Ownership And Control*, 26 J.L. & ECON. 301, 302-03 (1983).

45. *See id.*

46. *See* Lowenstein, *supra* note 9, at 753-54.

redeploy the assets of the corporation in such a way as to maximize the security holder's welfare.[47]

In a management buyout, the market with respect to the equity securities of the corporation functions in the stock market's second tier, a market for control. Buyers in the market for control view stock not merely as a claim to a portion of the net cash flow, but also as an opportunity to enhance the net cash flow by redeployment of the underlying asset base of the corporation. When management initiates a buyout, the conditions for a perfectly competitive market for control should exist in order to maximize societal welfare. This would help ensure that capital resources are allocated among competing uses based upon the return associated with the assets of the corporation deployed in their most useful configuration.

For purposes of this Article, therefore, a fair value for stock in a management buyout is defined as the price which would be paid to stockholders in a transaction where the buyer seeks to purchase control under perfect market conditions.[48] Perfect market conditions exist when there are several buyers and sellers, all possessing perfect information.[49] This definition of fair value is based on the assumption that assets will be allocated most efficiently in conditions approaching a perfect market and that a societal goal is the efficient allocation of resources.[50] It is also based on the assumption that stockholders are entitled to receive a price for their stock approximately equal to that established in a perfect competitive market for control.[51]

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47. Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 346 (1980); Herman & Lowenstein, *The Efficiency Effects of Hostile Takeovers* 15 (Center for Law and Economic Studies, Colum. Law School, Working Paper No. 20, 1986); *see* M. WHITMAN & M. SHUBIK, THE AGGRESSIVE CONSERVATIVE INVESTOR 51 (1979).

48. Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal For Legislation*, 83 COLUM. L. REV. 249, 275 (1983); *see* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 251-52 (rev. ed. 1968); Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 108 (1979). *But see* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1165 n.13 (fair value of stock implies a relationship to the future price of the stock rather than to some intrinsic value). Consistent with this approach, it has been suggested that a fair price is what a third party would offer. Chazin, *Fairness from a Financial Point of View in Acquisitions of Public Companies: Is "Third-Party Sale Value" the Appropriate Standard?*, 36 BUS. LAW. 1439, 1439 (1981); Weiss, *Balancing Interests in Cash-out Mergers: The Promise of Weinberger v. U.O.P., Inc.*, 8 DEL. J. CORP. L. 1, 33, 44-48 (1983). It has also been suggested that there is no single fair price for a share of stock, but rather that a "range of fairness" exists which is based on a "range of prices." Booth, *supra* note 21, at 638 n.31, (quoting Chazen, *supra*, at 1439).

49. *See, e.g.*, R. BREALEY & S. MYERS, *supra* note 24, at 20. The requirement that several buyers and sellers exist is normally restated as the requirement that no participant be sufficiently dominant so as to have a significant effect on price. *Id.*; *see also* Bradley, *supra* note 47, at 374 (concluding that competitive market for control exists where several bidders compete to purchase control of the target).

50. "In an allocationally efficient market, scarce savings are optimally allocated to productive investments in a way which benefits everyone." T. COPELAND & J. WESTON, *supra* note 41, at 289; *see also* J. LORIE, P. DODD & M. KIMPTON, THE STOCK MARKET: THEORIES AND EVIDENCE 1 (2d ed. 1985) (basic function of stock markets is to provide and allocate capital funds to firms with profitable investment opportunities).

51. This assumption raises several troublesome issues which are beyond the scope of this Article. For example, if stockholders are entitled to receive such a price, does this mean that buyers should be required to announce immediately their intent to obtain control of the corporation instead of the current threshold for such an announcement at the time the buyer acquires five percent of the

Recent data suggests that, at least in certain circumstances, stockholders do not receive fair value for their stock as measured in a competitive market. Although commentators have observed that stockholders selling to management in a buyout normally receive a premium over the prevailing market price for their stock,[52] this may not reflect the fair value of the stock as established by a perfectly competitive market for control. According to a recent article, 260 public companies were taken private between 1971 and 1987 and of those companies, approximately 30 have gone public again or have been liquidated at a value representing an increase of approximately 150% over the value paid to stockholders at the time the company was taken private.[53] Moreover, research conducted by Professor Lowenstein indicates that shareholders receive a higher value for their shares if more than one bidder competes to purchase their corporation, such as when conditions begin to approach that of a perfect competitive market. His study showed that where other parties successfully compete with management in bidding for a business, stockholders receive a premium which is a mean of fourteen percent and a median of eight percent over the price which management had bid for the stock.[54] Professor Lowenstein's findings suggest that management is not offering fair value to stockholders, at least to the extent that value is reflected in a market for control which begins to approach the conditions of a competitive market as a result of several bidders.

Fischel and Easterbrook have suggested, however, that if management is required to pay fair value for the stock, management will not be sufficiently motivated to buy the firm.[55] Such a result would call into question the propriety of requiring the disclosure of asset appraisals and projections since management

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stock of the company so that all selling stockholders may receive fair value? At least one study indicates that the gains to shareholders of target corporations in which the acquirers purchased shares prior to announcing bids were smaller than the gains to shareholders of target corporations not subject to prebid share purchases. Franks, *Insider Information and the Efficiency of the Acquisitions' Market*, J. BANKING & FIN. 379, 379-80 (1978). If such a requirement were imposed, would this discourage bids? *See* Oesterle, *Target Managers as Negotiating Agents For Target Shareholders In Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 52, 82 (1985); Easterbrook & Fischel, *supra* note 10, at 710. Last, are stockholders entitled to participate in the receipt of control premiums? The answer should be yes when no stockholder or group of stockholders already control the corporation. When control of the corporation is diffuse, there is no reason to preclude all stockholders from sharing the premium, since the premium is attributable to the opportunity to maximize the productive use of the assets and that opportunity is in effect "owned" by the public stockholders as a result of diffuse stock ownership.

52. DeAngelo, DeAngelo & Rice, *supra* note 10, at 388-96. It has been suggested that the disparity between the market price of a security as reflected in the stock price and the premium paid to stockholders in a management buyout may be attributable to tax benefits and to the difference between the market price of a company's stock and its instrinsic or enterprise value. Lowenstein, *supra* note 9, at 731, 751-54. After the Tax Reform Act of 1986, there are fewer tax benefits available to acquisitions. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11-64, at 511-65 & n.168 (4th ed. Supp. 1987) (discussing impact of Tax Reform Act of 1986 on corporations). It has also been suggested that the premium is attributable to the belief of the buyer that it can operate the target corporation more profitably than current management. *See* Easterbrook & Fischel, *supra* note 48, at 1173.

53. Hector, *supra* note 1, at 104.

54. Lowenstein, *supra* note 9, at 738.

55. *See, e.g.*, Easterbrook & Fischel, *supra* note 10, at 698; Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

represents an important source of potential buyers for corporations which can enhance stockholder wealth.[56] Moreover, management ownership of a corporation can result in the assets of the business being used more efficiently.[57] Nonetheless, requiring management to pay fair value is unlikely to deter it from entering into a management buyout. Management will, all other things being equal, place a greater value on the corporation than other stockholders.[58] It will usually view the prospects of the firm to be less risky than the stockholders because the stockholders will include in their assessment of the risk, the possibility that management will be inept, corrupt, or irresponsible.[59] Management would not include these possibilities as a risk factor since it would not delegate the role of management to a third party.[60] Management may also attach less risk to the corporation because it is more familiar with the firm than stockholders and will not include the potential for hidden problems as a component of risk. Thus, management will normally apply a lower capitalization rate than nonmanagerial stockholders to calculate the present value of the corporation's anticipated earnings. Because it will value the firm at a higher price than stockholders, all other things beings equal, management will usually be motivated to bid for the company. Moreover, management's desire to secure employment with the corporation may also cause it to place a higher value on the corporation's stock and to bid for the firm.[61]

Another argument against requiring management to pay fair value is that public stockholders are not injured if they receive less than fair value because when they purchased the stock they paid less than fair value. Stockholders may have paid less than fair value because the market had already assimilated the expectation that if a freezeout or management buyout occurred, stockholders would not receive fair value. As Professor Clark has pointed out, "the possibility that the company's stock price was depressed because the market anticipated that the controlling parties would engage in future self-dealing . . . is one that is hard to assess and put to use."[62] This is particularly true since, as will be discussed shortly, the state of the law applicable to buyouts is in flux. If the market had discounted the possibility of stockholders not receiving fair value to a present value which was reflected in the purchase price paid by stockholders, the possibility was presumably assigned a low probability because of the uncertainty of the direction the law would take and, therefore, had a negligible impact on the price paid by stockholders.[63]

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56. *See* Booth, *supra* note 21, at 640; *see also supra* text accompanying note 52.

57. Easterbrook & Fischel, *supra* note 10, at 705-07.

58. Booth, *supra* note 21, at 634.

59. Booth, *supra* note 21, at 634-35. The exception exists, of course, when management is aware of liabilities of the corporation which have not been disclosed to the public.

60. Booth, *supra* note 21, at 634-35.

61. *See* Coffee, *supra* note 13, at 17-18.

62. R. CLARK, CORPORATE LAW 509 (1986).

63. Indeed, an excellent recent study by Professors Weiss and White indicates that investors may pay little attention to judicial developments in corporate law in valuing stock "because the investors appreciate that the decisions do not foreshadow predictable differences in the outcome of future cases, since virtually all such cases will involve transactions that are potentially distinguishable from the cases that the Delaware courts have decided." Weiss & White, *Of Econometrics and*

It may also be possible, as Easterbrook and Fischel have suggested, that stockholders have impliedly contracted to permit management to pay less than fair value.[64] This argument is unpersuasive.[65] The stockholders do not possess sufficient information to knowingly enter into such a contract. They do not know the value that would be derived from using the firm's assets in the most profitable manner. This lack of knowledge of even the most basic elements of the purported contract with management suggests that such a "contract" should not be inferred since it would not achieve an efficient allocation of resources without adequate knowledge on both sides.[66]

Proponents of management buyouts have also suggested that stockholders receive fair value for their stock so long as they receive the market price or a premium over the market price which existed prior to the announcement of the buyout.[67] In effect, these proponents view market price as an accurate measure of value of the corporation at any given time.[68] This view of the accuracy of market prices is based on the assumption that the efficient market theory is an accurate description of the manner in which the stock market operates.[69] The efficient market theory states that if there is a large number of buyers and sellers of securities acting through a market mechanism, such as the New York Stock Exchange, the prices of the securities will fully reflect all available information about a company's securities.[70] The ability of an efficient market to assimilate all available information results from the efforts of analysts and investors "to beat the market," that is, to earn superior returns.[71]

As Lowenstein has pointed out, the assumption that under the efficient market theory the market price of stock prior to the announcement of a buyout is an accurate measure of the value of the corporation in a control transaction is incorrect.[72] Prior to the buyout the stock price has been established in the first

Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law, 75 CALIF. L. REV. 551, 602 (1987).

64. *See, e.g.*, Easterbrook & Fischel, supra note 10, at 711-14.

65. *See* Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 781 (1978); Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1405-06, 1413-15 (1985); Brudney, *supra* note 21, at 1082-91; Lowenstein, *supra* note 9, at 750.

66. *See* Brudney, *supra* note 65, at 1403, 1411.

67. *See, e.g.*, Easterbrook & Fischel, *supra* note 10, at 729; Easterbrook & Fischel, *supra* note 48, at 1168; Fama, *supra* note 55; Jensen & Meckling, *supra* note 55.

68. Jensen & Meckling, *supra* note 55.

69. Lowenstein, *supra* note 9, at 751-54.

70. R. BREALEY & S. MYERS, *supra* note 24, at 281-82; T. COPELAND & J. WESTON, *supra* note 41, at 287; J. LORIE, P. DODD & M. KIMPTON, *supra* note 50, at 55-56; Fischel, *supra* note 40, at 3-4. For a discussion referring to recent studies that the stock market may not be very efficient and implications on investment strategy, see Keane, *The Efficient Market Hypothesis on Trial*, FIN. ANALYST J. Mar.-Apr. 1986, at 58. Studies that confirm or reject the efficient market theory are summarized in V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE CASES AND MATERIALS 123-30 (1987); J. LORIE, P. DODD & M. KIMPTON, *supra* note 50, at 56-77; Gordon and Kornhauser, *Efficient Markets, Costly Information and Securities Research*, 60 N.Y.U. L. REV. 761, 834-46 (1985); Summers, *Does The Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591 (1986); Wang, *Some Arguments That the Stock Markets Is Not Efficient*, 19 U.C. DAVIS L. REV. 341, 349-62 (1986).

71. Fischel, *supra* note 40, at 3-4.

72. Lowenstein, *supra* note 9, at 751-54. For example, *Forbes* magazine reported that in Janu-

tier of the market. The market price, as an equilibrium price between buyers and sellers, largely reflects the short-term expectations of institutions and other major traders who view the stock as representing nothing more than discrete rights to portions of the net cash flow of the corporation.[73] Consequently, the aggregate market price of a corporation's stock may not reflect the asset value of the firm or the value of the firm as a whole. The institutional buyers usually do not expect to affect management of the corporation and, therefore, the price of any given stock merely reflects the implementation of current policies of the firm.[74] Even though a firm may possess valuable assets which can be sold profitably or deployed efficiently, the aggregate value of the corporation's stock, as determined by the market, may be much less then the value of the assets because of the expectation that management will not sell or redeploy the assets.[75] Such short-term investors, in performing their valuation analysis, would not weigh heavily the possibility that at some future date the corporation's assets may be sold at a large profit or that the firm may be sold as a whole at a large premium because the purchaser believes that it can more effectively manage the assets or the firm.[76] Of course, once that remote possibility becomes less remote, then the market equilibrium price reflects this and begins to rise, although perhaps not to the full value if management has successfully entrenched itself.

Thus, the efficient market theory does not support the conclusion that sellers will receive fair value in management buyouts regardless of whether the prerequisites for a perfectly competitive market for a transfer of control are established. Indeed, there is another major problem with relying on an efficient market to establish a fair price. Studies suggest that an efficient market does not assimilate inside information.[77]

There are three theoretical forms of an efficient market—the weak form, the semi-strong form, and the strong form.[78] The weak form hypothesizes that the

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ary 1988 the stock of Tenneco was trading at one-half of its estimated per-share break-up value. Cone, *Breaking Up Is Hard To Do*, FORBES, Feb. 8, 1988, at 41. The article states that the chairperson of Tenneco felt no pressure to realize the value of the assets because of an antitakeover plan which would require two-thirds of disinterested stockholders to approve any hostile bid. *Id.*

73. Lowenstein, *supra* note 9, at 751-54; *see* Booth, *supra* note 21, at 637.

74. Lowenstein, *supra* note 9, at 751-54.

75. Lowenstein, *supra* note 9, at 752-53.

76. Lowenstein, *supra* note 9, at 752-53.

77. *See, e.g.*, Collins, *SEC Product Line Reporting and Market Efficiency*, 2 J. FIN. ECON. 125 (1975) (stating that knowledge of profit and sales for each product line of publicly held corporations prior to the time the SEC required disclosure of that information would have resulted in abnormal trading profits and, therefore, that the market had not assimilated that nonpublic information); Lorie & Neiderhoffer, *Predictive and Statistical Properties of Insider Trading*, 11 J.L. & ECON. 35, 47 (1968) (studies of insider trading reports required by § 16 of the Securities Exchange Act of 1934 found purchases by insiders usually preceded large increases in the stock's price, indicating that the market had not assimilated the information possessed by the insider); Patell, *Corporate Forecasts of Earnings Per Share and Stock Price Behavior: Empirical Tests*, 14 J. ACCT. RES. 246, 273-74 (1976) (stock prices react to earnings forecasts of corporate management, indicating that forecasts had previously not been reflected in stock's price). It has been suggested that the market's failure to reflect inside trading is attributable to laws which prohibit inside insider trading and, therefore, those laws should be abolished. *See* Carlton & Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 867-68 (1983).

78. V. BRUDNEY & M. CHIRELSTEIN, *supra* note 70, at 121; J. COX, FINANCIAL INFORMATION, ACCOUNTING AND THE LAW 187 (1980); J. LORIE, P. DODD & M. KIMPTON, *supra* note 50,

market reflects new information slowly in a security's price. The semi-strong form theorizes that all public information is impounded rapidly in a security's price. The strong form takes this one step further and hypothesizes that all information, public and nonpublic, is reflected in a security's price. Studies indicate that the semi-strong form of the efficient market is the most accurate in describing the manner in which the market actually operates.[79] Thus, it seems probable that the price of a security reflects only public information, not nonpublic information which management may possess that indicates that the security has a value greater than its market price. While current inside trading restrictions may prohibit management from using some of this information to its benefit, a large body of the most useful information, asset appraisals and income projections, is likely outside the scope of current inside-trading restrictions. Moreover, since management is purchasing the corporation in a management buyout for its own benefit, it is clearly in management's best interests to ensure that the information remains secret.[80]

The lack of sufficient information not only conflicts directly with the requirement of perfect knowledge for a perfectly competitive market, but also indirectly contributes to the second reason that the current market has failed to approximate a perfectly competitive market—the absence of several bidders. In order to increase the number of bidders for corporate control, Lowenstein has suggested that a mandatory auction occur if management decides to purchase the corporation.[81] Indeed, the courts have recently begun to implement this

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at 56. Eugene Fama first proposed the terms "weak," "semi-strong" and "strong," in connection with the classification of empirical tests of the price behavior of securities, Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 388 (1970), not as an actual description of the manner in which efficient markets may operate. Gilson & Kraackman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 555 (1984).

79. *See, e.g.*, Ball & Brown, *An Empirical Evaluation of Accounting Income Numbers*, 6 J. ACCT. RES. 159, 163 (1968); Foster, *Stock Market Reaction to Estimates of Earning Per Share by Company Officials*, 11 J. ACCT. RES. 25-27 (Spring 1973); Pettit, *Dividend Announcements, Security Performance, and Capital Market Efficiency*, 27 J. FIN. 993-1007 (1972); *see also* J. COX, *supra* note 78, at 187 and studies cited therein (reviewing studies of the various forms of an efficient market); V. BRUDNEY & M. CHIRELSTEIN, *supra* note 70, at 121 and studies cited therein (reviews the relative accuracy of the three forms of the efficient market theory). *But see* Wang, *supra* note 70, at 341-75 (arguing that the insights from the semi-strong form are insufficient to reward analysts who search out and study information about corporations).

80. This analysis differs markedly from one proposed by Professors Fischel and Easterbrook in advocating that the market price equals the fair value of stock in an efficient market. They stated:

> When price changes, the change does not show that the old price was wrong; it shows only that new information has been incorporated into the price of the stock.
>
> We can conclude from this, with some confidence, that a tender offer at a price higher than the prevailing one also exceeds the value of the stock. True, the target's managers may know something about the firm's prospects not yet incorporated into the price of the shares. But the disparity between price and worth could not last long. If a bidder tried to steal the target by capitalizing on its special information, the target's managers could defeat the offer by disclosing the information to the public. The price would adjust to reflect the new information, and the offer would succeed only if it were higher than the new price. Tender offers at a premium thus must benefit the target's shareholders.

Easterbrook & Fischel, *supra* note 48, at 1167-68. When management intends to purchase the corporation itself, or encourage a "white knight" to purchase the corporation, management will clearly not want to disclose the information indicating a value greater than market value to the public.

81. Lowenstein, *supra* note 9, at 779. Professor Borden also suggested a mandatory auction in 1974, *see* Borden, *supra* note 12, at 1039, as have others. *E.g.*, Bebchuk, *The Case For Facilitating*

innovation.[82] Lowenstein would further prohibit the use of various "lock-up" provisions by management[83] and would require that the management group provide to bidders information "needed to bid intelligently."[84] The specific type of information which management would have to supply to other bidders would be the data which management had furnished to coinvestors and lenders who are financing management's bids.[85]

This solution, however, also will not ensure the creation of a perfectly competitive market for control. The data "needed to bid intelligently" should not only be disclosed to other bidders but should be disclosed to stockholders as well so that the information enters the public domain. This would have two major benefits. First, public disclosure of information would attract additional bidders. Second, since a perfectly competitive market requires informed buyers and sell-

Competing Tender Offers: A Reply and Extension, 35 STAN. L. REV. 23, 24 (1982); Bebchuk, *The Case for Facilitating Tender Offers*, 95 HARV. L. REV. 1028, 1044 (1982); Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CALIF. L. REV. 1671, 1709-13 (1985); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982). In contrast, Fischel and Easterbrook have argued that management should not be required to initiate an auction when a bid is made for the corporation by a third party because the initial bidder has incurred costs in identifying the corporation as an attractive investment which subsequent bidders will not have to incur. They also assert that an auction will reduce the number of offers because it will cause the corporation to be more expensive to purchase. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 2 (1982). Based on the foregoing, they conclude that management should remain passive in a tender offer. *Id.* at 1; *see* Easterbrook & Fischel, *supra* note 48, at 1198-99. It seems unlikely that those concerns would apply to a management buyout. First, management has not incurred any costs in identifying its corporation as an attractive acquisition. Second, as discussed earlier, *supra* text accompanying notes 58-61, management will normally value the corporation higher than outside investors so that it is unlikely that management bids would be deterred.

82. In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), the Delaware Supreme Court stated that once it becomes apparent that the sale of a company is inevitable, then the role of the board of directors changes from "defenders of the corporation bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.* at 182; *see also* Edelman v. Fruehauf, 798 F.2d 882, 886-87 (6th Cir. 1986) (under Michigan law, "[o]nce it becomes apparent that a takeover target will be acquired by new owners, whether by an alleged 'raider' or by a team consisting of management and a 'white knight,' " it becomes the duty of the target's director to ensure that the stockholders obtain the best price possible for their stock); Black & Decker Corp. v. American Standards Inc., 1988 Fed. Sec. L. Rep. (CCH) ¶ 93,685 (D. Del. March 16, 1988) (court ruled that recapitalization giving management control of 55% of the outstanding common stock triggered requirement that board of directors obtain the highest price for stockholders).

83. Lowenstein, *supra* note 9, at 741. It should be noted, however, that not all lock-ups may be harmful to stockholders. The availability of lock-ups may encourage bidders to enter a contest for control thereby "creating an auction for the company and maximizing shareholder profit." *Revlon, Inc.*, 506 A.2d at 183; *accord* Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274 (2d Cir. 1986); *see also* Note, *Lock-Up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068, 1076-82 (1983) (lock-up arrangements are beneficial to target shareholders because they induce otherwise reluctant bidders to enter the contest as white knights, thus raising the stakes in the contest for corporate control); Note, *Corporations-Mergers—"Lock-up" Enjoined Under Section 14(e) of Securities Exchange Act*—Mobil Corp. v. Marathon Oil Co., *669 F.2d 366 (6th Cir. 1981)*, 12 SETON HALL L. REV. 881, 892 (1981) (observing that "it is only by the inclusion of a lock-up agreement that many firms will agree to assume the risk and act as white knight, thereby allowing target management to defeat an unwanted takeoever and providing target shareholders with the opportunity to sell their shares at a higher premium").

84. Lowenstein, *supra* note 9, at 779; *see also* Bebchuk, *The Case for Facilitating Tender Offers*, 95 HARV. L.REV. 1028, 1049-50 (1982) ("[A] rule of auctioneering improves the information that constitutes the basis for acquisition decisions, and thus reduces the likelihood of an acquisition that produces no gain, or even a loss.").

85. Lowenstein, *supra* note 9, at 779 n.196.

ers, disclosing the information to the sellers, in this situation the stockholders, will ensure that the sellers as well as the buyers are informed. The stockholders will no longer have to rely on management to act fairly, but instead will have sufficient information to make their own decision.

Thus, in order to maximize societal welfare, full disclosure should be required. Although perfect knowledge, a prerequisite for a perfectly competitive market is not achievable, full disclosure is. Full disclosure will help achieve the societal goal of efficiently allocating resources and providing stockholders fair value for their shares.

What type of information would enable the public stockholders to obtain fair value from management in the sale of the company? Let us consider once again the various alternatives by which management may enhance its wealth in a management buyout. Management might plan to increase the efficiency of production by a more effective deployment of personnel or equipment. Management's plans might also involve the exploration of new business opportunities, use of more effective marketing methods, and a focus on long-term growth instead of short term profits. Further, it might involve the skillful use of tax benefits which were not available to the corporation.[86] Last, it might involve dismantling the business and selling it on a piecemeal basis.

Management could simply disclose its specific plans to stockholders. However, that alone would not suffice. Both advocates and proponents have recognized that a major potential problem with management buyouts is that management possesses a much firmer grasp on the potentialities of the business and the operations of the business than that possessed by stockholders. Management is privy to asset appraisals and financial projections which may not have been disclosed to the public and assimilated by the market into the stock price. Indeed, the efficient market theory does not imply perfect forecasting ability.[87] In order to ensure that management will not be able to utilize its superior knowledge to disadvantage stockholders, this information should be disclosed to stockholders.[88] The projections and asset appraisals would help stockholders quantify the impact that management's plans will have on the profitability of the corporation. The importance of this information in calculating an appropriate purchase price is illustrated by the fact that companies subject to hostile bids by former employees have recently begun to sue the employees, asserting that the

86. For example, § 338 of the Internal Revenue Code of 1954, as amended, permits the purchaser of at least eighty percent of the stock of a corporation to elect to treat the purchase of the stock as though it were a purchase of the corporation's asset, thereby increasing the depreciable basis of the corporation's assets. However, the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986), substantially reduced the attractiveness of making a § 338 election by treating the election as a recognition event which could result in a tax on the appreciation of the corporation's assets. B. BITTKER & J. EUSTICE, *supra* note 52, at 11-63 to -64.

87. R. BREALEY & S. MYERS, *supra* note 24, at 289.

88. Professor Roger J. Dennis has also recognized that disclosing soft information would help improve market efficiency in corporate control transactions. Dennis, *Mandatory Disclosure Theory and Management Projections: A Law and Economics Perspective*, 46 MD. L. REV. 1197, 1213, 1219 (1987).

employees were using confidential information.[89]

To ensure that management's projections and appraisals do not depart from management's true expectations, management should be required to disclose and explain any projections or appraisals that it had provided to its coinvestors and creditors that differ from the projections and appraisals disclosed to the stockholders.[90] This disclosure would help ensure the credibility of the soft information since, although management might seek to portray the corporation as having negative potentialities to the stockholders, it would certainly wish to present a more positive picture to the parties helping it purchase the corporation.

III. THE PROBLEM WITH MANAGEMENT BAILOUTS

There are other types of management control transactions which may require the disclosure of soft information in order to achieve conditions prerequisite to a perfect market for control. One is a management bailout.[91] In a

89. Cohen, *Ex-Employees Who Join Takeover Plots Can Expect Their Former Bosses to Sue,* Wall St. J., July 7, 1987, at 31, col. 3.

90. *See infra* text accompanying notes 209-57.

91. Another type of control transaction is a recapitalization. In a recapitalization, the corporation usually borrows a large amount of cash in order to make a distribution to stockholders. For example, see the Owens-Corning Fiberglas Corporation recapitalization plan described in its Proxy Statement/Prospectus dated October 16, 1986, and The Harcourt Bruce Jovanovich, Inc. recapitalization plan described in British Printing & Communication Corp. v. Harcourt Bruce Jovanovich, Inc., 664 F. Supp. 1519 (S.D.N.Y. 1987). The incurrance of a large amount of debt causes the corporation to become a less attractive takeover candidate. To ensure further that a hostile takeover will not succeed, usually a large percentage of voting stock is issued to management and employee stock ownership plans as part of the recapitalization. For example, when Owens-Corning Fiberglas Corporation ("Owens") became the target of a hostile tender offer at a price of seventy-four dollars per share by Wickes Companies, Inc., Owens announced that it would ask stockholders to approve a recapitalization pursuant to which each share of common stock held by the public stockholders would be converted into the right to receive fifty-two dollars in cash, a "Junior Subordinated discount Debenture" with a stated face amount of thirty-five dollars and one share of new common stock. Proxy Statement/Prospectus of Owens-Corning Fiberglas Corporation 1-2 (Oct. 16, 1986). Also, pursuant to the recapitalization, certain Owen employee benefit plans would receive five to six shares of new common stock instead of cash for each of their existing shares. *Id.* In a letter to the stockholders, the chairperson of the board of directors explained the purpose of the recapitalization plan as follows:

> The recapitalization is intended to provide stockholders with an opportunity to receive a significant premium over historical prices for their shares, while permitting them to retain a substantial ongoing equity interest in Owens-Corning, as well as to provide performance incentives to officers and other key employees through their increased equity participation in Owens-Corning.

Letter from W. Boeschenstein, Chairman of the Board, President and CEO of Owens-Corning Fiberglas Corp. to Stockholders, dated Oct. 16, 1986. The impact and regulation of recapitalizations are complex and deserve further study. In a recapitalization, usually the public stockholders continue to own a substantial equity portion in the corporation. Because the disclosure of soft information will reveal the corporation's strategic plans, thereby impairing the competitiveness of the corporation, one has to question whether the harm which the stockholders will indirectly suffer as a result of the loss of competitiveness will be greater than the benefit they review as a result of the disclosure of soft information. A recapitalization could possibly be the type of control transaction where it is appropriate to rely on outside directors to whom the soft information would be disclosed to ensure that stockholders receive fair price. However, there are several problems with relying on outside director to establish a fair price for stockholders. *See infra* text accompanying notes 255-57 (discussion of the problems of relying on outside directors to establish a fair price). Thus it seems that recapitalizations should be treated in the same manner as management buyouts.

management bailout, a corporation is subject to a hostile tender offer by someone inimical to management and, as a result, management tries to attract a "white knight"—a bidder who is friendly to management.

In a bailout, management may disclose nonpublic soft information in order to persuade the potential offeror that the price for which the corporation may be purchased is attractive.[92] The potential offeror then has information which the stockholders do not have and has a motive to use that information to offer a price for the stock which may be successful but which does not reflect the fair value of the stock based on management's experience, planning, and expectations about the future of the corporation.[93]

In this circumstance, it also seems appropriate to require the disclosure of income projections and asset appraisals to stockholders. When management has provided such information to a third party which will employ that information to its advantage, it seems reasonable to require the disclosure of that information to stockholders.

IV. THE UTILITY OF INCOME PROJECTIONS AND SOFT INFORMATION

The utility of soft information in making an investment decision cannot be overstated. While historical financial information about a business may be helpful to analyze the competence of management,[94] financial projections and asset appraisals provide the most useful information to investors.[95] In a management buyout, management and management's coinvestors are willing to purchase the corporation because of the belief that they will be able to profit from the purchase. The profit may, as described earlier, arise from the use of leverage, from improved management, or from improved deployment of assets. Regardless of the source of profit, management will have prepared financial projections which they will have shown to their coinvestors and to creditors who are financing the acquisition. The creditors may also have been shown asset appraisals. The coinvestors and creditors demand this information in order to make an in-

92. *See* Haddock, Macey & McChesney, *supra* note 40, at 709-10 (manager of a potential target "can enhance his own position by pointing out the undervalued nature of his firm to bidders, who will value his ability to discern such circumstances").

93. The question might be asked whether the soft information provided to the potential "white knight" should be disclosed to stockholders since it is likely that the information may represent management's most optimistic assessment. However, as long as the recipient of the information is sophisticated, as is likely to be the case for a white knight, management would not be overly optimistic because a sophisticated analyst may lose confidence in management as a result of an overly optimistic projection or appraisal.

94. *See, e.g.*, H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 24-31 (1979); Schneider, *Nits, Grits and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254, 266 (quoting Address by SEC Chairman Casey, New York Law Journal, Apr. 21, 1972, at 5, 8-9).

95. *See, e.g.*, ADVISORY COMMITTEE ON CORP. DISCLOSURE, REPORT TO THE SECURITIES AND EXCHANGE COMMISSION, 55-57 (Comm. Print 1977) [hereinafter REPORT]; Cragg & Malkiel, *The Consensus and Accuracy of Some Predictions of the Growth of Corporate Earnings*, 23 J. FIN. 67, 67 (1968); Herwitz, *Projections and Forecasts*, 4 ANN. INST. SEC. REC. 323, 327 (1973); Kripke, *A Search for a Meaningful Securities Disclosure Policy*, 31 BUS. LAW 293, 298 (1975); Note, *Disclosure of Future-Oriented Information Under the Securities Laws*, 88 YALE L.J. 338 (1978).

formed decision about whether to commit their funds to the purchase of the enterprise.

One method analysts frequently employ to value stock is to capitalize anticipated future earnings.[96] This method is employed if the business is expected to continue as a going concern. If the business is expected to be discontinued or divided up and sold, then asset valuation is the more useful method for valuing the business.[97] In illustrating the comparative utility of historical data versus soft information, a former commissioner of the SEC stated:

> We would not think much of a military general staff or intelligence officer which told field commanders they were not going to give them their estimates as to the enemy's strength and dispositions for fear they might not be accurate or complete, but would prefer to give them something that they were sure was reliable, like information about the enemy's dispositions in World War II.[98]

Securities analysts spend a great deal of time trying to forecast a corporation's earnings in order to anticipate movement in the company's stock and to value the stock.[99] However, one would expect corporate management to project profits and sales more accurately than financial analysts.[100] The studies confirm this.[101] Intuitively, one would also expect that management is best equipped to

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96. *See, e.g.*, B. GRAHAM, D. DODD & S. COTTLE, SECURITIES ANALYSIS 443-46 (1962); J. LORIE, P. DODD & M. KIMPTON, *supra* note 50, at 88-95; Blum & Katz, *Depreciation and Enterprise Valuation*, 32 U. CHI. L. REV. 236, 236 (1965); Mann, *Prospectuses: Unreadable or Just Unread? —A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222, 224 (1971); Note, *Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation*, 81 COLUM. L. REV. 1525, 1528 (1981).

97. *See* Speed v. Transamerica Corp., 99 F. Supp. 808, 828 (D. Del. 1951), *modified*, 235 F. 2d 369 (3d Cir. 1956) (corporate insiders had violated rule 10b-5 where they offered to purchase minority stockholders' stock with a view towards liquidating the corporation without disclosing that corporation's assets had greatly appreciated over book value).

98. Address by A.A. Sommer, Jr., SEC Commissioner, *Forecasting: A Look at the Future*, Corporate Financial Forecast and Disclosure Conference 3-4 (Mar. 29, 1974), *quoted in* Brown, *Corporate Communications and the Federal Securities Laws*, 53 GEO. WASH. L. REV. 741, 794 n.231 (1985).

99. Indeed, commentators have stated that "[t]he purpose of the security analysis function is not to dredge published reports but to generate information on the future earnings of firms that is not yet available." J. LORIE, P. DODD & M. KIMPTON, *supra* note 50, at 96. A survey of analysts conducted by the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission confirms that most analysts view an earnings forecast as the end product of their work. REPORT, *supra* note 95, at 55. Consistent with this view, portfolio managers who were also surveyed stated that the most important information they obtain from analysts is the earnings forecast. REPORT, *supra* note 95, at 158.

100. Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1199 (1970). Professor Kripke stated:

> If there is any hope that the public or even the professionals can make an informed investment judgment, it must start from a crystallization of all of the plethora of information into a projection for the future. The management is in the best position to make the initial estimate; on the basis of it the professional or investor could then make his own modifications.

Id.

101. *E.g.*, Basi, Carey & Twark, *A Comparison of the Accuracy of Corporate and Security Analysts' Forecasts of Earnings*, 51 ACCT. REV. 244 (1976); Imhoff, Jr., *The Representativeness of Management Earnings Forecasts*, 53 ACCT. REV. 836, 845-47 (1978); Jaggi, *Further Evidence on the Accuracy of Management Forecasts vis à vis Analysts' Forecasts*, 55 ACCT. REV. 96 (1980); Ruland, *The Accuracy of Forecasts by Management and by Financial Analysts*, 53 ACCT. REV. 439 (1978).

estimate the value of assets of the corporation if the corporation were sold on a piecemeal basis. Yet, the courts and the SEC have been reluctant to require the disclosure of soft information.

The next portion of this Article will focus on the extent to which disclosure of soft information is currently required, tracing the developments in both federal and state law. The Article concludes that state law presents the strongest source for the imposition of a requirement that soft information be disclosed in management buyout situations. Because of the impact such a requirement might have on capital markets, however, federal regulation is required.

V. THE CURRENT REGULATORY SCHEME FOR DISCLOSURE OF SOFT INFORMATION IN MANAGEMENT BUYOUTS AND BAILOUTS

For many years the SEC discouraged the use of soft information,[102] such as projections and appraisals, viewing that type of information as potentially misleading and unreliable.[103] However, beginning in 1973, the SEC began to reconsider its position and after a series of false starts adopted "guides" for disclosing projections of future economic performance.[104] In 1979, the SEC adopted a "safe harbor" rule in order to encourage companies to disclose projections.[105] The safe harbor provided that a "forward-looking statement" is not fraudulent "unless it is shown that such statement was made or reaffirmed without a rea-

102. *See, e.g.*, Guidelines for the Release of Information by Issuers Whose Securities are in Registration, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192 (Aug. 16, 1971) (companies should avoid making projections, forecasts, or predictions in a prospectus); Adoption of Amendments to Proxy Rules, Exchange Act Release No. 5276, [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,380 (Jan. 17, 1956) (predictions as to earnings may be misleading in proxy statements); Brown, *supra* note 98, at 792; Hiler, *The SEC And The Courts' Approach To Disclosure Of Earnings Projections, Asset Appraisals, And Other Soft Information: Old Problems, Changing Views*, 46 MD. L. REV. 1114, 1116-21 (1987); Note, *Target Corporation Disclosure of Soft Information In Tender Offer Contests*, 54 FORDHAM L. REV. 825, 830 (1986). For an excellent summary of the SEC's early approaches to soft information, see REPORT, *supra* note 95.

103. *See* Flynn v. Bass Bros. Enter., 744 F.2d 978, 985 (3d Cir. 1984) (stating that SEC's policy against disclosing soft information stems from its concern about the reliability of such information and that investors will accord them more weight than is warranted); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1294 (2d Cir. 1974) (same).

104. In 1973 the SEC stated that it intended to issue rules pertaining to the disclosure of projections. Statement by the Commission on Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5362, [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,211 (Feb.2, 1973). Subsequently, in 1975, the SEC proposed some very complex rules. Notice of Proposed Rule 132, Securities Act Release No. 5581, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,167 (Apr. 28, 1975). It withdrew the proposed rules the following year because of extensive criticism. Notice of Adoption of an Amendment to Rule 14a-9, Securities Act Release No. 5699, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,461 (Apr. 23, 1976). The SEC then reviewed the report of the Advisory Committee on Corporate Disclosure. REPORT, *supra* note 95; *see* Preliminary response of the Commission to the Recommendations of the Advisory Committee on Corporate Disclosure, Securities Act Release No. 5906 [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,505 (Feb. 15, 1978). After reviewing the report, the SEC adopted in 1978 "guides" for disclosing projections, Guides for Disclosure of Projections of Future Economic Performance, Securities Act Release No. 5992, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,756 (Nov. 7, 1978), and also proposed a safe harbor rule, Proposed Safe-Harbor Rule for Projections, Securities Act Release No. 5993 [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,757 (Nov. 7, 1978).

105. Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117 (June 25, 1979).

sonable basis or was disclosed other than in good faith."[106] The safe harbor also purported to impose on plaintiffs in securities fraud actions the burden of proving that a projection had been made in bad faith or without a reasonable basis.[107]

The SEC has also enacted other rules to encourage the use of asset appraisals and income projections. Regulation S-K, Item 10(b) permits the use of "management's projections of future economic performance that have a reasonable basis and are presented in an appropriate format."[108] Moreover, asset appraisals may be disclosed when all or part of a company's assets are to be liquidated.[109] Because these provisions permit rather than require disclosure, and because management has no incentive to disclose such information when seeking to purchase the corporation, the provisions give little benefit to shareholders in the context of a management buyout.

Last, the SEC has actually required the disclosure of asset appraisals in certain narrow situations. In order to appreciate the extent to which such disclosure fails to ensure the presence of conditions which approximate a perfect competitive market in a buyout or bailout, a more detailed review of the mechanics and current regulatory scheme of management buyouts and bailouts is required.

A. *Regulations Specifically Applicable to Buyouts and Bailouts*

A management buyout and a management bailout may be implemented in a number of different ways. As discussed earlier, a management buyout is usually effected by management and other investors forming a corporation (Newco) which it then proposes to merge with the publicly held corporation (target).[110] If management does not possess a majority interest in the target, the proposal for a merger may be preceded by a tender offer by Newco for the target's stock or by a redemption by the target of its stock in order to increase the percentage of target stock owned by Newco.[111] When a tender offer precedes the proposal for a merger, the transaction is called a "two-step" transaction.[112] A management bailout usually occurs where the target becomes the object of interest of an entity which management views as hostile to its welfare and, as a result, attempts to attract a friendly buyer or "white knight."[113] The white knight will then tender an offer for the stock of the target.

A labyrinth of federal regulations requiring varying degrees of disclosure

106. 17 C.F.R. §§ 230.175(a), 240.3b-6 (1988).

107. Safe Harbor Rule for Projections, Securities Act Release No. 6084, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,117, at 81,939 (June 25, 1979).

108. 17 C.F.R. § 229.10b (1988).

109. Interpretive Release Relating to Proxy Rules, Exchange Act Release No. 16,833, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,117 (May 23, 1980).

110. *See* 1 M. LIPTON & E. STEINBERGER, *supra* note 21, § 9.03(5), at 9-15; Booth, *supra* note 21, at 630-31; Brudney, *supra* note 21, at 1091-92; Note, *supra* note 12, at 1018-19.

111. 1 M. LIPTON & E. STEINBERGER, *supra* note 21, § 9.02(2), at 9-8 to 9-9.

112. 1 M. LIPTON & E. STEINBERGER, *supra* note 21, § 9.02(2), at 9-8 to 9-9.

113. 1 M. LIPTON & E. STEINBERGER, *supra* note 21, § 6.05(5)(c).

may apply to management bailouts and buyouts.[114] Where a "two-step" transaction is involved, the first step, the tender offer, is subject to the provisions of the Williams Act.[115] The purpose of the Williams Act was to ensure adequate disclosure while preserving a balance between the bidder and target company. The Senate Report accompanying the Williams Act stated:

> The committee has taken extreme care to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. The bill is designed to retain full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case.[116]

Although the legislative history expresses concern about maintaining a balance, the statutory language of the Williams Act and rules promulgated thereunder generally do not require the disclosure of soft information.

When management has sought to attract friendly suitors in a bailout and those suitors tender for the stock of the target, the tender offer will be subject to section 14(d)(1) of the Williams Act.[117] Section 14(d)(1) requires that the suitors file a Tender Offer Statement on Schedule 14D-1[118] with the SEC. Item 3(b) of Schedule 14D-1 requires the suitor to describe "any contacts, negotiations or transactions" which have occurred between the target and the suitor.[119] Item 5 of Schedule 14D-1 requires the suitor to describe any "material change" in the target's business.[120] However, there is no requirement that management disclose soft information which it has provided to the suitors.[121]

Within ten days of the suitor's tender offer, management must, pursuant to rule 14e-2, either (1) recommend that stockholders accept or reject the tender offer; (2) state that it has no opinion with respect to the tender offer; or (3) state that it cannot take a position with respect to the tender offer.[122] However, again there is no express requirement that management disclose the soft information which it had provided to the suitors.

After the suitors have obtained a sufficient percentage of the outstanding stock of the target, they usually propose to merge the target into another corporation in order to freeze out the stockholders who did not tender. If, as a result of the merger, the target will cease to be subject to the reporting requirements of

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114. *See* T. HAZEN, THE LAW OF SECURITIES REGULATIONS 297-400 (1985); Comment, *A Critical Survey of Target Company Disclosure Obligations Under the Williams Act*, 59 TEMPLE L.Q. 1189, 1190-1221 (1986).

115. Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1982)).

116. S. REP. No. 550, 90th Cong., 1st. Sess. 3 (1967).

117. Securities Exchange Act of 1934 § 14(d)(1), 15 U.S.C. § 78n(d)(1) (1982).

118. 17 C.F.R. § 240.14d-100 (1988).

119. *Id.*

120. *Id.*

121. Radol v. Thomas, 772 F.2d 244, 252-54 (6th Cir. 1985) (although target had supplied asset appraisals to a "white knight," target was not obligated to disclose the appraisals to its stockholders).

122. 17 C.F.R. § 240.14e-2(a) (1988).

the Exchange Act,[123] rule 13e-3[124] applies and requires the disclosure of additional information which is described in Schedule 13E-3.[125]

Schedule 13E-3 contains the *only* requirement for disclosure of soft information. Item 8(a) of Schedule 13E-3 requires the suitor to state whether the merger is "fair or unfair" to the remaining stockholders and Item 8(b) requires the suitor to support this statement by a discussion of "material factors." The instructions to Item 8(b) state that material factors will "normally" include the liquidation value of the target. Moreover, Item 9 of Schedule 13E-3 requires that appraisals obtained from an outside party be disclosed. Note that while this information is certainly extremely valuable, its disclosure is only required when the target will no longer be a reporting company under Section 12[126] and, even then, only in the second step of the transaction after the majority of stockholders have already tendered their shares to the tender offeror.[127] Thus the information most useful to stockholders is disclosed only after the majority of stockholders have already sold their stock and cannot use it.

In a buyout, when target's management is itself purchasing the target, that purchase may be implemented in several ways. First, management may itself purchase the stock of the target in a tender offer. Second, management may cause the target to tender for the stock of other stockholders, or last, management may cause the corporation to purchase back its stock on the open market with a view to increasing the percentage of outstanding stock held by management. The tender offer or purchases will then usually be followed by a merger.

As mentioned earlier, when management is tendering for the stock of the target, management and their coinvestors will form Newco which will in turn tender for the target's stock. Newco's tender offer will be subject to rule 13e-3 if Newco is treated as an "affiliate" of the target and the "transaction has either a reasonable likelihood or a purpose of" causing the target to go private. Thus, if Newco does not qualify as an "affiliate"[128] of the target, the provisions of Schedule 13E-3 will not apply and the liquidation value and any appraisal reports from third parties remain immune from disclosure requirements.

This loophole is not available when the target is itself tendering or purchas-

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123. 15 U.S.C. § 78*l*, o(d) (1982).

124. 17 C.F.R. § 240.13e-3 (1988). Rule 13e-3 applies to any purchase of stock, tender offer by an issuer or its affiliate, and any merger or similar transaction between an issuer and an affiliate if such transaction "has either a reasonable likelihood or a purpose of" causing the company to go private. The term "affiliate" is defined as "a person that directly or indirectly . . . controls, is controlled by, or is under common control with [the] issuer." *Id.* § 240.13e-3(a)(1).

125. *Id.* § 240.13e-100.

126. 15 U.S.C. § 78*l* (1982).

127. *Radol*, 772 F.2d at 254.

128. For the definition of affiliate, see *supra* note 124. It has been suggested that the SEC will normally attempt to treat Newco as an affiliate of the target company if management is acquiring or owns 10% or more of Newco's voting stock. Cogutt & Spatt, *Considerations Of The Buyer* in THE LEVERAGED BUYOUT OF A PUBLIC CORPORATION IN LEVERAGED ACQUISITIONS AND BUYOUTS 207, 235 (1986). Reliance on a specific percentage ownership as delineating a bright-line test, however, is difficult. *See* Interpretative Release Relating to Going Private Transactions Under Rule 13e-3, Exchange Act Release No. 34-17719, 1985 Fed. Sec. L. Rep. (CCH) ¶ 23,709 n.28 (Apr. 13, 1981) ("existence of a control relationship . . . does not turn solely upon the ownership of any specific percentage of securities").

ing its own stock. However, even in those situations, the disclosure requirements of rule 13e-3 only apply if the "transaction has either a reasonable likelihood or a purpose of" causing the target to go private. Management and its coinvestors can avoid disclosure requirements if they seek control of the target without taking it private (although going private is certainly one of the common justifications for management buyouts). In that case, rule 13e-4[129] would apply if the corporation's purchases of its own stock constitute a "tender offer,"[130] or rule 13e-1[131] would apply if the repurchases are not classified as a "tender offer." However, neither rule 13e-1 nor rule 13e-4 requires that *any* soft information be disclosed.[132] Moreover, even when rule 13e-3 does apply, the only soft information which must be disclosed is the appraisals obtained from third parties. Another important piece of soft information—financial projections for the entire corporation and for important operating segments or divisions of the corporation—is not required. This latter information is extremely valuable in estimating the value which could be obtained for the corporation if it were sold on a piecemeal basis.[133]

Interestingly, in 1979, at the same time the SEC adopted rule 13e-3, it proposed an amendment which would require disclosure of "certain information concerning projections of revenues, income, earnings, or losses per share prepared by or on behalf of the issuer . . . and furnished by the issuer or affiliate to a person who has loaned funds or other consideration to be used in the transaction or a person who has furnished a report, opinion, or appraisal."[134] However this proposal has never been adopted or withdrawn.

If the tender offer or purchase of stock is the first part of a two-step transaction, Newco will complete the transaction by proposing that the target merge into it. Normally, such a proposal would be governed by the provisions of section 14(a) of the Securities Exchange Act of 1934 which do not expressly require the disclosure of soft information.[135] If, however, "either a reasonable likelihood or a purpose" of causing the company to go private exists, the disclosure requirements of rule 13e-3 will again apply and require only disclosure of any appraisal values obtained from third parties.

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129. 17 C.F.R. § 240.13e-4 (1988).

130. The term "tender offer" is not defined in the Securities Exchange Act of 1934 or the rules promulgated thereunder. Although the SEC proposed a definition of the term in 1979, the proposal was never adopted. *See* Securities Exchange Act Release No. 16,385 (1979). Consequently, the courts have had to wrestle with an appropriate definition of the term. *See, e.g.*, Hanson Trust PLC v. SCM Corp., 774 F.2d 47, 57 (2d Cir. 1985); *see also* Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1378 (1986) (excellent discussion of reasons that corporate purchases which are not tender offers should be regulated in a manner similar to tender offers).

131. 17 C.F.R. § 240.13e-1 (1988).

132. If the target's repurchase is in the form of a tender offer, rule 13e-4 applies. Rule 13e-4 requires that Schedule 13E-4 be filed with the SEC prior to or on the same day as the commencement of the tender offer, Item 5(3) of Schedule 13E-4 requires disclosure of "any other material change in the issuer's corporate structure or business." Item 7 requires disclosure of book value per share. There is no requirement that soft information be disclosed.

133. See *infra* text accompanying notes 258-61.

134. Securities Exchange Act Release No. 34-16076 (Aug. 2, 1979).

135. 15 U.S.C. § 78n (1982).

B. *The General Antifraud Provisions*

In closing a discussion of the regulation of disclosure in management control transactions, the three general antifraud provisions should also be mentioned. The judiciary has focused on these provisions in determining whether to require the disclosure of soft information since the current statutory and regulatory scheme only require its disclosure in narrow circumstances. Rule 10b-5[136] prohibits any person from making "any untrue statement" of a "material fact" or omitting a "material fact" in connection with the purchase or sale of a security. Rule 14a-9[137] similarly prohibits the making of a "false or misleading" statement of a "material fact" or the omission of a material fact in soliciting proxies. Last, rule 14e-3[138] prohibits any person who possesses a nonpublic "material fact" relating to a tender offer which she knows or has reason to know has been acquired directly from the tender offeror or the target of the tender offeror from purchasing or selling securities of the offeror or target.

VI. THE FEDERAL COURT'S APPROACH TO SOFT INFORMATION

While the SEC has endeavored to encourage the disclosure of financial projections, and has even required the disclosure of certain types of "soft information" in specific circumstances,[139] the federal courts have been slow in mandating that financial projections be disclosed to investors under the general antifraud provisions of rules 10b-5, 14a-9, and 14e-3.[140] Relying in part on the SEC's historic opposition to disclosure of "soft" information, the federal courts have usually refused to hold companies liable for failing to disclose projections of earnings[141] and appraisals of assets.[142] In general, the courts' refusals have been based on a determination that soft information does not qualify as a "material fact."[143]

The test for determining if a fact is material is whether there is a " 'substan-

136. 17 C.F.R. § 240.10b-5 (1988).

137. *Id.* § 240.14a-9.

138. *Id.* § 240.14e-3.

139. See *supra* text accompanying notes 125-27.

140. *See generally* Kerr, *A Walk Through The Circuits: The Duty To Disclose Soft Information*, 46 MD. L. REV. 1071 (1987) (surveys various approaches adopted by federal courts to soft information).

141. *See, e.g.*, Walker v. Action Indus., Inc., 802 F.2d 703, 709 (4th Cir. 1986), *cert. denied*, 455 U.S. 209 (1986); Starkman v. Marathon Oil Co., 772 F.2d 231, 241-42 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986); Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227, 1233 (1st Cir. 1984); Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1221 (9th Cir. 1981); Freeman v. Decio, 584 F.2d 186, 199-200 (7th Cir. 1980). *But see* Flynn v. Bass Bros. Enter., 744 F.2d 978, 988 (3rd Cir. 1984) (holding that in certain circumstances court would require the disclosure of soft information).

142. *See, e.g.*, Gerstle v. Gamble Skogmo, Inc., 478 F.2d 1281, 1292 (2d Cir. 1973); Kohn v. American Metal Climax, Inc., 458 F.2d 255, 265 (3d Cir.), *cert. denied*, 409 U.S. 874 (1972).

143. However, partial disclosure of a projection makes the projection a material fact thereby imposing an obligation to disclose the projections completely and accurately. Panter v. Marshall Field & Co., 646 F.2d 271, 292 (7th Cir. 1981); Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1221 n.7 (9th Cir. 1980); Sunstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1046 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Marx v. Computer Sciences Corp., 507 F.2d 485, 489-92 (9th Cir. 1974).

tial likelihood that a reasonable shareholder would consider it important.' "[144] In *Basic Inc. v. Levinson*[145] the United States Supreme Court stated that application of this standard to determine if a corporation had misstated a material fact when it denied that it was engaging in preliminary merger discussions would require the finder of fact to balance " 'both the indicated probability that [the merger] will occur and the anticipated magnitude of the event in light of the totality of the company activity.' "[146] The Court, however, expressly refused to address the manner in which the materiality standard should be applied to "any other kinds of contingent or speculative information, such as earnings forecasts or projections."[147]

The inclination of the lower federal courts to conclude that soft information does not qualify as a material fact is sound because appraisals and projections represent management's ideas and thoughts which are difficult for the courts to verify independently.[148] Moreover, given the uncertain classification of soft information as a "fact," it is difficult for courts to determine that soft information should become a fact because it is management's idea about valuation or the future rather than someone else's idea.[149] Also, as will be discussed later,[150] good reasons, such as limiting the harm to the corporation's competitiveness, may exist for limiting the circumstances in which the disclosure of soft information should be required. Yet by basing a requirement that soft information be disclosed on a broad definition of the term material fact, it would be very difficult for the courts to confine the disclosure of soft information to those situations where the benefits from disclosure exceed the harm to the corporation. Despite these considerations, however, the courts' rationales for determining that soft information is normally not a material fact have not been adequately articulated and have not been entirely consistent with one another. In fact, the courts have adopted four approaches to the issue.

A. *The Decisions and Some Implications.*

First, while the United States Court of Appeals for the Second Circuit has not addressed the issue whether to require the disclosure of projections as material facts, it has concluded that the appraisal value of assets is not a material fact within the meaning of rule 14a-9.[151] In *Gerstle v. Gamble-Skogmo, Inc.*[152] the

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144. Basic, Inc. v. Levinson, 108 S. Ct. 978 (1988) (quoting TSC Indus. v. Northway, Inc., 426 U.S. 438, 494 (1976)).

145. 108 S. Ct. 978 (1988).

146. *Id.* at 987 (quoting SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969)).

147. *Id.* at 984 n.9.

148. *But see* Kripke, *Rule 10b-5 Liability and "Material Facts,"* 46 N.Y.U. L. REV. 1061, 1070 (1971) (asserting that most facts in a disclosure document do not represent absolutes, but rather probabilities).

149. *See* Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227, 1231 (1st Cir. 1984).

150. *See infra* text accompanying notes 203-05.

151. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1292-94 (2d Cir. 1973); *accord* Hecco Ventures v. Avalon Energy Corp., 606 F. Supp. 512, 519-20 (S.D.N.Y. 1985).

152. 478 F.2d 1281 (2d Cir. 1973).

court refused to impose liability on the defendant for failing to disclose the liquidation value of the assets of General Outdoor Advertising Co. (GOA) in a proxy statement in which it proposed to merge GOA into itself. The court reasoned that, although the SEC had changed its view on disclosing appraisals and no longer forbade it, the defendant was entitled to rely upon the SEC's long standing antipathy to the disclosure of appraisal values.[153] The lower courts of the Second Circuit have applied similar reasoning in concluding that financial projections also do not have to be disclosed,[154] as has the United States Court of Appeals for the First Circuit.[155]

Consistent with the approach of the First and Second Circuits, the United States Courts of Appeals for the Seventh Circuit and the Ninth Circuit, relying on the SEC's traditional discouragement of the use of projections, have also concluded that sections 14(e) and 10(b) impose no duty to disclose projections and other soft information to the public.[156] Indeed, these courts appear to believe that the soft information must be "reasonably certain" before it *may* be disclosed, let alone be required to be disclosed.[157] This belief would prohibit the disclosure of any true projection since no projection can be reasonably certain until the event occurs or is about to occur.

The second approach, which the Sixth Circuit has adopted, is that there is no duty to disclose financial projections unless they are "substantially certain."[158] In *Starkman v. Marathon Oil Co.*[159] the court addressed the issue whether Marathon Oil should have disclosed asset appraisals and financial projections in its rule 14e-2 letter to stockholders and its Schedule 14D-9 filing with the SEC when it became subject to a friendly tender offer by U.S. Steel. The tender offer was the first stage of a two-step takeover. After U.S. Steel had accumulated fifty-one percent of the outstanding stock in Marathon Oil, it then merged Marathon Oil into a newly created subsidiary in a freeze-out merger. The court stated that since rules 14e-2 and 14d-9 did not expressly require the disclosure of the soft information, it would determine whether rule 10b-5 required such disclosure.[160] The court concluded that the soft information could

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153. *Gerstle*, 478 F.2d at 1294.

154. *See, e.g.*, Mendell v. Greenberg, 612 F. Supp. 1543, 1550 (S.D.N.Y. 1985); Flum Partners v. Child World, Inc., 557 F. Supp. 492, 499 (S.D.N.Y. 1983); Lewis v. Oppenheimer & Co., 481 F. Supp. 1199, 1208 (S.D.N.Y. 1979). *But see* Kronfeld v. Trans World Airlines, Inc., 832 F.2d 726, 733 (2d Cir. 1987) (the lack of a cause of action for failure to disclose future business plans in *Flum Partners v. Child World, Inc.* is a disposition of a particular case, not a broad general statement of law), *cert. denied*, 108 S. Ct. 1470 (1988).

155. Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227, 1233 (1st Cir. 1984).

156. *See* Panter v. Marshall Field & Co., 646 F.2d 271, 292-93 (7th Cir. 1980), *cert. denied*, 454 U.S. 1092 (1981); Vaughn v. Teledyne, Inc., 628 F.2d 1214, 1221-22 (9th Cir. 1980); Freeman v. Decio, 584 F.2d 186, 199-200 (7th Cir. 1978). *But see* Plaine v. McCabe, 797 F.2d 713, 716-18 (9th Cir. 1986) (reversing district court's grant of summary judgement on issue of whether projections should have been disclosed to stockholders, reasoning that law was developing in this area).

157. *Panter*, 646 F.2d at 292; *Vaughn*, 628 F.2d at 1221.

158. Starkman v. Marathon Oil Co., 772 F.2d 231, 241-42 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986); *see* Radol v. Thomas, 772 F.2d 244, 252-53 (6th Cir. 1985), *cert. denied*, 477 U.S. 903 (1986); Biechele v. Cedar Point, Inc., 747 F.2d 209, 216 (6th Cir. 1984).

159. 772 F.2d 231 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986).

160. *Id.* at 239.

not be classified as a "material fact" under rule 10b-5 which would require its disclosure.[161] The court reasoned that the SEC did not require disclosure of projections and only required disclosure of asset appraisals for freeze-out mergers pursuant to rule 13e-3.[162] Moreover, the court noted that other cases it had decided[163] indicated that projections and asset appraisals should be disclosed only if the reported values are "virtually as certain as hard facts."[164] The court quoted Judge McCree's statement that " 'the law mandates disclosure only of existing material facts . . . . It does not require an insider to volunteer any economic forecast.' "[165]

To date the Sixth Circuit has not applied its "substantially certain" test to require that projections be disclosed. Indeed, it seems unlikely that the "substantially certain" test will ever require disclosure of income projections and will rarely require disclosure of asset appraisals in the context of management buyouts and bailouts. The Sixth Circuit explained its "substantially certain" test as follows:

> Our cases fully support a rule under which a tender offer target must disclose projections and asset appraisals based upon predictions regarding future economic and corporate events only if the predictions underlying the appraisal or projection are substantially certain to hold. An example is when the predictions in fact state a fixed plan of corporate activity.[166]

Consider the application of this test to some proposals that management might consider in order to increase profitability of a corporation after purchasing it in a management buyout or that management might disclose to a white knight in order to make the company appear more attractive. Suppose, for example, that management has developed a new concept for marketing the corporation's product which management expects will substantially increase revenues.[167] Although management believes that the new marketing method will increase revenues, it cannot quantify accurately the increase in revenues and, therefore, the increase in net income of the corporation, because the actual impact will depend upon a number of factors beyond management's control—general economic conditions and the reaction of competitors. Thus, although the change in marketing methods is "a fixed plan of corporate activity" as described by the court, the predictions about increases in revenue which would underlay a projection of net income, could not be viewed "as substantially certain to hold" with the result that management would not be required to provide

161. *Id.* at 240-41.

162. *Id.* at 240.

163. *See* Biechele v. Cedar Point, Inc., 747 F.2d 209, 216 (6th Cir. 1984); James v. Gerber Products Co., 587 F.2d 324, 327 (6th Cir. 1978); Arber v. Essex Wire Corp., 490 F.2d 414, 421 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974).

164. *Starkman*, 772 F.2d at 241.

165. *Id.* (quoting Arber v. Essex Wire Corp., 490 F.2d 414, 421 (6th Cir.), *cert. denied*, 419 U.S. 830 (1974)).

166. *Starkman*, 772 F.2d at 241.

167. This concept might be as simple as selling the corporation's product directly to retailers rather than using distributors.

stockholders its estimate of the quantitative impact of its fixed plan on the corporation. Indeed, any plan to increase revenue would be treated in a similar manner under the "substantially certain" test because of the influence of other exogenous factors on revenue such as general economic conditions.

The "substantially certain" test would treat most asset appraisals in the same way. Since the appraisals of individual assets or divisions of a corporation necessarily involve assumptions about their ability to contribute to net income or about the nature of the demand for such assets or divisions, it is unlikely that any quantitative analysis involving the appraisal of such assets could be classified as "substantially certain to hold." An exception to this general rule will arise when an established market exists for the asset. In that case, the value of the asset can be determined by looking to the market. Thus, in *Speed v. Transamerica Corp.*[168] the United States District Court for the District of Delaware held that an insider who purchased shares from minority stockholders with an intent to liquidate the corporation violated rule 10b-5 by failing to disclose that the corporation's inventory of tobacco had appreciated substantially.[169]

The Fourth Circuit has adopted the third approach to the mandatory disclosure of soft information: equivocation. In *Walker v. Action Industries*[170] the court refused to hold the defendant, Action Industries, liable under rule 10b-5 for its failure to disclose financial projections in connection with a tender offer it had made for some of its own stock and a subsequent press release regarding its year-end financial results.[171] The projections indicated that future sales would be substantially greater than the year-end results which had been announced in the press release. The court stated that it was not holding that there was never a duty to disclose financial priorities under any circumstances, but rather that in this case no such duty arose.[172] The court reasoned that the facts before it did not require disclosure of the projections for several reasons. First, the court noted that the provisions applicable to self-tender offers, rule 13e-4 and Schedule 13E-4, did not require the disclosure of projections.[173] Second, the court observed that the nature of the projections could result in investors' being misled because the defendant prepared projections frequently and the projections fluctuated widely.[174] Last, the court stated that although the SEC had changed its rules prohibiting such projections in favor of permitting them, the SEC had not imposed a duty to disclose financial projections in disclosure documents generally.[175] The court concluded:

> The transition from nondisclosure to permissive disclosure was heralded primarily by the SEC's modification of its regulations such as the

168. 99 F. Supp. 808 (D. Del. 1951), *aff'd with modification as to damages*, 235 F.2d 369 (3rd Cir. 1956).

169. *Id.* at 828.

170. Walker v. Action Indus., 802 F.2d 703 (4th Cir.), *cert. denied*, 455 U.S. 209 (1986).

171. *Id.* at 710.

172. *Id.*

173. *Id.* at 709.

174. *Id.* at 709-10. The court also found disclosure of the projections impractical due to their frequency and variation. *Id.*

175. *Id.* at 709.

> adoption of voluntary disclosure provisions in rule 175. We perceive the current SEC regulatory environment to be an experimental stage regarding financial projection disclosures. Respecting these evolutionary processes, we believe that a further transition, from permissive disclosure to required disclosure, should be occasioned by congressional or SEC adoption of more stringent disclosure requirements for financial projections, rather than by the courts.[176]

The court's statement that the SEC or Congress should impose the requirement that financial projections be disclosed conflicts, however, with its subsequent statement in the same opinion:

> We do not hold that there is no duty to disclose financial projections under any circumstances. . . . We also note that our holding is not intended to discourage disclosures of financial projections. . . . Of course, it would appear prudent to release only those projections that are reasonably certain. Furthermore, if a company undertakes projection disclosures, it must make the full disclosures necessary to avoid making the statements misleading.[177]

Perhaps the court's reference to the requirement that projections be reasonably certain before they may be disclosed suggests that the court was adopting the Sixth Circuit's substantially certain test. Reconciling the conflicting statements is difficult. The best that can be said about the Fourth Circuit's approach is that it is in a state of flux.[178]

The fourth approach to deciding whether soft information qualifies as "material fact," the use of a balancing test, has been adopted by the Third Circuit. In *Flynn v. Bass Bros. Enterprises*,[179] Bass Brothers Enterprises (Bass Brothers) tendered for the outstanding shares of National Alfalfa Dehydrating and Milling Company (National Alfalfa) at $6.45 per share. After acquiring ninety-two percent of the stock of National Alfalfa, Bass Brothers then merged National Alfalfa into a wholly owned subsidiary.[180] Bass Brothers' interest in National Alfalfa had been piqued by a report prepared by a third party which included appraisals of National Alfalfa's assets. The report valued National Alfalfa at a range from $6.40 to $16.40 per share.[181] A subsequent report from the same third party provided two additional values: one value of $17.28 per share was attributed by the third party to the former president of National Alfalfa and the other value of $7.60 per share was the third party's own evaluation. Bass Broth-

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176. *Id.* at 709.

177. *Id.* at 710.

178. This is particularly true in light of Lockspeiser v. Western Maryland Co., 768 F.2d 558, 562 (4th Cir. 1985), where the court ruled that the issue whether coal and timber reserves should have been included in a proxy statement was a question of fact to determined under the standards of TSC Indus. v. Northway, Inc., 426 U.S. 438, 449 (1976). The court in *Walker* refused to apply the holding of *Lockspeiser* to require the disclosure of financial projections and asset valuations, reasoning that the two cases differed because of the type of disclosure involved. *Walker*, 802 F.2d at 709.

179. 744 F.2d 978 (3rd Cir. 1984).

180. *Id.* at 982.

181. The report calculated the per share values as follows: "$6.40 could be realized through 'liquidation [of National Alfalfa] under stress conditions'; $12.40 could be realized through 'liquidation in an orderly fashion over a reasonable period of time'; $16.40 represented National Alfalfa's value 'as [an] ongoing venture.'" *Id.*

ers' initial tender offer did not refer to the reports. In a supplement, however, Bass Brothers stated that the current market value of National Alfalfa's assets could be "substantially higher than its original cost as reflected on the books of the Company" and that "stockholders could receive, upon liquidation of the Company, an amount per share significantly higher than the current book value and possibly higher than the price of $6.45 per share."[182]

Plaintiffs, minority stockholders of National Alfalfa, claimed that sections 10(b) and 14(e) of the Securities Exchange Act of 1934 required Bass Brothers to disclose the asset appraisals it possessed and National Alfalfa to disclose an internal report valuing the company at $12.95 per share.[183] The court determined that soft information should not as a matter of law be deemed immaterial, but that it should be disclosed if required by the circumstances.[184] The court stated that in order to determine whether soft information should have been disclosed, the court should "weigh the potential aid such information will give a shareholder against the potential harm, such as undue reliance, if the information is released with a proper cautionary note."[185] The court then related several factors which it would consider in balancing the potential benefit against the potential harm. Those factors were:

> the facts upon which the information is based; the qualifications of those who prepared or compiled it; the purpose for which the information was originally intended; its relevance to the stockholders' impending decision; the degree of subjectivity or bias reflected in its preparation; the degree to which the information is unique; and the availability to the investor of other more reliable sources of information.[186]

The court declined to give its newly announced standard retroactive effect and opted instead to evaluate Bass Brothers' conduct by the standards which prevailed when the tender offer occurred.[187]

B. *Critique of the Federal Cases*

The reluctance of the courts to require that soft information be disclosed is based on the SEC's traditional opposition to disclosure of soft information and the fear that investors will be misled. These justifications are misplaced. First, the SEC no longer discourages the responsible use of soft information. Indeed it is encouraged. The SEC has promulgated rules 175[188] and 3b-6[189] which provide a safe harbor for projections made in good faith with a reasonable basis. Similarly, regulation S-K, Item 10(b), advocates the use of "management's projections of future economic performance that have a reasonable basis and are

182. *Id.* at 982.
183. *Id.* at 983.
184. *Id.* at 988.
185. *Id.*
186. *Id.*
187. *Id.*
188. 17 C.F.R. § 230.175 (1988).
189. *Id.* § 240.3b-6.

presented in an appropriate format."[190] Moreover, asset appraisals may be disclosed when all or part of a company's assets are to be liquidated.[191] And, as discussed earlier, rule 13e-3 requires the disclosure of appraisals received from third parties.[192]

Second, investors should not be misled by soft information so long as assumptions underlying the information and the "soft" nature of the information are disclosed. The best way to illustrate the "soft" nature of the information to investors is to show the impact that changes in assumptions will have on income projections and asset appraisals.[193] Indeed, failure to disclose soft information may actually be more misleading to investors than disclosing it, since expectations about the future play a major role in valuing securities.[194] Moreover, information currently provided to investors is misleading because it does not provide information which is customarily used to make an investment decision. As former SEC Chairman Casey stated:

> [A] backward looking prospectus only tells half of the story. Investors do not put up their money solely on the basis of past history. They are always partly sold . . . by verbal assurances about the prospects of the company. Such projections are at least as valuable, if not more so, than the past three years financial record . . . .[195]

It should also be noted that financial accounting information is routinely provided to investors although it also contains several items of soft information. For example, under generally accepted accounting principles estimates are made of uncollectible accounts receivable,[196] useful lives of assets,[197] and inventory values[198] in composing financial statements.[199]

Thus, the reluctance of the federal courts to require the disclosure of soft information is not adequately explained by the courts' opinions. However, the opinions indicate to some extent the nature of what the courts' concerns should be. The courts' only tool for crafting an appropriate standard for when soft information should be disclosed is the term "material fact" under rules 10b-5,

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190. *Id.* § 229.10b.

191. Interpretive Release Relating to Proxy Rules, Exchange Act Release No. 16,833, 3 Fed. Sec. L. Rep. (CCH) ¶ 24,117 (May 23, 1980).

192. 17 C.F.R. § 240.13e-100, Schedule 13E-3, item 9 (1980).

193. *See also* Kerr, *supra* note 140, at 1110 (misleading nature of soft information can be "greatly alleviated through the use of experts, disclaimers, and qualifying disclosures").

194. *See, e.g.*, H. KRIPKE, *supra* note 94, at 25; Kripke, *supra* note 100, at 1197-1201; Schneider *supra* note 94, at 264-70.

195. Address by SEC Chairman Casey to the Association of the Bar of New York, New York Law Journal, Apr. 21, 1972, at 5, 8-9, *quoted in* Schneider, *supra* note 94, at 266.

196. *Recognition and Measurements in Financial Statements of Business Enterprises*, Statement of Financial Accounting Concepts No. 5, ¶ 23 (1984).

197. Accounting Research Bulletin No. 43, ch. 9, § A(9) *reprinted in* ACCOUNTING PRINCIPLES 6031 (CCH 1973); Accounting Principles Bulletin Statement No. 4, ¶159 *reprinted in* 2 ACCOUNTING PRINCIPLES 6031.

198. Accounting Research Bulletin No. 43, ch. 4, statement 5, *reprinted in* ACCOUNTING PRINCIPLES, 6015-16 (CCH 1973). Inventory is carried on the balance sheet at the lower of the cost of the inventory or its market value, as estimated by management of the corporation.

199. Indeed, because of the "soft" nature of these estimates, the Advisory Committee on Corporate Disclosure to the SEC recommended that economic assumptions underlying financial statement items be disclosed. REPORT, *supra* note 95.

14a-9, and 14e-3. Before a duty to disclose arises, there must be a "material fact" to disclose. Accordingly, the courts have had to grapple with the issue whether an asset appraisal and income projection should constitute "facts." The inclination of the courts to conclude that this information does not qualify as fact is sound because appraisals and projections represent management's ideas and thoughts which are difficult for the courts to independently verify. Moreover, given the uncertain classification of soft information as a "fact," it is difficult for courts to hold that soft information becomes a fact because it is management's idea about valuation or the future rather than someone else's idea.[200]

This analysis is useful for understanding why the Supreme Court in *Basic, Inc. v. Levinson*[201] refused to discuss whether the current definition of materiality would apply to soft information. In that case the corporation had publicly denied that it was engaging in preliminary merger negotiations when in fact it was engaging in such negotiations. The existence of the preliminary negotiations was a "fact" in that it had occurred and was capable of independent verification. Consequently, the Supreme Court had to address only the issue whether the "fact" was "material." In contrast, management's ideas about the future income or asset valuations of a corporation are far more difficult to qualify as "facts." Accordingly, the Court's admonition in *Basic* that it was not addressing the applicability of the materiality standard to "contingent or speculative information, such as earnings forecasts or projections"[202] was well advised. The issue pertaining to soft information is not whether it is "material," but whether it is a "fact."

Last, the reluctance of the federal courts to classify soft information as "material fact" is appropriate because a broad definition of the term "material fact" would require disclosure of soft information in situations where it should not be disclosed. Sound policy reasons may exist for not establishing conditions prerequisite to a perfect market for control in situations where management has not implemented a buyout or bailout. The model of corporate management assumes that when management does not have conflicts of interest, it can be relied upon to maximize stockholder welfare. So long as this is true, there is no reason to require the disclosure of soft information, since such disclosure places the disclosing corporation at a competitive disadvantage to control nondisclosing corporations.[203] Indeed, the creation of a continuously existing market for control may actually harm stockholders because of the potential diversion of management's attention from maximizing stockholder wealth to devising ways to prevent takeovers.[204] Some of the methods which management might use to

200. *See* Pavlidis v. New England Patriots Football Club, Inc., 737 F.2d 1227, 1233 (1st Cir. 1984).

201. 108 S. Ct. 978 (1988).

202. *Id.* at 984 n.9.

203. *See* Blanchette v. Providence & Worcester Co., 428 F. Supp. 347, 354 (D.D.C. 1977); Broder v. Dane, 384 F. Supp. 1312, 1318-19 (S.D.N.Y. 1974); *see also* Dennis, *supra* note 88, at 1212 (discussing potentially negative effects of disclosure of soft information).

204. Herman & Lowenstein, *The Efficiency Effects Of Hostile Take-Overs*, in KNIGHTS, RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 215 (1988).

prevent a takeover, such as increasing debt or engaging in "defensive acquisitions," could harm stockholder welfare by impairing the long-term profitability of the corporation.[205] Because of this potentially deleterious impact, soft information should be required to be disclosed only in situations where management can no longer be entrusted with the task of managing the corporation for the benefit of stockholders because of an inherent conflict of interest and where the stockholders have to make a decision in regard to holding their stock.[206] That is, the mandatory disclosure should only occur in connection with management buyouts and bailouts.[207] Yet, by basing a requirement that soft information be disclosed on a broad definition of the term "material fact," it would be very difficult for the courts to limit the disclosure of soft information to those situations. Consequently, several good reasons exist for the federal courts not to require the disclosure of soft information under the current statutory and regulatory scheme.

Other than the Third Circuit in *Flynn*, the federal courts have also been reluctant to classify soft information as a "fact" based on a balancing test which considers several factors.[208] Several reasons exist for not employing such a nebulous standard. First, the inquiry of the *Flynn* balancing test as to whether the soft information may mislead unsophisticated investors is misplaced since the harm such investors might suffer is probably less than the harm the market as a whole would suffer from having incomplete information. It is undisputed that earnings are the most important factors in analyzing investment alternatives. Depriving the market of the expectations of management with respect to such data significantly reduces the ability of the market to make informed investment decisions. Moreover, so long as the prerequisites to an efficient market, several buyers with perfect knowledge, are present it seems unlikely that unsophisticated investors would be injured as a result of misinterpreting soft information because the market as a whole would be reacting to the information and establishing a price.

Another major problem with the balancing test arises from the fact that the courts would necessarily be articulating a standard on a case-by-case basis. This creates several difficulties since the interaction of disclosure requirements with other considerations should be approached from a broad perspective. For exam-

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205. *Id.*

206. Of course management always has some interests which conflict with the interest of stockholders to the extent that management will be seeking to fulfill its personal goals as well as the stockholder's interest. *See, e.g.*, A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Marris, *A Model of the "Managerial" Enterprise*, LXXVII Q.J. ECON. 185 (1963). This does not mean, however, that stockholders or the market should continuously assert control over the day-to-day activities of management. As Professor Buxbaum eloquently stated:

> A large organization, whatever its mission, cannot achieve its goals by constituting its members into an ongoing committee of the whole. Even participatory democracies, worker-owned enterprises, and cultural revolutions accept the distinction between mass and cadre, wherever they may at times draw the line between the two.

Buxbaum, *supra* note 81, at 1671.

207. As discussed *supra* in note 91, recapitalizations may also be the type of situation which would involve the disclosure of soft information, although further analysis is required before a final recommendation can be made.

208. *See supra* notes 179-87 and accompanying text.

ple, the uncertainty associated with a case-by-case approach could cause publicly reporting companies to disclose projections at times that such disclosure would not be required in order to avoid the possibility of liability. This policy, while minimizing liability, could at the same time place the corporation at a competitive disadvantage vis-à-vis firms not subject to a public reporting requirement. Moreover, courts are not equipped to measure the impact of their disclosure requirements in capital markets and to adjust their requirements accordingly. The courts' perspectives, instead, are limited to the facts before them. Indeed, courts are not well equipped to establish the format for disclosing projections or appraisals that would maximize the disclosure of useful information while at the same time minimize the likelihood of confusion. The contributions of accountants, analysts, and business persons are necessary in order to fashion a reasoned approach to disclosure of soft information.

VII. THE DELAWARE COURTS' APPROACH TO SOFT INFORMATION

Federal law is not the only potential source of authority, however, for requiring the disclosure of soft information. Another, less familiar source of disclosure obligation is state fiduciary law. The Delaware courts have been experimenting with the extent to which the fiduciary duties of directors, officers, and majority stockholders require the disclosure of soft information. As discussed below, the Delaware courts have required disclosure of soft information in certain situations, although the scope of the duty to disclose is not entirely clear.

The Delaware courts' requirement that soft information be disclosed in certain situations, in contrast to the majority of federal courts' refusal to require such disclosure, illustrates the bifurcated nature of the rationales underlying disclosure. The Delaware courts have required disclosure as a matter of fiduciary duty, not as the result of a concern for the efficient function of the securities markets. The fiduciary duties imposed on directors, officers, and majority stockholders arise from the delegation of management of the corporation by stockholders to directors and officers.[209] When management can no longer be entrusted with the task of managing the corporation for the benefit of the stockholders because of inherent conflicts of interest, as is the case in a buyout or bailout, disclosure of soft information helps restore the stockholders to a position of power by enabling them to bargain effectively with management.

Under Delaware law, the extent of disclosure necessary to satisfy management's duty of candor to stockholders is dependent upon the nature of management's participation in the transaction. When management is in effect serving two masters, the duty of candor seems to require the disclosure of the maximum price that management is willing to pay for the corporation's stock as well as other forms of soft information.

209. *See* Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 809 (1983) (stating that one central feature of the fiduciary relationship is that the fiduciary obtains authority for the sole purpose of enabling the fiduciary to act effectively).

The Delaware Supreme Court first articulated this rule in *Lynch v. Vickers Energy Corp.*,[210] where the court stated that the duties of directors and of majority stockholders to minority stockholders "required 'complete candor' in disclosing fully 'all the facts and circumstances surrounding the' tender offer."[211] In *Lynch* a minority stockholder of TransOcean Oil, Inc. (TransOcean) claimed that the directors of TransOcean and Vickers Energy Corporation (Vickers), the parent corporation of TransOcean, had violated the fiduciary duty of candor owed to TransOcean shareholders when Vickers tendered for the minority stockholder's stock at twelve dollars per share. The shareholder alleged that Vickers failed to disclose that a "highly qualified" petroleum engineer, who was a member of TransOcean's management, had calculated the net asset value of TransOcean to be worth significantly more than the minimum amount disclosed in the offer and that Vicker's management had authorized open market purchases at up to fifteen dollars per share of TransOcean's stock during the period immediately preceding the tender offer.[212] The court concluded that Vickers should have disclosed the engineer's appraisal and also its "top" offer because the duty to deal in complete candor with the plaintiffs required the disclosure of "all information in their possession germane to the transaction."[213] The court defined the term "germane" as "information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock."[214] The court did not expressly consider whether the appraisal of the net asset values would have misled the minority stockholders, but it noted that the author of the appraisal was highly qualified and a member of senior management.[215]

Later, in *Weinberger v. UOP, Inc.*,[216] the court again applied the duty of candor to require a majority stockholder and its nominee directors to disclose its top bid for the minority stock of the corporation. In *Weinberger v. UOP, Inc.*, Signal Companies, Inc. (Signal) owned 50.5% of the stock of UOP, Inc.[217] Two directors of Signal, Arledge and Chitiea, who were also directors of UOP, wrote a report which concluded that it would be a good investment for Signal to acquire the remaining 49.5% of UOP shares at any price up to twenty-four dollars per share. Signal ultimately decided to offer twenty-one dollars per share. Although Arledge, Chitiea, and other Signal employees and directors were also directors of UOP, they did not disclose their report to the other directors of UOP when the UOP directors decided to recommend to the minority stockholders that they approved a cash-out merger with Signal for twenty-one dollars per share.[218] Similarly, the proxy statement sent to shareholders requesting ap-

210. 383 A.2d 278 (Del. 1977).

211. *Id.* at 279 (quoting Lynch v. Vickers Energy Corporation, 351 A.2d 570, 573 (Del. Ch. 1976), *rev'd*, 383 A.2d 278 (Del. 1977)).

212. *Id.* at 279-80.

213. *Id.* at 281.

214. *Id.*

215. *Id.* at 280.

216. 457 A.2d 701 (Del. 1983).

217. *Id.* at 704.

218. *Id.* at 707.

proval of the merger did not disclose the Arledge-Chitiea report.

The Delaware Supreme Court held that Signal and the Signal representatives on the UOP board violated the duty of candor owed to UOP's board and minority stockholders by failing to disclose the report.[219] The court articulated the scope of the duty of candor as requiring the defendants to disclose " 'all information in their possession germane to the transaction in issue.' "[220] The court again defined the term "germane" as "information such as a reasonable shareholder would consider important in deciding whether to sell or retain stock."[221]

In *Rosenblatt v. Getty Oil Co.*[222] the Delaware Supreme Court went out of its way to stress that the duty of candor does not require majority stockholders or directors to disclose their top bid in every situation where they are purchasing stock from or freezing-out minority stockholders, but only in instances where they stand on both sides of the transaction.[223] In *Rosenblatt* minority stockholders of Skelly Oil Company (Skelly) challenged a stock-for-stock merger of Skelly into its majority stockholder, Getty Oil Company (Getty).[224] Plaintiffs alleged that Getty had projected a decrease in its earnings, which would decrease the value of its stock, but had failed to disclose this to Skelly's minority stockholders who would receive Getty stock in the merger.

The Delaware Supreme Court refused to impose a duty on Getty to disclose the projections because it appeared that Skelly had already known about the projections and because there was "not the slightest indication that its disclosure could have materially affected the exchange ratio negotiations."[225] The court also provided an additional rationale, stating:

> While it has been suggested that *Weinberger* stands for the proposition that a majority shareholder must under all circumstances disclose its top bid to the minority, that clearly is a misconception of what we said there. The sole basis for our conclusions in *Weinberger* regarding the non-disclosure of the Arledge-Chitiea report was because Signal appointed directors on UOP's board, who thus stood on both sides of the transaction, violated their undiminished duty of loyalty to UOP. It has nothing to do with Signal's duty, as the majority stockholder, to the other shareholders of UOP.[226]

It is difficult to assess the extent to which the court in *Rosenblatt* intended

219. *Id.* at 709-10. Consistent with the holdings of *Weinberger v. UOP, Inc.* and *Lynch*, the Delaware Court of Chancery ruled in Joseph v. Shell Oil Co., 482 A.2d 335 (Del. Ch. 1984), that the majority stockholder of Shell Oil Company ("Shell") had violated its duty of candor when it had failed to disclose to the minority stockholders that Shell's management had valued Shell's stock at a price higher than the majority stockholder's tender offer. The court imposed the duty to disclose because two directors of Shell were also employees of the majority stockholder and were aware of the higher valuation. *Id.* at 343.

220. Weinberger v. UOP, Inc., 457 A.2d at 710 (quoting *Lynch*, 383 A.2d at 281).

221. *Id.*

222. 493 A.2d 929 (Del. 1985).

223. *Id.* at 939.

224. *Id.* at 936.

225. *Id.* at 939.

226. *Id.*

to limit the duty of candor. The court may have wanted to limit the instances in which the duty of candor will arise, or may have simply desired to limit the type of disclosure required by the duty of candor. The correct interpretation of *Rosenblatt* seems to be that the court did not intend to limit the instances in which the duty of candor will arise, but rather desired to limit the level of required disclosure by not requiring that majority stockholders and directors disclose their top bid in all circumstances. This interpretation seems most persuasive since the court did not even refer to its holding in *Lynch* when it limited the circumstances in which the top bid must be disclosed, thereby indicating that it was focusing on the level of disclosure required, not the existence of the duty itself.

In any event, *Rosenblatt*'s restriction on the extent of disclosure required under the duty of candor will probably not benefit management in a buyout or bailout. In a buyout, management is clearly on both sides of the transaction in the same way in which the Signal employees and directors who sat on the UOP board were. This conflict of interest arises because management is supposed to be serving the stockholders while at the same time management is seeking to benefit itself by using its knowledge about the corporation's business. Similarly, in bailouts, management places itself on both sides of the transaction when it seeks to attract an acquiror which will be receptive to permitting management to continue being employed with the target. Thus, in buyouts and bailouts, the duty of candor may still require management to disclose its "top bid," or at least the information which management possesses pertaining to the value of the corporation.

Although the Delaware Supreme Court has sought to limit the instances in which it will require disclosure of management's top bid, that court will still require disclosures of appraisals and projections as part of the duty of candor. In *Bell v. Kirby Lumber Corp.*[227] the court stated that if the defendant had not attached a report appraising the assets of the corporation to a proxy statement, the defendant would have breached the duty of complete candor required by *Lynch*.[228] Similarly, in *Harman v. Masoneilan International Inc.*,[229] the court held that plaintiff's allegations that the majority stockholder had failed to disclose "management's prediction of near term significant increases in sales and earnings"[230] and other items were sufficient to withstand a motion to dismiss for lack of subject matter jurisdiction.[231]

However, the Delaware Supreme Court has left it to the lower courts to outline factors which should be considered in determining when the duty of candor will require disclosure of soft information.[232] Because the duty of candor's

227. 413 A.2d 137 (Del. 1980).

228. *Id.* at 148.

229. 442 A.2d 487 (Del. 1982).

230. *Id.* at 490.

231. *Id.* at 498.

232. The Delaware Court of Chancery has required the disclosure of soft information in several circumstances. In Kahn v. United States Sugar Corp., Civ. No. 7313 (Del. Ch. Dec. 10, 1985), the court found that United States Sugar Corporation and its majority stockholders had breached their

requirement that all "germane" facts be disclosed is substantially equivalent to the requirement of the federal securities laws that all "material facts" be disclosed,[233] the Delaware Court of Chancery has looked to federal cases for guidance as to the appropriate method of delineating the types of soft information which should be disclosed. In *In Re Anderson, Clayton Stockholders Litigation*[234] minority shareholders challenged a recapitalization plan for Anderson, Clayton & Co. (Anderson) pursuant to which Anderson would borrow substantial funds, distribute those funds to stockholders, and sell a twenty-five percent equity interest in Anderson to an employee stock-ownership plan for forty-five dollars per share.[235] Management of Anderson would be one of the primary beneficiaries of the stock-ownership plan. Minority stockholders claimed that the proxy statement distributed to stockholders in connection with obtaining stockholder approval of the recapitalization failed to disclose that a draft opinion of an investment bank had valued Anderson's stock at between forty-six and sixty dollars per share and also failed to disclose a report in which American Appraisal Associates, Inc., had appraised Anderson's assets.[236]

The court determined that it would not require the draft opinion to be disclosed. Noting that the proxy statement had disclosed the investment bank's final opinion, the court observed:

> While *facts* concerning the firm or its business which support or justify an opinion as to value may themselves be material for a shareholder required to evaluate a proposal, to go beyond disclosure of the opinion itself (where that is appropriate) and require disclosure of intermediate opinions would, in my view, risk far more mischief than it would promise benefit.[237]

In regard to whether the appraisal report should have been disclosed, the

duty of complete candor in tendering for the stock held by minority stockholders. The court stated that the offering documents had failed to reveal (1) that the value at which the company carried real estate on its financial statements was based on acqusition costs incurred in 1931, and (2) that management of the company had estimated that the real estate had a per-share value greatly in excess of the tender offer price. *Id.* In Wacht v. Continental Hosts, Ltd., Civ. No. 7954 (Del. Ch. Apr. 11, 1986), the court rejected a motion to dismiss when plaintiffs alleged that the defendant's directors had failed to provide minority stockholders adequate information from which to decide whether to seek an appraisal in a cash-out merger. Plaintiff alleged that material information not disclosed included the current value of defendant's assets and projections of defendant's business or financial performance. In Edick v. Contran Corporation, Civ. No. 2662 (Del. Ch. March 18, 1986), the Court of Chancery rejected a defendant's motion to dismiss where defendant had asserted that plaintiff's exclusive remedy was statutory, an appraisal pursuant to DEL. CODE ANN. tit. 8, § 262 (1974). The court stated that because plaintiff had attacked a reverse stock split on the grounds of unfair dealing and inadequate disclosure they were not restricted to the disclosure remedy. *Edick*, Civ. No. 2662. The allegation of inadequate disclosure arose from the fact that the "Notice to Stockholders and Information Statement" which was sent to stockholders announcing the reverse stock split had referred to appraisals and comparable sales date but had not disclosed those items.

233. *See, e.g., Rosenblatt*, 493 A.2d at 944; Smith v. Van Gorkum, 488 A.2d 858, 890 (Del. 1985); Muskin, *Trans Union: A Nailed Board*, 10 DEL. J. CORP. L. 405, 419 (1985). *But see* Quillen, *Trans Union, Business Judgement and Neutral Principles*, 10 DEL J. CORP. L. 465, 475 (1985) (suggesting that "germane" fact under Delaware law may be broader than "material fact" under federal law).

234. 519 A.2d 680 (Del. Ch. 1986).

235. *Id.* at 682.

236. *Id.* at 690-91.

237. *Id.* at 691.

court decided that the balancing of several factors advocated in *Flynn*[238] was the appropriate method for resolving that issue. After reciting the factors enumerated in *Flynn*, the court stated:

> This checklist seems reasonably complete as an intermediate guide in attempting to assess whether a shareholder would likely find the appraisal results of actual significance. Absent special circumstances, the key factor will relate to the form of transaction under consideration. Thus, for example, an appraisal done with a professionally acceptable degree of care would be most likely to be found material where shareholders are asked to authorize liquidation of the firm.[239]

Because the appraisal report estimated only the replacement and liquidation values of Anderson's assets, and not their value as part of a going concern, the court concluded that it would not require the appraisal to be disclosed.[240]

Subsequently, in *Weinberger v. Rio Grande Industries*[241] the Delaware Court of Chancery engaged in more detailed examination of the disclosure requirements for soft information. In that case, plaintiffs, stockholders of Rio Grande, claimed that Rio Grande and its directors had violated their fiduciary duty to stockholders when they recommended that stockholders accept a tender offer by a subsidiary of Anschutz Corporation without disclosing certain projections which forecasted substantial improvement in Rio Grande's income in the subsequent three years. The projections had been prepared in connection with an application to the United States Interstate Commerce Commission (ICC) to obtain additional railroad track rights.

In addressing the issue whether Rio Grande and its directors should have disclosed the projections, the court, citing the earlier decision *In re Anderson*,[242] noted that Delaware courts have already recognized that certain types of soft information may be important to shareholders considering whether to tender their shares or to approve a merger when these transactions are not contested and, as a result, the disclosure to shareholders was one-sided.[243] The court stated:

> In such transactions, where corporate fiduciaries were provided with information that, although arguably "soft," indicated with some degree of reliability that the corporation was worth more than the tender offer or merger price, our Courts have held that such information must be publicly disclosed to stockholders.[244]

The court then noted that the "pivotal question" was whether the court should flatly reject requiring the disclosure of soft information or adopt the approach of the Third Circuit in *Flynn* and balance the benefit of disclosure against the harm

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238. *See supra* text accompanying note 186.

239. *In re Anderson*, 519 A.2d at 692.

240. *Id.* at 692-93. For an interesting discussion about why liquidation value varies from going concern value, see Coffee, *supra* note 13.

241. 519 A.2d 116 (Del. Ch. 1986).

242. 519 A.2d 669; *see supra* text accompanying notes 234-36.

243. *Weinberger*, 519 A.2d at 129.

244. *Id.* at 128.

that might arise from the stockholders being misled. The court observed that recent decisions of the Court of Chancery had "implicitly or explicitly" adopted *Flynn*.

The court in *Weinberger v. Rio Grande, Industries* recognized that in *Starkman v. Marathon Oil Co.*[245] the Third Circuit had criticized the *Flynn* test as being uncertain and unpredictable.[246] The court, however, rejected this criticism, noting that the alternative to the *Flynn* test—proscribing the disclosure of all soft information— was "unacceptable, because it would deprive shareholders of information that both our Supreme Court and the SEC have recognized may be critical to an informed, reasoned shareholder decision as to how to vote or whether to tender."[247] The court continued:

> The analytically relevant question, therefore, is not whether uncertainty can be eliminated but how it can be minimized. Under *Flynn* it will be clear in many cases whether the questioned information should be disclosed. In cases of genuine doubt, the uncertainty can be mitigated where the "soft" information is disclosed but qualified with an appropriate cautionary explanation.[248]

The court then determined whether the soft information which the plaintiff alleged should have been disclosed had "sufficient indicia of reliability to require disclosure."[249] The court observed that points in favor of mandatory disclosure were the projection's relevance to the stockholders' tender decision and the qualifications of the preparer of the projections. Militating against the reliability of the projections, however, was the fact that the projections had been prepared as "advocacy" documents for the ICC, not "for valuation purposes and to assist management in making a business decision as to the amount of the tender offer or merger consideration."[250] Also weighing heavily against the reliability of the projections was the fact that they were premised on the highly speculative assumption that the ICC would act favorably on behalf of Rio Grande on all issues before it. The court noted that because of these speculative assumptions, Morgan Stanley had given virtually no weight to the projections in arriving at its opinion that the tender offer was fair. Based on this, the court concluded that plaintiff had failed to establish that the projections "had sufficient indicia of reliability to require disclosure."[251]

As stated earlier, the Delaware courts' requirement that soft information be disclosed in certain situations, in contrast to the refusal of the majority of federal courts to require such disclosure, emphasizes the bifurcated nature of the rationales underlying disclosure. The Delaware courts have required disclosure as a matter of fiduciary duty, not as the result of a concern for the efficient function of the securities markets. The stockholders' delegation of the management of

245. 772 F.2d 231, 242 (6th Cir. 1985), *cert. denied*, 475 U.S. 1015 (1986).
246. Weinberger v. Rio Grande Industries, 519 A.2d at 129.
247. *Id.* at 128-29.
248. *Id.*
249. *Id.* at 130.
250. *Id.*
251. *Id.*

the affairs of a corporation to directors and officers imposes on the directors and officers an obligation not to use the information acquired in the course of performing such duties for their personal benefit at the expense of the stockholders without disclosing such information to the stockholders. Similarly, the courts have imposed fiduciary duties on controlling stockholders who have acquired confidential information about a corporation in order to prevent such stockholders from using that information for their benefit, without disclosing the information to minority stockholders.

The extent of the disclosure necessary to satisfy the fiduciary's duty to the stockholders is dependent on the position of the fiduciary. When the fiduciary serves two masters, as was the case in *Weinberger v. UOP, Inc.*, the duty of candor requires the disclosure of all information, including the fiduciary's top bid. When the fiduciary is not serving two masters, the disclosure of the top bid may not be required and the extent to which asset appraisals and income projections must be disclosed is determined by applying the *Flynn* balancing test.

Application of the *Flynn* test to determine the extent of disclosure required under state fiduciary duties may make sense because the disclosure duty arises from the delegation of management of the corporation to the directors and officers. To permit directors, officers, and controlling stockholders, by virtue of their special relationship with directors and officers, to benefit from this delegation violates ancient and basic notions of fairness regarding principal-agent relationships. Disclosure of soft information helps restore the stockholders to a position of power in being able to bargain effectively with management. Moreover, the Delaware courts are correct in applying a balancing test in determining the scope of the duty of disclosure because the basis of the duty is to enable stockholders to bargain effectively with management. To provide meaningful protection to stockholders the soft information has to be comprehensible. If it is misleading, it will not enable the stockholders to bargain effectively and make an intelligent investment decision.

The use of a balancing test by the Delaware courts and the uncertainty about whether management must disclose its top bid, however, will have the same negative impact on the capital markets as the federal courts' use of the balancing test. Courts are not equipped to establish a format for disclosing projections or appraisals that would maximize the disclosure of useful information while at the same time minimize the likelihood of confusion. The courts are also not equipped to measure the impact of their disclosure requirements on capital markets and to adjust their rulings accordingly. In addition, a case-by-case approach in conjunction with the uncertainties created by a balancing test may cause corporations to disclose soft information when the courts would not actually require disclosure in order to avoid the possibility of the imposition of liability.

Requiring management to disclose its top bid could also stifle buyouts and their concomitant benefits by creating a disincentive for management to bid for their corporations. As discussed earlier, management will normally assign a

higher value to the corporation than stockholders will. Requiring that management disclose its top bid, however, may cause management not to bid out of fear that it will ultimately have to pay a price higher than its top bid if it is to succeed. Moreover, requiring management to disclose its top bid may conflict with the conditions prerequisite to a perfectly competitive market. Implicit in the requirement that there be several buyers and sellers with perfect knowledge for a competitive market is the premise that the bargaining be at arm's-length and that the bargaining parties possess equivalent information. While providing information to stockholders which permits them to value the corporation helps achieve an efficient allocation of resources, informing the stockholders of management's top bid would provide the stockholders an informational advantage which might achieve a suboptimal result. Consequently, requiring that management disclose its top bid could negatively impact societal welfare by impeding the creation of a perfect competitive market for control.

Another potential impediment to the creation of a perfect market for control is the Delaware Supreme Court's suggestion that management will be relieved of its duty to disclose soft information to stockholders if a committee of outside directors is established to negotiate on behalf of public stockholders. In *Weinberger v. UOP, Inc.*[252] the court indicated in dictum that the duty of candor would not have required disclosure of the Arledge-Chitiea report if a committee of outside directors had been appointed to negotiate with Signal. The court stated in a footnote:

> Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with Signal at arm's length. Since fairness in this context can be equated to conduct by a theoretical, wholly independent, board of directors acting upon the matter before them, it is unfortunate that this course apparently was neither considered nor pursued. Particularly in a parent-subsidiary context, a showing that the action taken was as though each of the contending parties had in fact exerted its bargaining power against the other at arm's length is strong evidence that the transaction meets the test of fairness.[253]

The court did not indicate in this dictum whether the Signal employees and directors of UOP would have had to disclose the Arledge-Chitiea report to the outside directors who constituted the committee. The above quoted footnote, however, suggests that they would since failure to require disclosure would not have resulted in arm's-length bargaining. Even with the establishment of a committee of outside directors, Signal would still possess an obvious informational advantage over the outside directors in the event the report was not disclosed. The dictum does clearly suggest, however, that soft information need not be disclosed to stockholders if a committee of independent directors is established to bargain on behalf of the stockholders.

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252. 457 A.2d 701 (Del. 1983); *see supra* text accompanying notes 216-21.
253. *Id.* at 709-10 n.7 (citations omitted).

The use of outside directors is certainly an improvement over relying on directors who are also employees of the corporation and may be more concerned about retaining their jobs than about serving the stockholders' best interests. However, it is far from clear that the stockholders should delegate to the directors the decision about the price at which they should sell their stock. In *Dynamics Corp. of America v. CTS Corp.*[254] Judge Posner pointed out two substantial difficulties with relying on the impartiality of outside directors.[255] First, outside directors will be influenced either consciously or subconsciously by their friendship with inside directors.[256] Second, since outside directors who devote only part time to the corporation are less familiar with the corporation than inside directors, there is a natural tendency for the outside directors to defer to the inside directors.[257]

Even if independent directors could achieve an arm's-length bargaining posture, it is not clear that the use of independent directors is an appropriate proxy for the market mechanism in achieving fair value for the stockholders. Using the market mechanism has the advantage of involving several stockholders who are evaluating the soft information and using it to value their stock with the result that a more accurate valuation may occur. Moreover, release of the information to the public increases the likelihood that if management's bid is low, other bidders who have analyzed the soft information will be able to enter the contest for control. Because this will increase the number of potential buyers and increase the market's knowledge about the corporation, it will help establish the prerequisites for a perfectly competitive market for control and maximize societal welfare.

VIII. PROPOSED RULES

A. *The Need For Administrative Action*

Given the difficulties with the judicial attempts to establish the circumstances and format for disclosing soft information, the best solution is for the SEC to promulgate rules which would require the disclosure of soft information in management buyouts and bailouts. In contrast to the courts which are confined to considering the facts before them, the SEC can fashion rules which will maximize societal welfare after considering a myriad of facts. The SEC is also equipped to monitor the impact of its rules and revise them if unexpected results occur. Moreover, the SEC can issue rules that could tailor the type of disclosure necessary to ensure that stockholders will not be misled and at the same time

254. 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds,* 107 S. Ct. 1637 (1987).

255. *See also* Brudney, *The Independent Director—Heavenly City or Potemkin Village?,* 95 HARV. L. REV. 597, 616-22, 642-59 (arguing that independent directors are ineffective for enforcing managment integrity because they lack the time, knowledge and incentive to perform such a role). *But see* PRINCIPLES OF CORPORATE GOVERNANCE, ANALYSIS AND RECOMMENDATION, Reporter's Note 11, at 56 (Tent. draft No. 5, Apr. 15, 1986) (stating that the interest of a director in the continuation of his directorship for other than pecuniary reasons does not result in a conflict of interest).

256. *Dynamics Corp. of Am.*, 794 F.2d at 256.

257. *Id.*

limit the disclosure requirement to situations involving buyouts and bailouts. Last, the SEC rules can apply to all corporations subject to its jurisdiction, not just Delaware corporations.

B. *Basic Principles to Guide Formulation of the Rules*

Since it will rarely be in management's best interest to disclose projections or appraisals in a buyout or bailout, the SEC should promulgate rules requiring such disclosure. Although specific recommendations should be considered only after the benefit of public hearing, certain general principles can be identified. First, because the two major determinants of a stock's value will be projected income and liquidation value, the SEC should require these items to be disclosed. Second, because all projections or appraisals are based on assumptions, the assumptions should be stated and explained so that a person generally knowledgeable about finance and business could comprehend the explanations. Third, sensitivity analysis in regard to the projections and appraisals should be disclosed to stockholders so that the impact of changes in the major assumptions on projected income and liquidation value can be illustrated to stockholders. Last, any projections or appraisals provided to any third party, such as creditors or investment groups solicited by management or acting in concert with management to purchase the corporation, should also be disclosed with explanations as to any variations from the other projection and appraisals.

The first suggestion, that projections and appraisals should be disclosed, recognizes that income projections and liquidation values are the major determinants of stock price. The income projections should be presented in three forms. First, management should be required to disclose the income per share which they project as most likely to occur. The assumptions underlying this projection should be disclosed in detail sufficient that a sophisticated stockholder, knowledgeable about business affairs in general, could analyze the projections. Second, sensitivity analysis should then be applied to the projections which illustrate what projected income would be if none of the assumed changes occur. And third, sensitivity analysis should illustrate what projected income would be if the assumed changes are more successful than anticipated. For example, if management is projecting increased profits because of a larger market share, management should also disclose projections showing income if the increased market share does not materialize and projections showing income if the increase in market share is greater than expected. The sensitivity analysis will illustrate to stockholders that the projected income can change markedly as a result of failure to achieve anticipated goals, thereby emphasizing the "soft" nature of the projections. Moreover, the sensitivity analysis will permit analysts to gain additional insight into the various factors contributing to the corporation's net income.

It will be difficult for the SEC to specify the factors contributing to net income upon which the sensitivity analysis should focus since factors which contribute significantly to income will vary from business to business. Consequently, the SEC should approach the problem from the other end. That is, the

SEC should require that the sensitivity analysis depict both a scenario in which income is fifteen percent less than the projection which represents the most likely income amount and a scenario in which income is fifteen percent greater than the probable income projection. In composing these alternative scenarios, management should be required to identify the factors which contribute most significantly to the changes in net income. This would illustrate the interrelationship between assumptions about factors contributing to net income and net income in a situation involving a significant change in net income.

Liquidation values present a different problem. Liquidation values can vary significantly depending on the assumptions about the type of liquidation which will occur.[258] Experience with recent management buyouts suggests that the greatest return is derived not when the assets are sold on an asset-by-asset basis, but rather when the business is carved into smaller operating units and sold on that basis. Consequently, at least one liquidation valuation should be based on the price that could be received if the corporation were carved into units which could function as independent businesses. This type of valuation, however, presents further problems. Such a valuation would require management to project income for the constituent parts of the corporation, and then determine an appropriate capitalization rate to capitalize those earnings. Yet, management's choice of a capitalization rate may vary significantly from the stockholders.'[259] In addition, disclosing the projections and assumptions underlying the projections to investors is preferred so that the investors can make their own valuation. These concerns, plus the view that the price management pays for the corporation should be derived from arm's-length bargaining, suggest that the management should not be required to disclose the "value" of the operating units into which the corporation can be divided, but rather should be required to show the pro forma historical performance of each business segment plus projected income.[260] The historical data could provide a helpful background to help stockholders analyze the projections.[261]

In the event that management discloses projections of income for the busi-

258. Liquidation value can be calculated using two general methods. One method involves estimating the value at which the assets could be sold. The other method involves capitalizing the anticipated earnings which the assets will generate. *See* REPORT, *supra* note 95, at A-381 to A-382 (citing Comment, *The Use of Appraisals in SEC Documents*, 122 U. PA. L. REV. 138, 139 (1973)); Kripke, *supra* note 100, at 1199-1200.

259. See *supra* text accompanying notes 59-61.

260. The operating units for which the projections are provided should be based on the various lines of business in which the corporation currently engages. The definition of the lines of business should be determined by reference to various industry segments currently reported pursuant to generally accepted accounting principles. FASB Statement No. 14 defines the term "industry segment" as "a component of an enterprise engaged in providing a product or service or a group of related products or services primarily to unaffiliated customers . . . ." FASB Statement No. 14 Paragraph 10(a). Appendix D of Statement No. 14 describes several criteria for determining what operations should be grouped together in the same segment, including common production or sales facilities, similar geographical or customer markets, and comparable sensitivity to price changes or shifts in general economic conditions.

261. Several studies have shown the utility to investors of financial data of the industry segments of the corporation. *See, e.g.*, Collins, *SEC Line-of-Business Reporting and Earnings Forecasts*, 4 J. BUS. RES. 117 (1976); Collins, *supra* note 77; Collins & Simonds, *SEC Line-of-Business Disclosure and Market Risk Adjustments*, 17 J. ACCT. RES. 352 (1979).

ness segments to third parties which differ from the projections disclosed to stockholders, management should be required to disclose those projections to stockholders as well as a detailed explanation as to why those projections differ. Finally, management should be required to provide the liquidation value of the corporation's assets if sold in an orderly manner over a one-year period. In the event that management has obtained an estimate from an outside appraiser, that appraisal should be disclosed with the assumptions used by the appraiser.

The foregoing disclosure requirements should be promulgated pursuant to the authority granted to the SEC in sections 13(e) and 14(d)[262] of the Securities Exchange Act of 1934 and should become applicable at the time that management, an affiliate of management, or any other person to whom management has disclosed soft information purchases or offers to purchase stock in the corporation with a view to increasing the amount of the stock they own by more than ten percent of the outstanding stock of the corporation during a one-year period.[263] This would ensure that the market has sufficient information to assess the price which the bidder is willing to pay at the time the bidder initiates the purchase,[264] but would not cause the disclosure of that information for relatively small shifts in control.

C. *Critique*

One of the major disadvantages of requiring disclosure of soft information, however, is that it requires management to disclose its strategic plans to the public. This could place the corporation at a competitive disadvantage compared to those corporations which are not subject to buyouts or bailouts and, consequently, do not have to disclose soft information.[265]

One method to deal with this problem might be to require all registered companies to disclose projections, appraisals, and the underlying assumptions as part of the annual or quarterly reporting process, thereby placing all public corporations in the same position. That solution, however, ignores the fact that corporations registered with the SEC compete in a global economy with corpo-

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262. The rules pertaining to management buyouts should be promulgated under section 13(e). However, the best source of authority for requiring disclosure of soft information in bailouts is section 14(d) since the "white knight" in a bailout is usually not an affiliate of the target and, therefore, not covered by the language of section 13(e).

263. The rules fashioned in this manner would include recapitalizations as well as buyouts and bailouts. Although further study is necessary before a definitive conclusion can be reached as to the proper treatment of recapitalizations, it currently seems appropriate to require disclosure of soft information in recapitalizations as well as buyouts and bailouts. The competitive harm to the corporation arising from the disclosure of soft information in a recapitalization would be partially diminished by not requiring the corporation to update the disclosed soft information after the recapitalization is complete. *See supra* note 91.

264. Thus, the rules would require that the soft information be disclosed at the time of the initial purchase of shares in a two-step tender offer, not at the second stage, as is currently the case. *See* Radol v. Thomas, 772 F.2d 244, 254 (6th Cir. 1985), *cert. denied,* 477 U.S. 903 (1986); *supra* text accompanying note 127.

265. It should be noted that the harm to the corporation will be considered by management in selecting a time to implement a buyout and that management would probably select a time which minimized the harm to the corporation. However, management would not have such discretion for a bailout, since in the bailout management is responding to a possible takeover.

rations which would not be required to disclose such soft information and which therefore could acquire a competitive advantage over American companies by having American corporations' plans. Also, for reasons discussed earlier, the creation of a continuous market for control is not in the stockholder's best interest, since in most instances other than a buyout or bailout, management presumably acts to help increase stockholder wealth, or at least management is not appropriating a large amount of the stockholder wealth. Consequently, it is inappropriate to require the disclosure of soft information on an ongoing basis.

Another way to minimize the harm would be to confine the obligation to disclose soft information to those situations in which the corporation will no longer be a reporting company as a result of the proposed transaction. Justifying such a distinction, however, is difficult. A corporation which is either reporting or nonreporting after the bailout or buyout will have suffered harm from the disclosure. The only distinction is that the nonreporting company's implementation of the strategy revealed in the soft information will take place behind a shroud of secrecy.

Perhaps in order to provide this same advantage to the reporting company, the reporting company should not be required to revise the soft information after the bailout or buyout is completed.[266] Although not updating the soft information could cause stockholders to be misled, the harm that the corporation would suffer from updating the disclosure seems to be greater than the harm that the stockholders would suffer because of the damage to the corporation's competitiveness. This may be particularly true in the context of a buyout because after the buyout management's interest will be more congruous with the public stockholders' interest by virtue of management's increased stake in the corporation.

There are other costs attributable to disclosing soft information to consider. First, the requirement that soft information be disclosed may deter management from attempting to purchase the corporation. This would have an adverse impact on stockholders because one very important source of buyers for their stock will have been lost. However, as stated earlier, management will, all other things being equal, place a greater value on the stock of the corporation than the stockholders. Moreover, management is well aware that even the most carefully devised plans are revised as they are implemented. Because in most cases the implementation of the plans will occur when the corporation is no longer publicly held, changes in the plan would not be available to the corporation's competitors. Although this will not obviate all the damage caused by disclosure of the plans, it will help reduce the damage somewhat because the implementation of the plans will not occur in public view.

Another cost to consider is the potential imposition of liability on management and the corporation in connection with disclosure of the projections. It is

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266. Others have also concluded that there should be no duty to update the disclosures. *E.g.*, REPORT, *supra* note 95, at 360 (unless information becomes misleading); Schneider, *supra* note 94, at 269. *But see* Gray, *Proposal for Systematic Disclosure of Corporate Forecasts*, 29 FIN. ACCT. J. 64, 67-68 (1973) (expressing opposite view); Reiling & Burton, *Financial Statements: Signposts As Well As Milestones*, HARV. BUS. REV., Nov.-Dec. 1972, 45, 52 (same).

not entirely clear that the shift of the burden of proof to the plaintiff in rules 175 and 3b-6, the safe harbors for projections, is within the scope of the SEC's authority.[267] Moreover, a safe harbor for asset appraisals should be crafted. Thus, legislative action may be necessary.

A further important cost to be factored is the expense of preparing and disclosing the projections and appraisals.[268] This expense will ultimately be passed on to the stockholders since it will presumably reduce the price offered by management for the stock. In effect this expense can be viewed as an additional cost arising from the principal-agent relationship. It is an expense that results from the stockholders' delegation of management of the corporation. This additional agency cost should not deter the imposition of the disclosure requirement because the cost is probably small in comparison to the benefit the stockholders will receive and the other existing agency costs.

Finally, the danger always exists that stockholders will be misled by the information. Disclosure of sensitivity analysis and appropriate precautions, however, should minimize this danger. Moreover, because the market is dominated in take-over situations by large sophisticated investors who have the greatest impact on the price of the corporation's stock, individual investors are unlikely to be harmed by the soft information in the event they are confused by it.[269]

IX. CONCLUSION

The current market for control in management buyouts and bailouts has not resulted in an optimal allocation of resources because the market lacks the conditions prerequisite to a perfectly competitive market. In particular, the market lacks several bidders and full knowledge of the target corporation. In order to achieve these conditions, management should be required to disclose asset appraisals and income projections. Although the courts have indicated a willingness in certain circumstances to require the disclosure of soft information, a remedy crafted by the courts is inappropriate because of the limitations inherent to formulating law on a case-by-case basis and the narrow language from which the courts must formulate a rule. Instead, the requirement should be imposed by the SEC. To ensure that the benefits from the disclosure of soft information exceed the costs, the disclosure requirements should be limited to those circumstances where management can no longer be trusted to manage the corporation for the benefit of stockholders. If the disclosure requirements are carefully tailored, they can contribute to an optimal allocation of resources and

267. The rule may conflict with the allocations of the burden of proof for private actions brought under sections 11, 15 U.S.C. § 77k(a), and 12(2), 15 U.S.C. § 77*l*(2), of the Securities Act of 1933. *See* Note, *The Safe-Harbor Rule for Projections: Caveat Projector*, 11 LOYOLA U. CHI. L.J. 345, 357 (1980).

268. The actual out-of-pocket costs of disclosing soft information could be estimated by surveying corporations who have made such disclosures in the past. For an example of the use of surveys to calculate hard costs associated with disclosure compliance, see REPORT, *supra* note 95, at 22-28. Other costs, however, such as loss of competitive advantage and confusion of stockholders are more difficult, if not impossible, to quantify.

269. J. Dennis, *supra* note 88, at 1214.

the payment of a fair price to public stockholders, while minimizing the harm to corporate competitiveness.