Corporate Control Transactions

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Transactions in corporate control often produce gains for the corporation. Substitution of one set of managers for another, for example, often produces gains because assets increase in value under better management, and would-be managers offer payments to shareholders to compete for the for the right to manage the firm's pool of assets. In other situations managers may "squeeze out" some shareholders in order to reduce the agency costs of management and thereby increase the value of the firm. Managers of a parent corporation may decide that a combination with a partially owned subsidiary will create gains because of economies of scale or management. Finally, managers may seek control of new business opportunities to maximize the profit from exploiting them.

These devices for allocating corporate control pose a common problem because they sometimes involve an unequal division of the gains from the transaction. Shares in a control bloc, for example, may be sold at a price greater than that paid for the remaining shares; minority shareholders frozen out in a going-private transaction may receive less than the shareholders not frozen out; managers who personally exploit a corporate opportunity may prosper relative to others. In each case one might argue that the gains should be distributed more widely. Such "sharing" arguments are popular among academic lawyers, and courts are beginning to apply these arguments to some corporate control transactions. We argue, in contrast, that those who produce a gain should be allowed to keep it, subject to the constraint that other parties to the transaction be at least as well off as before the transaction. Any attempt to require sharing simply reduces the likelihood that there will be gains to share.

The traditional rule of judicial deference to the arrangements adopted by shareholders and managers still governs in some kinds of transactions.

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The authors are indebted to Charles Cope, Chicago 1982, for ideas and computations presented in a paper he wrote in 1980-1981. The authors thank Douglas G. Baird, Walter J. Blum, Michael P. Dooley, Ronald J. Gilson, J.A.C. Hetherington, John H. Langbein, Bernard D. Meltzer, Richard A. Posner, Kenneth E. Scott, Matthew L. Spitzer, Cass R. Sunstein, and participants in the law and economics workshops of Cornell, Northwestern, Stanford and the University of Chicago, Michigan and Toronto Law Schools for their helpful comments. The Law and Economics Program of the University of Chicago provided support for the research and writing of this article.

For example, owners of controlling shares may sell at a substantial premium, without any obligation to share the bounty with other shareholders.[1] Managers may arrange to take a corporate opportunity for themselves, with the consent of the directors, or may allocate an opportunity for a family of connected corporations to the firm that can make the most profitable use of it.[2] Mergers that are set up in arms' length bargaining may distribute the lion's share of the gain to one party, even though both parties to the merger are controlled by the same people.[3] These rules have proved hardy, despite incessent challenge.[4] At the same time, however, courts have held that a controlling shareholder may not enter into certain profitable transactions, not involving the sale of control, unless the profits are shared with other shareholders.[5] State and federal restrictions effectively require tender offerors to share much of the gain with the managers and shareholders of acquired corporations.[6] And a recent series of cases in Delaware may be read as requiring the sharing of gains in parent-subsidiary mergers and going-private transactions.[7]

1. *E.g.*, Treadway Co. v. Care Corp., 638 F.2d 357 (2d Cir. 1981); Zetlin v. Hanson Holdings, 48 N.Y.2d 684, 397 N.E.2d 387 (1979); Tryon v. Smith, 191 Ore. 172, 229 P.2d 251 (1951). *But see infra* pp. 716-19.

2. *E.g.*, Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970). Things may (or may not) be different if a particular allocation can be characterized as a waste of corporate assets, a transaction for which unanimous consent has been required. Schreiber v. Bryan, 396 A.2d 512 (Del. Ch. 1979).

3. *E.g.*, E.I. Du Pont de Nemours & Co. v. Collins, 432 U.S. 46 (1977); Weinberger v. UOP, Inc., 426 A.2d 1333 (Del. Ch. 1981), *aff'd*, No. 58, 1981 (Del. Feb. 9, 1982).

4. For representative statements of the criticism, *see* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 217-19 (rev. ed. 1967); M. EISENBERG, THE STRUCTURE OF THE CORPORATION 308-11 (1976); Andrews, *The Stockholder's Right to Equal Opportuity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965); Bayne, *The Sale-of-Control Premium: The Intrinsic Illegitimacy*, 47 TEX L. REV. 215 (1969); Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965); Berle, *"Control" in Corporate Law*, 58 COLUM. L. REV. 1212 (1958); Brudney & Chirelstein, *Fair Shares in Corporate Mergers*, 88 HARV. L. REV. 297 (1974) [hereinafter cited as *Corporate Fair Shares*]; Brudney & Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) [hereinafter cited as *Corporate Freezeouts*]; Brudney & Clark, *A New Look At Corporate Opportunities*, 94 HARV. L. REV. 997 (1981); Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Chazen, *Fairness From A Financial Point of View in Acquisitions of Public Companies: Is "Third Party Sale Value" the Appropriate Standard?* 36 BUS. LAW. 1439 (1981); Greene, *Corporate Freeze-Out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Hazen, *Transfers of Corporate Control and Duties of Controlling Shareholders*, 125 U. PA. L. REV. 1023 (1977).

5. *E.g.*, Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rep. 592 (1969).

6. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter cited as *Responses of a Target's Management to Tender Offers*], for a summary. *See also* Easterbrook & Fischel, *Takeover Bids, Defensive Tactics, and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Fischel, *Efficient Capital Market Theory, The Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1 (1978).

7. Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981); Roland Int'l Corp. v. Najjar, 407 A.2d 1032 (Del. 1979); Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977); Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977). *But see* Dofflemyer v. W.F. Hall Printing Co., 432 A.2d 1198 (Del. 1981); Fins v. Pearlman, 424 A.2d 305 (Del. 1980); Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980); Weinberger v. UOP, Inc., 426 A.2d 1333 (Del. Ch. 1981), *aff'd*, No. 58, 1981 (Del. Feb. 9, 1982).

We suggest a coherent approach to the allocation of gains in these transactions. In Part I we argue that the legal system should supply rules that mimic the *ex ante* agreements shareholders would reach if they could bargain for and enforce their agreements costlessly. We demonstrate in Part II that all shareholders can benefit from rules that allow the party responsible for a gain to allocate to himself as much as he can. If so, then shareholders would vote unanimously for such an allocation rule in advance of the transaction in question, and the rule should be upheld by the courts. In Part III we apply this approach to a number of corporate control transactions and show that, for the most part, the traditional rules of corporation law are consistent with our analysis. We conclude in Part IV with a comparison between the rules governing corporate control transactions and the legal rules in other contexts.

I. The Function of Fiduciary Duties

Corporate directors and other managers are said to be fiduciaries, who must behave in certain upright ways toward the beneficiaries of fiduciary duties. Yet, as Justice Frankfurter put it, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary?"[8] In this section we provide a framework for analyzing the meaning and scope of the duty owed by corporate managers.

Fiduciary principles govern agency relationships. An agency relationship is an agreement in which one or more persons (the principal) delegates authority to another person (the agent) to perform some service on the principal's behalf. The entire corporate structure is a web of agency relationships. Investors delegate authority to directors, who subdelegate to upper managers, and so on. Delegation of authority enables skilled managers to run enterprises even though they lack personal wealth, and it enables wealthy people to invest even though they lack managerial skills. It reduces the risks that investors must incur, because it enables them to spread investments among many enterprises. Delegation also helps managers to pool enough capital to take advantage of available economies of scale in production, to reduce the costs of bargaining and contracting, and to obtain the benefits of productive information that must be used in secret or not at all.[9]

8. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

9. Because the use of information by one entity does not preclude its use by another entity, it often is necessary to extend the scope of the firm in order to take advantage of new productive information. Otherwise the firm's rivals would take a free ride on the efforts involved in creating the information. *See* Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309; Jarrell & Bradley, *The Economic Effects of Federal and State*

Delegation—including the "separation of ownership and control"—exists because both principal and agent share in the benefits of agency relationships. Nonetheless, the interests of agents may diverge from the interests of principals after the delegation has occurred. Directors and other managers often hold only a small stake in the firm and thus capture only a small part of the gains from their efforts; correspondingly, they suffer through the stock market only a small part of the losses they create. The smaller the managers' share in the enterprise, the more the managers' interest diverge from the interests of the principals. This phenomenon exists in any agency relationship. For example, a real estate agent on a five percent commission will not undertake even $10 worth of effort to improve the realized price by $100, because the agent reaps only $5 of this sum. The $10 effort, however, would be highly advantageous to the principal.

This divergence of interests between principals and agents may be controlled by the operation of the employment market. An unfaithful or indolent agent may be penalized by a lower salary, and a diligent agent may be rewarded by a bonus for good performance. In addition, the threat of sales of corporate control induces managers to perform well in order to keep their positions. Finally, competition in product markets helps to control agents' conduct, because a poorly-managed firm cannot survive in competition with a well-managed firm (other things being equal).

Although these market mechanisms automatically reduce the divergence of interests between agents and principals,[10] they do not eliminate the costs of the agency relationship. They do not work without extensive, and costly, monitoring, so that principals and others know how well the agents perform.[11] And the mechanisms may be inadequate to deal with one-time defalcations, when the agent concludes that the opportunities of the moment exceed any subsequent penalties in the employment market.

Investors might try to deal with these problems by hiring full-time monitors to look over the shoulders of managers, but this is costly and does not deal with the question, "Who monitors the monitors?" Full-time monitors become managers themselves, in all but name, and monitors who do not work full time lack both the incentive to watch carefully and the information to determine how well others are performing their tasks.

Regulations of Cash Tender Offers, 23 J. LAW & ECON. 371, 382-87 (1980); Kitch, *The Law and Economics of Rights in Valuable Information*, 9 J. LEGAL STUD. 683 (1980).

10. *See* R. WINTER, GOVERNMENT AND THE CORPORATION (1978). We discuss many of these market mechanisms in more detail in *Responses of a Target's Management to Tender Offers*, *supra* note 6, at 1168-74.

11. *See* Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

The fiduciary principle is an alternative to direct monitoring. It replaces prior supervision with deterrence, much as the criminal law uses penalties for bank robbery rather than pat-down searches of everyone entering banks. Acting as a standard-form penalty clause in every agency contract, the elastic contours of the fiduciary principle reflect the difficulty that contracting parties have in anticipating when and how their interests may diverge.

Socially optimal fiduciary rules approximate the bargain that investors and agents would strike if they were able to dicker at no cost. Such rules preserve the gains resulting from the delegation of authority and the division of labor while limiting the ability of agents to further their own interests at the expense of investors. The existence of such "off-the-rack" rules reduces the costs of transacting and of enforcing restrictions on the agent's powers. It also reduces the risk that managers will manipulate the articles of incorporation to their advantage once they assume control.[12]

Fiduciary principles contain anti-theft directives, constraints on conflict of interest, and other restrictions on the ability of managers to line their own pockets at the expense of shareholders. But these principles have limits that reflect the distinction between managerial practices that harm investors' interests and practices that simultaneously benefit managers and investors. For example, managers of a corporation are free to funnel business to another corporation in which they have an interest if the transaction is approved by disinterested directors or is "fair" (advantageous) to the firm.[13]

Because the fiduciary principle is fundamentally a standard term in a contract to which investors are parties, it makes little sense to say that managers may, consistent with the fiduciary principle, sacrifice the interests of investors to other ends, so long as investors are not hurt "too much."[14] Presumably "too much" in this context means "by so much that investors start contracting around the rule." Such re-contracting may be exceedingly costly, however, because once a firm has been established shareholders have no practical way of revising the articles on their own to overcome intervening legal surprises. To use the fiduciary principle for any purpose other than maximizing the welfare of investors subverts its

12. Although investors doubtless should foresee the possibility of such manipulations of the bargain, they have great difficulty policing such abuses because no single investor has a sufficient incentive to watch the managers' conduct. *See Responses of a Target's Management to Tender Offers*, *supra* note 6, at 1170-71, 1180-82.

13. The fiduciary duty of a corporate director diverges sharply from the fiduciary duty of a trustee in this respect precisely because the interests of the principals are different. R. WINTER, *supra* note 10, at 33.

14. *See* Langbein & Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980) (critical discussion of one suggestion along those lines).

function by turning the high costs of direct monitoring—the reason fiduciary principles are needed—into a shield that prevents investors from controlling their agents' conduct.[15]

II. Equal Treatment, Fiduciary Duty, and Shareholders' Welfare

Many scholars, and a few courts, conclude that one aspect of fiduciary duty is the equal treatment of investors. Their argument takes the following form: fiduciary principles require fair conduct; equal treatment is fair conduct; hence, fiduciary principles require equal treatment. The conclusion does not follow. The argument depends upon an equivalence between equality and fair treatment, which we have questioned elsewhere.[16] To say that fiduciary principles require equal (or even fair) treatment is to beg the central question—whether investors would contract for equal or even roughly equal treatment.[17]

Our analysis of this question requires that a distinction be drawn between rules that maximize value *ex ante* and actions that maximize the returns of certain investors *ex post.* A simple example illustrates the point. A corporation may choose to invest its capital in one of two ventures. Venture 1 will pay $100, and the returns can be divided equally among the firm's investors. Thus, if there are 10 investors in the firm, the expected value to each investor is $10. Venture 2 will pay $150, in contrast, but only if the extra returns are given wholly to five of the ten investors. Thus, five "lucky" investors will receive $20 apiece, and the unlucky ones $10. Because each investor has a 50 percent chance of being lucky, each

15. In saying this we do not necessarily rule out arguments that directors owe fiduciary duties to employees and other groups. Under some circumstances employees are investors in the firm; they invest their human capital, to the extent that they become specialists and obtain skills that are less valuable to other employers. Firms recognize this investment with long term contracts, pension plans, severance payments, and other devices for "repaying" human capital once it is withdrawn from the firm. But fiduciary duties to employees, like fiduciary duties to other investors, are implied contractual terms; there is little warrant for manipulating fiduciary principles to override explicit contractual terms or for using them to achieve ends other than the probable result of cost-free bargaining. We need not pursue the point. The corporate control transactions we discuss in this article involve conflicts among shareholders, not divergences of interest between employees and shareholders, consumers and shareholders, or any other conflict.

16. Easterbrook, *supra* note 9, at 323-30; Easterbrook, Landes & Posner, *Contribution Among Antitrust Defendants: A Legal and Economic Analysis,* 23 J. LAW & ECON. 331, 342-43 (1980); Fischel, *supra* note 6, at 10-15.

17. Lawyers beg this question with regrettable frequency. As George Stigler observed: "Since the fairness of an arrangement is a large factor in the public's attitude toward it, the lawyers as representatives of the public seek to give their schemes the sheen of justice. They employ to this end two approaches. One is to invoke any widely-held belief—on the tacit but convincing ground that any position is invulnerable against nonexistent attack." Fairness is an invulnerable position; who is for *un*fairness? But for lawyers fairness is "a suitcase full of bottled ethics from which one freely chooses to blend his own type of justice." Stigler, *The Law and Economics of Public Policy: A Plea to the Scholars,* 1 J. LEGAL STUD. 1, 2, 4 (1972).

would think Venture 2 to be worth $15.[18] The directors of the firm should choose Venture 2 over Venture 1 because it has the higher value and because none of the investors is worse off under Venture 2.

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

In sum, if the terms under which the directors obtain control of the firm call for them to maximize the wealth of the investors, their duty is to select the highest-paying venture and, following that, to abide by the rules of distribution. If unequal distribution is necessary to make the stakes higher, then duty requires inequality. The *ex post* inequality under Ventures 2 and 3 is no more "unfair" than the *ex post* inequality of a lottery, in which all players invest a certain amount but only a few collect. The equal treatment of the investors going into Ventures 2 and 3, and the gains they receive from taking chances, make the *ex post* inequality both fair and desirable.[19]

We hope that our analysis of Ventures 2 and 3 above are uncontroversial. If corporate control transactions sufficiently resemble Ventures 2 and 3, this analysis supplies a guide for analyzing the fiduciary duties of corporate managers. A class of control transactions resembles Ventures 2 and 3 if: (1) control changes and financial restructurings produce gains for investors to enjoy; (2) the existence or amount of the gain depends upon unequal distribution; and (3) shareholders would prefer the unequal distribution to a more equal distribution of smaller gains from an alternative transaction (or no transaction). We address these issues in the remainder of Part II and conclude by advancing a fiduciary principle under which managers always are free to engage in transactions resembling Venture 2. For practical reasons, however, our principle prohibits transactions resembling Venture 3.

18. *See infra* pp. 712-13 (discussing relevance of risk aversion).

19. The firm's managers could not easily justify a choice of Venture 2 or 3, followed by a "surprise" equal distribution of the proceeds among the 10 investors. In the example we posed, the firm obtained the higher returns only by agreeing to unequal distribution. It might get away with a breach of these conditions once, but Ventures 2 and 3 or their equivalent soon would become unavailable. Besides, if the firm promises to pay some investors unequally when it undertakes the venture, the managers could not be "fair" to the unlucky investors without being unfair to the lucky ones. *See* Broad v. Rockwell Int'l Corp., 642 F.2d 929, 955-60 (5th Cir. 1981) (en banc) (fiduciary duties require managers to abide by bargains and disregard considerations of fairness), *cert. denied*, 102 S. Ct. 506 (1981).

A. *The Potential Gains from Control Transactions*

It should be clear that managers do not always maximize the wealth of investors. We have already discussed the costs of principal-agent relationships. Because managers have only a small stake in the fortunes of the firm, these costs may be quite high. Managers may not work as hard as they would if they could claim a higher share of the proceeds—they may consume exessive perquisites, and they may select inferior projects for the firm without bearing the consequences of their action. Corporate control transactions can reduce agency costs if better managers obtain control of the firm's assets or if they alter the incentive structure facing existing managers. Corporate takeovers, and subsequent changes in management, increase the wealth of investors.[20]

The sale of a control bloc of stock, for example, allows the buyer to install his own management team, producing the same gains available from a tender offer for a majority of shares but at lower cost to the buyer. Because such a buyer believes he can manage the assets of a firm more profitably, he is willing to pay a premium over the market price to acquire control. The premium will be some percentage of the anticipated increase in value once the transfer of control is effectuated. If there were no anticipated increase in value, it would be irrational for the buyer to pay the premium. There is a strong presumption, therefore, that free transferability of corporate control, like any other type of voluntary exchange, moves assets to higher valued uses.

Other transactions present similar opportunities for gain. The freezeout of minority shareholders may create gains when it facilitates a takeover. Transfers of control are expensive, and apart from the obvious cost of the premium over the market price necessary to induce the sale of control, the purchaser must invest considerable sums in research to determine which firms can be operated profitably after a shift in control. Transfers of control will occur only if the purchaser believes it can recoup these costs. Recoupment is difficult. Although the purchaser benefits if the share prices of the target firm appreciate after the transfer in control, this gain accrues equally to shareholders who did not sell to the purchaser. By eliminating free-riding shareholders in a freezeout, the purchaser may recoup the costs of the acquisition by appropriating the gains from the transfer of control. Such a freezeout clearly increases expected aggregate shareholders' wealth if it increases the likelihood of a profitable transfer of

20. *Responses of a Target's Management to Tender Offers, supra* note 6, at 1168-88. For related arguments about the sources of gains in corporate control changes, see Borden, *Going Private—Old Tort, New Tort, or No Tort?* 49 N.Y.U. L. REV. 987, 1006-13 (1974); *Corporate Fair Shares, supra* note 4, at 308; Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes,* 1980 AM. BAR FOUND. RES. J. 69.

control.

In addition, a freezeout of minority shareholders in a longstanding subsidiary will produce gains if the value of the combined entity is greater than the sum of the separate values of the parent and the subsidiary. Such an increase in value may be attributable to economies of scale, centralized management and corporate planning, or economies of information. Moreover, a freezeout of the minority shareholders of a subsidiary is beneficial if it reduces the cost of policing conflicts of interest and enables the firm to make additional cost-justified investments. A parent may not send new projects to a subsidiary, for example, if the parent's investors must guarantee loans to finance the projects. Under these circumstances, the parent's investors bear a proportionally greater risk of loss than the minority shareholders in the subsidiary, but they do not receive a proportionally greater share of any gains. Thus, the elimination the minority shareholders can increase the likelihood that profitable new ventures will be undertaken.[21]

Other control transactions attack agency costs directly. Although public ownership of a firm may be value-maximizing at one time, changes in the firm's line of business or financial structure may make it worthwhile for the firm to "go private" later. When firms go private they eliminate—or substantially reduce—the separation of ownership and control that creates the clash of interest between principal and agent. Other things being equal, the lower agency costs mean higher returns to investors.[22] In addition, going-private transactions may eliminate costs attributable to public ownership, which include substantial (and increasing) expenditures for legal and auditing fees, stockholder relations and compliance with myriad disclosure obligations mandated by the SEC and organized stock exchanges.[23] By going private, the firm can avoid these costs of compliance and reduce the risk of liability resulting from failure to comply with uncertain disclosure obligations. Moreover, the avoidance of disclosure obligations can benefit the firm if it might have to sacrifice prospective business opportunities if disclosure were required.[24]

Similarly, the allocation of a "corporate opportunity" to a corporate insider may allow that opportunity to be exploited more effectively or at lower cost. The firm incurs substantial agency costs in the exploitation of

21. *Cf. infra* pp. 733-35 (discussing allocation of corporate opportunities).

22. Indeed, greater concentrations of control in public corporations may be associated with higher profits. *See* DeAlessi, *Private Property and Dispersion of Ownership in Large Corporations*, 28 J. FIN. 839 (1973); Stano, *Executive Ownership Interests and Corporate Performance*, 42 S. ECON. J. 272 (1975).

23. *See* S. PHILLIPS & R. ZECHER, THE SEC AND THE PUBLIC INTEREST (1981).

24. *See* Easterbrook, *supra* note 9; Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699 (1981); Jarrell & Bradley, *supra* note 9; Kitch, *supra* note 9.

the opportunity because managers, who cannot capture the gains, lack the appropriate incentives. Managers who assign opportunities to themselves can appropriate a greater portion of the marginal gains from their efforts, and thus they have a greater incentive to produce such gains. The manager can compensate the firm by taking a lower salary and bonus, and the reduction in agency costs may be mutually beneficial.

Of course, some control transactions do not produce gains. In a few instances changes in control may be attributable to self-aggrandizement of buyers rather than to gains in the use of the acquired firms' assets.[25] We do not think this managerialist explanation of control shifts is important in designing legal rules. If one firm wants to squander its money by paying too much for control, managers have no duty to turn the money away; an auctioneer does not stop the auction at the "right" price in order to protect bidders from paying too much. The market penalizes buyers who pay too much money for a deal, and those losses serve as signals to future buyers. The corporate law can ignore overpayments, for they are self-deterring.[26]

Some corporate control transactions that do not produce gains, however, are not always self-deterring. Looting may explain certain transfers of control. Some going-private transactions may be motivated by a desire to exploit inside information rather than to reduce agency costs. And sometimes a manager may appropriate control of a corporate opportunity even though the firm would have been able to exploit the opportunity more profitably.

At least for publicly-traded firms, the market offers information that distinguishes value-increasing control transactions from others in which looting or mismanagement may be in store. The information is contained in the price of a firm's shares. If the control change is associated with an increase in price, the investors apparently do not fear looting or other harm to the firm. If a syndicate acquires a control bloc of shares, and the price of the remaining shares *rises,* relative to the market as a whole, then the shareholders are betting on the basis of available information that the new controller will be better for their interests than the old. Precisely the same reasoning can be used when analyzing whether a manager has appropriated a corporate opportunity that could have been used more profitably by the firm. If the firm's share prices do not fall after the taking of the corporate opportunity, investors do not believe that they have been

25. M. EISENBERG, THE STRUCTURE OF THE CORPORATION 30-33 (1976).

26. We discuss the evidence about the managerialist hypothesis about control shifts in *Responses of a Target's Management to Tender Offers, supra* note 6, at 1185-87. *See also* Fischel, *supra* note 24, at 710-14 (critical discussion of the managerialist hypothesis). *Cf.* Easterbrook, *Predatory Strategies and Counterstrategies,* 48 U. CHI. L. REV. 263, 267-68, 278-80 (1981) (discussion of self-deterring conduct).

injured. Many studies of these price changes have been made; they show gains in the overwhelming majority of control transactions.[27]

Fewer price signals are available in going-private transactions, because such a transaction frequently eliminates public trading of the firm's shares. Even these transactions, however, leave some traces. If the price paid to frozen-out shareholders is higher than the price that the shares commanded before the transaction, the buyer anticipates that the transaction will produce gains. There is little percentage in paying $15 for shares selling at $10. If the only purpose of the transaction is to eliminate minority shareholders, it is irrational for the controlling shareholder to pay a premium over the market price. By using corporate assets to pay minority shareholders more than their shares are worth, the controlling shareholder will have decreased the value of his own holdings and therefore be worse off as a result.

All of these observations follow directly from the simple proposition that investors have no desire to give away their money. If they pay more for shares after a transaction than before, their dollar votes are a signal of gain and loss. One can obtain reliable information from the direction of price changes without necessarily believing that the prevailing price perfectly embodies the available knowledge.[28]

B. *The Gains May Depend on Unequal Division*

In many cases the apportionment of the gain makes little difference to the success of the transaction. If the gain from taking over a corporation exceeds the cost incurred by the acquiror, he would be indifferent to who

27. *See Responses of a Target's Mangement to Tender Offers, supra* note 6, at 1186-88 (discussion of empirical evidence); Schwert, *Using Financial Data to Measure Effects of Regulation*, 24 J. LAW & ECON. 121 (1981) (discussing methods of using stock prices to support inferences about how transactions affect firms' fortunes).

28. The analysis in the text follows even more directly from the efficient capital market hypothesis, which courts and even the SEC are beginning to accept. *See, e.g.*, Rolf v. Blyth, Eastman Dillon & Co., 637 F.2d 77 (2d Cir. 1980) (adjusting damages award to take account of market changes—case assumed that markets efficiently evaluate stocks' worth), 570 F.2d 38 (2d Cir. 1978) (liability opinion), *cert. denied*, 439 U.S. 1039 (1978); Seaboard World Airlines v. Tiger Int'l, 600 F.2d 355, 361-62 (2d Cir. 1979) (explicitly adopting efficient capital market hypothesis); Mills v. Electric Auto-Lite Co., 552 F.2d 1239, 1247 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977) (same, but also adopting a "fair shares" conclusion). The SEC's simplification of disclosure and reporting requirements is based on the belief that the price of widely-traded securities captures the import of information now required to be disseminated more widely. *See* 14 SEC. REG. & L. REP. (BNA) Supp. (March 10, 1982). The line of cases dispensing with the reliance requirement under Rule 10b-5 and adopting the "fraud on the market" theory also rests on the belief that markets efficiently incorporate information in price—including fraudulent information, which inflates the price and harms the investor even if he never heard or saw the fraudulent statement. *See, e.g.*, Panzirer v. Wolf, 663 F.2d 365 (2d Cir. 1981); Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975), cert. denied, 429 U.S. 816 (1976); *In re* LTV Securities Litig., 88 F.R.D. 134 (N.D. Tex. 1981). These cases are discussed in Fischel, *The Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities* (unpublished manuscript on file with *Yale Law Journal*).

receives the premium that is necessary to obtain control. But the fact that apportionment is irrelevant to the acquiror in many cases does not mean that apportionment of gains is always immaterial—in some marginal cases apportionment is the decisive factor. Suppose that a prospective acquiror of control concludes that, by expending $10, he can create a 50 per cent chance of producing $30 in gains. If the prospective acquiror is risk-neutral, the transaction will go forward because the expected gains of $15 exceed the $10 cost of the transaction. If the fiduciary principle is interpreted to require the prospective acquiror to share the $20 gain in the event it is realized, however, and absorb the entire loss if the gain is not realized, the deal may become unprofitable because the costs exceed the expected gains.

In theory, the law could require sharing of the $5 expected gain, but courts could not calculate this amount because they could not observe the *ex ante* risk of failure. Moreover, a large part of the cost to the acquiror is an opportunity cost—the money the acquiror could have made by devoting his talents to other projects. Another cost is the premium required to compensate risk-averse acquirors for risk-bearing. Because it would be difficult or impossible to compute opportunity costs and risk premia in the context of litigation, it would be difficult or impossible to implement a sensible sharing rule. Even if opportunity costs could be approximated, judicial errors would arise, and beneficial control changes would be stifled.[29]

A sharing requirement also may make an otherwise profitable transaction unattractive to the prospective seller of control. To illustrate, suppose that the owner of a control bloc of shares finds that his perquisites or the other amenities of his position are worth $10. A prospective acquiror of control concludes that, by eliminating these perquisites and other amenities, he could produce a gain of $15. The shareholders in the company benefit if the acquiror pays a premium of $11 to the owner of the controlling bloc, ousts the current managers, and makes the contemplated improvements. The net gains of $4 inure to each investor according to his holdings, and although the acquiror obtains the largest portion because he holds the largest bloc, no one is left out. If the owner of the control bloc must share the $11 premium with all of the existing shareholders, however, the deal collapses. The owner will not part with his bloc for less than a $10 premium. A sharing requirement would make the deal unprofitable to him, and the other investors would lose the prospective gain from

29. *See Responses of a Target's Management to Tender Offers*, *supra* note 6, at 1168-80 (observing that managers' defenses against tender offers, which sometimes enable target's shareholders to receive larger fraction of gains from a control change, reduce number of tender offers and effectiveness of tender offer process in monitoring managers).

the installation of better managers.[30]

Other value-increasing transactions would also be deterred by a sharing requirement. First, as we have noted above, sometimes a purchase of control is profitable to the purchaser only if he can prevent minority shareholders from sharing in the gains. Freezeouts of minority shareholders after a transfer of control perform precisely this function. Second, if the controlling shareholder in a going-private transaction or merger of a subsidiary into a parent corporation must underwrite the costs of future value-increasing transactions and thereby incur a proportionally greater risk of loss than the minority shareholders in the event expectations are not realized, the deal may become unprofitable to the controlling shareholder if he must share the gains with minority shareholders if all goes well. Thus, a sharing principle in these transactions leads to a reduction in total wealth as people desist from entering into otherwise profitable transactions.

There are other ways in which the gains from corporate control transactions may depend on unequal distribution. Because investors in the firm must cooperate to transfer control, sharing creates incentives to "free ride." In a tender offer, for example, shareholders must tender rather than hold their shares if the bid is to succeed; in a merger (other than a short-form merger), they must vote favorably rather than abstain. If gains must be shared equally, however, each shareholder may find it worthwhile not to cooperate in the transaction. To illustrate, suppose that all of the gains from a tender offer must be shared equally among the investors in the target corporation and that, if there is a follow-up merger, non-tendering shareholders cannot be eliminated for less than the tender offer price. When a prospective acquiror makes a bid, the investors recognize that the acquiror can profit only to the extent it causes the value of shares to rise. If the bidder is offering $50 per share, the reasoning runs, it cannot profit unless value eventually rises above $50. Under the legal rules assumed above, it may be rational for every shareholder to spurn the $50 offer and hope that enough other shareholders tender to make the offer succeed: If

30. The common law recognizes that unequal distribution of gains facilitates the transfer of assets to higher-valued uses. Someone who discovers a lode of ore need not share the knowledge (and the profits) with the farmer under whose land the ore lies but may, instead, send an agent to buy the farm for the going price of farmland. A sharing requirement would lead to less searching for ore and lower wealth for society. *See* Leitch Gold Mines v. Texas Gulf Sulfur, 1 Ont. 2d 469 (1969). *See also* Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178 (1817). *Cf.* Northeastern Tel. Co. v. AT&T, 651 F.2d 76, 88-91 (2d Cir. 1981) (a multi-product firm need not share joint costs of production among many products, because pricing all products at fully distributed cost would reduce allocative efficiency); Fischel, *supra* note 6, at 9-26 (analysis of how disclosure obligations of Williams Act decrease incentive of bidders to produce valuable information); Jovanovic, *Truthful Disclosure of Information*, 13 BELL J. ECON. 36 (1982); Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978); Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472 (1980).

there is a follow-up merger, the "fair" price cannot be less than $50 for the untendered shares. If there is no follow-up merger, the shareholder expects the price to exceed $50. Each shareholder, in other words, may attempt to take a free ride on the efforts of the bidder and other shareholders. To the extent free riding prevails, it reduces the chance that the beneficial transaction will go forward.[31]

A final reason why the gains from beneficial transactions may depend on unequal division is that sharing rules may lead to costly attempts to appropriate greater parts of the gains. The appropriation problem arises because most gain-sharing rules do not produce completely predictable results—it is difficult to determine the "fair" price. If all investors are entitled to a "fair" share of the bounty, each will find it advantageous to claim as much as possible and fight for his claim. He would spend as much as a dollar, on the margin, to claim another dollar of the benefits. It is possible for a substantial part of the gain to be frittered away, therefore, as claimants attempt to make the argument that they are entitled to more.[32] Fear for this eventuality may cause otherwise beneficial control transactions to fall through; in any event resources will be wasted in litigation or other skirmishings.

C. *Investors Prefer the Fiduciary Principle That Maximizes Aggregate Gains*

Do investors prefer a larger pie even if not everyone may have a larger slice in every case? We argue here that they do, for two reasons. First, their expected wealth is greatest under this interpretation of the fiduciary principle, and second, they may deal with any risk by holding diversified portfolios of investments.

Clearly, if control transactions produce gains, and if the gains depend on unequal allocation, then the expected wealth of the shareholders in the aggregate is maximized by a rule allowing unequal allocation. *All* share prices *ex ante* will be highest when the probability of a value-increasing transaction in the future is the greatest. Shareholders can realize this value at any time by selling their shares, or they can hold the shares and

31. *See* Grossman & Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42 (1980); *Responses of a Target's Management to Tender Offers, supra* note 6, at 1173-75 & n.33.

32. The same problem arises whenever there are profits to which several parties can stake—or create—plausible claims. *See, e.g.*, Hirshleifer & Riley, *The Analytics of Uncertainty and Information: An Expository Survey*, 17 J. ECON. LIT. 1375, 1389-91 (1979); Posner, *The Social Costs of Monopoly and Regulation*, 83 J. POL. ECON. 807 (1975); Spence, *Job Market Signalling*, 97 Q. J. ECON. 355 (1973). Markets usually devise antidotes for such rent-seeking expenditures. *See* Barzel, *Some Fallacies in the Interpretation of Information Costs*, 20 J. LAW & ECON. 291 (1977). A rule of corporation law allowing unequal division of gains in control transactions is one such response.

take the chance of gaining still more as a result of the unequal allocation of gains *ex post.*

This argument may seem to disregard the fact that many investors are risk averse—they prefer a sure $10, say, to a one in ten chance of receiving $100. On the surface, therefore, it seems that investors might benefit from equal or fair division of gains notwithstanding the loss of some gains as a result. This argument, however, ignores the lessons of modern portfolio theory. By investing in many firms simultaneously, risk averse investors can reduce the risk of losses without extinguishing profitable-but-risky transactions.[33]

There are two kinds of risk: systematic risk, which is common to all investments in the portfolio (e.g., risk that a change in the interest rate will affect the value of *all* equity interests), and unsystematic or diversifiable risk. Risk is diversifiable to the extent that an investor, by investing in a portfolio containing many separate securities, can insulate himself from the risk. Suppose, for example, that ten firms bid for a single license to operate a television station. After the FCC makes the award, the stock of one firm will be worth $100 per share, and the stock of the other nine firms will be worthless. Each investment, standing alone, is very risky. But a shareholder can purchase one share in each of the ten firms, and this portfolio of investments will be worth $100 with certainty.

It is difficult to find firms whose fortunes are so closely intertwined. Nonetheless, diversification is highly useful in reducing risk because even an imperfectly negative correlation between the risks of different firms will dampen the volatility of the portfolio as a whole. An investor holding a diversified portfolio of New York Stock Exchange firms would barely notice the wreck of the Penn Central—not only because Penn Central stock would be a small part of the portfolio but also because bad news for the Penn Central is good news for the Chesapeake and Ohio.

The risks involved in corporate control transactions are diversifiable. Corporate control transactions are pervasive. There are mergers, takeovers, freezeouts, tender offers, going-private transactions and related events in abundance. Indeed, there is a strongly negative correlation among the risks. An investor with a reasonably diversified portfolio would be on the winning side of some transactions and the losing side of others. For example, if shareholders of one corporation obtain little of the gain from a given merger, the shareholders of the other corporation obtain

33. There is a burgeoning literature on the theory of portfolio management. For a succinct and lucid description, see Langbein & Posner, *supra* note 14, at 77-83. More complete discussion of diversification may be found in J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 171-256 (1973); Langbein & Posner, *Market Funds and Trust-Investment Law*, 1976 AM. BAR FOUND. RESEARCH J. 1.

more. An investor holding a diversified portfolio with stock in both corporations is concerned with the total gain from the transaction, not with how the gain is allocated. Indeed, the investor with shares of both would see any expense in allocating the gain as pure loss. To the extent an unequal allocation raises the number and amount of gain transactions, therefore, investors with diversified portfolios would prefer to allow the unequal allocation to continue.

Diversification is available at remarkably low cost. In fact, it is less expensive to hold a diversified portfolio of investments than to hold an undiversified one, because diversification allows investors to avoid the expenses of investigating, picking, and trading stocks. Investors with little personal wealth can diversify by purchasing shares of mutual funds, which hold representative samples of stocks, mortgages, and many other investment vehicles.

The existence of diversification—not its employment—supports our argument for allowing the gains from corporate control transactions to be apportioned unequally. The availability of diversified investment portfolios means that investors who seek shelter from risk can find it, at low cost. Others may elect to take greater risks in pursuit of larger gains, just as they may elect to hold only one risky stock. Perhaps they will become fabulously wealthy, but if they do not they will have little claim that they were treated inequitably. Any attempt to set fair prices for corporate control transactions, in the name of protecting investors who choose not to diversify, penalizes other investors who eliminate risk through diversification, and in the process it reduces the number of value-increasing control transactions.

We have shown that the *ex post* inequality under Ventures 2 and 3, like the *ex post* inequality in a lottery, is not "unfair" if, *ex ante*, all investors have an equal chance to win and can eliminate risk through diversification. We now consider a potential objection to this reasoning. One might argue that this *ex ante* equality is absent in corporate control transactions because insiders systematically benefit at the expense of outsiders. Small shareholders, the argument runs, consistently will be frozen out, deprived of control premiums, and otherwise disadvantaged by insiders.

The argument loses its plausibility on close examination. One need not be wealthy to be on the "winning side" of a control transaction, and neither wealth nor status as an insider ensures being a winner. If corporation A purchases from corporation B a control block of shares in corporation C, a small (or outside) shareholder might participate in the gains by holding shares in any of the three firms. Similarly, if corporation D merges with corporation E (its long-held subsidiary) and freezes out the

minority shareholders of corporation E, these shareholders may participate in the gains by holding shares of corporation D. Small shareholders also may participate in the gains resulting from tender offers, going private transactions, allocation of a corporate opportunity to a parent rather than a subsidiary, and other types of corporate control transactions, simply by holding shares in the firm that produces the gains. There is no need for the small shareholder to identify these situations in advance. By holding a diversified portfolio containing the securities of many firms, the small shareholder can ensure that he will participate in the gains produced. All shareholders therefore have a chance of receiving the gains produced by corporate control transactions—if not an equal chance, at least enough of a chance to allow diversification of the risk. There remain cases in which it is impossible for an investor to share in gains or diversify away the risk by holding stock in both firms. This would be true, for example, where one of the firms is privately held. The shareholder can minimize this non-diversifiable risk, however, by not investing in firms that are controlled by an individual or a privately-held firm.

D. *Market Value as a Benchmark Under the Fiduciary Principle*

In the circumstances we have discussed, shareholders unanimously prefer legal rules under which the amount of gains is maximized, regardless of how the gains are distributed.[34] The ideal transaction is one like Venture 2 above, in which the gains are unequally distributed but all shareholders are at least as well off as they were before the transaction. Shareholders may also benefit from transactions in which the distribution of gains leaves some shareholders worse off than before the transaction—as in Venture 3—but there are probably few such transactions. We cannot imagine why gains would depend on making some investors worse off, and we have not encountered any example of such a transaction. In a world of costly information, investors will view Venture 2 transactions very differently from Venture 3 transactions, which would raise all-but-insuperable difficulties in determining whether the transaction produced gain. One can imagine instances, of which looting is a good example, in which the person acquiring control pays a premium to some investor(s) in order to obtain control and obliterate the remaining claims, recouping the premium without putting resources to a more productive use. A require-

34. The formal conditions for unanimous assent are set out in DeAngelo, *Competition and Unanimity*, 71 AM. ECON. REV. 18 (1981). Some of the formal conditions (e.g., spanning—a complete range of investments—and costless information) are not satisfied in real markets. Nonetheless, as Eugene Fama and Merton Miller have observed, unanimity is often fairly inferable even when the formal conditions cannot be fully satisfied. E. FAMA & M. MILLER, THE THEORY OF FINANCE 176-78 (1972).

ment that all investors receive at least the market value of their positions prior to the transactions would be a useful rule-of-thumb for separating beneficial deals from potentially harmful ones. If every investor receives at least what he had before, and some receive a premium, the transaction *must* produce gains.

The requirement that everyone receive at least the value of his investment under existing conditions serves much the same function as the rule against theft. A thief *might* be able to put stolen resources to a better use than his victim, but if so then he can pay for those resources. Thus, a requirement of payment increases the likelihood that transactions are value-increasing. Moreover, the proscription of theft also reduces the incentive of property owners to take elaborate precautions against theft. For example, investors might resort to costly monitoring devices to reduce the chance of confiscation of their shares. When all transactions are consensual, these precautions become unnecessary. By prohibiting confiscation, therefore, the fiduciary principle reduces wasteful expenditures while simultaneously reducing the number of socially inefficient corporate control transactions.[35]

III. The Fiduciary Principle in Operation

Investors' welfare is maximized by a legal rule that permits unequal division of gains from corporate control changes, subject to the constraint that no investor be made worse off by the transaction. In essence, this is a straightforward application of the Pareto principle of welfare economics. In this section of the article we examine the corporate law doctrines and scholarly commentaries that apply to several kinds of control transactions. We find that the cases and statutes by and large mirror the economic principles that we have discussed. We sketch the area of congruence and criticize the few cases (and many scholarly essays) that adopt a different approach.

A. *Sales of Control Blocs*

Sales of controlling blocs of shares provide a good example of transactions in which the movement of control is beneficial. The sale of control

35. A rule against confiscation would be created by contract even if it were not part of existing law. Whoever controlled a corporation would find it advantageous to insert an anti-confiscation provision in the articles of incorporation. If he did not, the firm could not expect to receive much for its shares. New shareholders would fear confiscation and would take (expensive) steps to protect their interest. Because no firm has monopoly power over investment opportunities, the expected costs of these precautions would reduce by an equal amount the price that purchasers would be willing to pay. Thus the sums that the controlling party receives would reflect the costs created by the risk of confiscation. *Cf.* Grossman & Hart, *Disclosure Law and Takeover Bids*, 35 J. FIN. 323 (1980)(analyzing consequences and incentive effects of disclosure regulations).

may lead to new offers, new plans, and new working arrangements with other firms that reduce agency costs and create other gains from new business relationships. The premium price received by the seller of the control bloc amounts to an unequal distribution of the gains. For the reasons we have discussed, however, this unequal distribution reduces the costs to purchasers of control, thereby increasing the number of beneficial control transfers, and increasing the incentive for inefficient controllers to relinquish their positions.

Numerous academic commentators, however, argue for some form of sharing requirement.[36] Adolph Berle, for example, has argued that control is a "corporate asset" requiring that premiums paid for control go into the corporate treasury.[37] Another well-known proposal is the "equal opportunity" rule advocated by Professors Jennings[38] and Andrews.[39] This proposal would entitle the minority shareholders to sell their shares on the same terms as the controlling shareholder.

Both of these proposed treatments of the control premium would stifle transfers of control. If the premium must be paid into the corporate treasury, people may not consent to the sale of a controlling bloc; if minority shareholders may sell on the same terms as the controlling shareholder, bidders may have to purchase more shares than necessary, possibly causing the transaction to become unprofitable. Minority shareholders would suffer under either rule, as the likelihood of improvements in the quality of management declined.

The mountain of academic commentary calling for some type of sharing requirement has not been influential, and the legal treatment of control sales is largely along the lines of wealth maximization. Sales at a premium are lawful, and the controlling shareholder generally has no duty to spread the bounty.[40] The rhetoric of the cases, however, is not uniform. In particular, the famous case of *Perlman* v. *Feldmann*[41] suggests that the gains may have to be shared in some circumstances.

In *Perlman* the president and chairman (Feldmann) of the board of

36. *See, e.g.*, A. BERLE & G. MEANS, *supra* note 4; Andrews, *supra* note 4; Bayne, *supra* note 4; Berle, *supra* note 4; Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259 (1967); Hazen, *supra* note 4; Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); Leech, *Transactions in Corporate Control*, 104 U. PA. L. REV 725 (1956); O'Neal, *Sale of a Controlling Corporate Interest: Bases of Possible Seller Liability*, 38 U. PITT. L. REV. 9 (1976).

37. A. BERLE & G. MEANS, *supra* note 4; Berle, *supra* note 4.

38. Jennings, *supra* note 4.

39. Andrews, *supra* note 4.

40. *See, e.g.*, cases cited in *supra* note 1, Claggett v. Hutchinson, 583 F.2d 1259 (4th Cir. 1978); Honigman v. Green Giant Co., 309 F.2d 667 (8th Cir. 1962), *cert. denied.* 372 U.S. 941 (1963); Barsy v. Verin, 508 F. Supp. 952 (N.D. Ill. 1981); Ritchie v. McGrath, 1 Kan. App. 2d 481, 571 P.2d 17 (1977).

41. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

Newport Steel, a producer of steel sheets, sold his controlling bloc of shares for $20 per share at a time when the market price was less than $12 per share. The purchasers, a syndicate organized as Wilport Company, consisted of end-users of steel from across the country who were interested in a secure source of supply during a period of shortage attributable to the Korean War.

Because of the war, steel producers were prohibited from raising the price of steel. The "Feldmann Plan", adopted by Newport and some other steel producers, effectively raised the price of steel to the market-clearing price. Under the plan, prospective purchasers provided Newport and other steel producers with interest-free advances in exchange for commitments for future production. Newport had used those advances to replace equipment in order to expand and compete more effectively with other steel producers.

The Second Circuit held in *Perlman* that the seller of the control bloc had a duty to share the control premium with other shareholders. The court's holding that Feldmann could not accept the premium paid by Wilport without violating his fiduciary duty was based on a belief that the steel shortage allowed Newport to finance needed expansion via the "Plan", and that the premium represented an attempt by Wilport to divert a corporate opportunity—to secure for itself the benefits resulting from the shortage. The court stated that "[o]nly if defendants had been able to negate completely any possibility of gain by Newport could they have prevailed."[42]

There are several problems with this treatment. Foremost is its assumption that the gain resulting from the "Plan" was not reflected in the price of Newport's stock. Newport stock was widely traded, and the existence of the Feldmann Plan was known to investors. The going price of Newport shares prior to the transaction therefore reflected the full value of Newport, including the value of advances under the Feldmann Plan. The Wilport syndicate paid some two-thirds more than the going price and thus could not profit from the deal unless (a) the sale of control resulted in an increase in the value of Newport, or (b) Wilport's control of Newport was the equivalent of looting. To see the implications of the latter possibility, consider the following simplified representation of the transaction. Newport has only 100 shares, and Wilport pays $20 for each of 37 shares. The market price of shares is $12, and hence the premium over the market price is $8 x 37 = $296. Wilport must extract more than $296 from Newport in order to gain from the deal; the extraction comes at the expense of the other 63 shares, which must drop approximately $4.75 each,

42. *Id.* at 177.

to $7.25.

Hence, the court's proposition that Wilport extracted a corporate opportunity from Newport—the functional equivalent of looting—has testable implications. Unless the price of Newport's outstanding shares plummeted, the Wilport syndicate could not be extracting enough to profit. In fact, however, the value of Newport's shares rose substantially after the transaction. Part of this increase may have been attributable to the rising market for steel companies at the time, but even holding this factor constant, Newport's shares appreciated in price.[43] The data refute the court's proposition that Wilport appropriated a corporate opportunity of Newport.

It seems, then, that the source of the premium in *Perlman* is the same as the source of the gains for the shares Wilport did not buy: Wilport installed a better group of managers and, in addition, furnished Newport with a more stable market for its products. The gains from these changes must have exceeded any loss from abolition of the Feldmann Plan.

Doubtless not all public shareholders have the same good fortune as those who held Newport Steel. Looting is a profitable transaction under some circumstances. Existing holders of control, no less than prospective purchasers, however, have an incentive to put their hands in the til, and a proposal to ban sales of control at a premium as an antidote to looting is like a proposal to ban investments in common stocks as an antidote to bankruptcy.

If it were feasible to detect looters in advance, it might make sense to put the sellers of control blocs under a duty not to allow shares to pass to the knaves—certainly the sellers of control can detect knavery at a lower cost than the public shareholders who are not parties to the transaction. Indeed, some cases have held that a seller of a control bloc can be liable

43. Charles Cope has computed changes in the price of Newport shares using the market model, well developed in the finance literature, under which the rate of return on a firm's shares is a function of the market rate of return, the volatility of the firm's price in the past, a constant, and a residual component that represents the consequences of unanticipated events. Increases in this residual reflect good news for the firm. Cope found a significant positive residual for Newport in the month of the sale to Wilport. *See* Cope, Is the Control Premium Really a Corporate Asset? (April 1981) (unpublished paper on file with *Yale Law Journal*).

The raw price data are no less telling. The $12 price to which the Perlman court referred was the highest price at which shares changed hands before the sale of control. The average monthly bid prices for Newport stock during 1950 were:

July: 6 ¾
August: 8 ½
September: 10 ⅞
October: 12 ½
November: 12 ⅜
December: 12

The sale to the Wilport syndicate took place on August 31, 1950. This pattern of prices certainly does not suggest that the 63% interest excluded from the premium perceived any damage to Newport.

for failing to investigate adequately a prospective purchaser of control.[44] The wisdom of such holdings is suspect, however, because it is difficult if not impossible to detect looters as they approach. A looter takes the money and runs, and looting is by nature a one-time transaction. Once looters have absconded with the assets of one firm, they acquire a reputation that prevents them from repeating this act. But when they first obtain control, they may appear quite innocuous. Any requirement that owners of control blocs investigate buyers and not sell to suspected looters is equivalent to a program of preventive detention for people who have never robbed banks but have acquisitive personalities.

Although sellers could spend substantial sums investigating buyers and investors still more in litigating about the quality of investigation, and the result of some investigations would be a refusal to sell, almost all of these refusals would be false positives. That is, they would be refusals that reduced the gains available from transferring control. Sometimes the best way to manage a firm is to break it up—to sell off unprofitable operations and reorganize the rest. Some managers are especially skilled in reorganizing or liquidating seriously ailing firms. Yet it seems likely that the suspicion of looting would fall most heavily on such people, for it is hard to say in advance whether a radical restructuring of a firm would be good or bad for the shareholders.[45] A legal rule that has its greatest bite when a firm is approached by a buyer with a proposal for radical (and potentially highly beneficial) surgery is unlikely to increase the value of investments.

We do not suggest that the legal system should disregard looting, but we think it likely that the best remedies are based on deterrence rather than prior scrutiny. Looters, when caught, could be heavily fined or imprisoned, taking into account the frequency with which looting escapes detection. Penalties for looting could be made high enough to be effective. The costs of deterrence are probably much lower than the costs of dealing with looting through a system of prior scrutiny that would scotch many valuable control shifts as a byproduct.

44. *E.g.*, Insuranshares Corp. v. Northern Financial Corp., 35 F. Supp. 22 (E.D. Pa. 1941); Gerdes v. Reynolds, 28 N.Y.S. 2d 622 (1941).

45. *See, e.g.*, Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (1964), in which the family controlling Holland Furnace Co. refused to sell to Maremont, arguing that Maremont had an unsavory reputation as a liquidator of other firms. Holland bought Maremont's shares at a premium price, to the dismay of most of Holland's shareholders. After fending off Maremont's bid for control, Holland steadily went downhill. Its woes are spelled out in W. CARY & M. EISENBERG, CORPORATIONS 677-78 (5th ed. 1980). The management of a corporation quite frequently resists a takeover bid on the ground that the prospective buyer would reorganize or liquidate the firm — as if the firm had a "right to life" at the expense of the investors.

B. *Changes in Control Structure*

A variety of practices may affect the way in which investments are pooled to obtain or hold control. Voting trusts, holding companies, and many other devices allocate control as effectively as the sale of control blocs. These control transactions have the same potential benefits as sales of controlling stock, and accordingly they should be evaluated the same way. By and large, the corporate law does so. Shareholders may form voting trusts and holding companies without any obligation to share the gains; the only significant limitation, usually imposed by statute, is that voting trusts lapse unless periodically renewed. This provision, like the rule against perpetuities, prevents the combination of a dead hand and a current deadlock from diverting corporate assets into wasteful endeavors.

Again, however, there is an exception to the general rule. In *Jones v. H.F. Ahmanson & Co.*,[46] the owners of 85 percent of the stock of United Savings and Loan Association, a closely held corporation, organized a Delaware holding company. In exchange for 250 shares of the holding company, they transferred all of their shares in the savings and loan along with several other businesses that they owned. The holding company then went public, issuing both stock and debentures. The former controlling shareholders of the savings and loan thus held stock in a highly leveraged holding company, and the position of the minority shareholders of United was unaffected. In the next few years, the profits of the savings and loan went up, while the prices of the shares of the leveraged holding company went up even faster.

The minority shareholders in the savings and loan—acting *after* the rise in the holding company's price—demanded admission to the venture. The controlling shareholders offered them the equivalent of $2,400 per United share, while the value of United shares placed in the holding company at the outset had risen to the equivalent of $8,800. The disgruntled minority shareholders brought suit. The Supreme Court of California, citing *Perlman* and referring to the gain sharing proposals of Berle and Jennings, held that "the controlling shareholders may not use their power to control the corporation for the purpose of promising a marketing scheme that benefits themselves alone to the detriment of the minority."[47] With respect to the appropriate relief, the court insisted that "the minority shareholders be placed in a position at least as favorable as that the majority created for themselves."[48] The court permitted minority shareholders to elect between the appraised value of their shares at the time of the exchange and the

46. 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).
47. 1 Cal. 3d at 115, 460 P.2d at 476, 81 Cal. Rptr. at 604.
48. 1 Cal. 3d at 118, 460 P.2d at 478, 81 Cal. Rptr. at 606.

economic value of the holding company stock that they would have had at the time of the action.

At first blush, the case appears to present a classic usurpation of a corporate opportunity—the ability to go public—by the controlling shareholder. Because the majority could have included the minority without jeopardizing the transaction, there was no need to exclude the minority.

But this interpretation of *Ahmanson* is unconvincing. The controlling shareholders in *Ahmanson* wished to consolidate their 85% stock ownership of the savings and loan with several other businesses in one corporation. Such a consolidation could produce efficiencies, from centralized management or otherwise. Participation by the minority in the holding company would decrease the incentive of the controlling shareholders to create the gains by incurring the costs of consolidating the related businesses.[49] The California Supreme Court failed to perceive this difficulty with its sharing requirement.

More fundamentally, the court did not grasp the significance of the minority shareholders' delay in bringing suit. The costs and risks of creating the holding company were borne by the controlling shareholders, and their expected reward was the premium resulting from the increased value of the transformed asset. The minority shareholders bore none of the costs, and allowing them to "free ride" on the benefits would reduce the number of value-increasing transactions in the future. Moreover, a substantial part of the increase in the price of the holding company's shares was attributable to its leverage. The minority shareholders carefully waited to see whether United's earnings rose before demanding to participate in the holding company; if United's earnings had fallen, the minority doubtless would have held onto their United shares while those who participated in the holding company were wiped out in favor of the debenture holders. If generally accepted, the court's *ex post* view of fairness, giving the minority a right to participate in the gains without taking the risk of loss, would go a long way toward discouraging beneficial control transactions.

49. In contrast to the California Supreme Court, the lower court held that no fiduciary duty was breached. The concurring opinion of Judge Moss cogently articulated the danger of equating fiduciary duty with a sharing requirement under the facts of *Ahmanson*:

> It is difficult to assess the effect of a rule of fiduciary duty upon the incentives that operate in our entrepreneurial system of capital formation and development . . . The consolidation of several related businesses under a single top management by means of a holding company in many cases produces benefits for the constituent companies and their minority shareholders as well as for the persons who control the holding company . . . The incentive of financiers to take the risks involved in the formation and financing of a holding company and the acquisition of control of potential subsidiary corporations might well be diminished by a rule that requires them in the absence of any showing of harm to the subsidiary or to its shareholders to share the benefits of their enterprise with the minority shareholders of each subsidiary corporation.

Jones v. H.F. Ahmanson & Co., 76 Cal. Rptr. 293, 303 (2d Dist. Ct. App. 1969).

C. *Sale of Office*

Managers could transfer control by selling their offices. A sale of office is unlawful in every state, however, in the absence of contractual permission.[50]

This application of the fiduciary principle is usually explained as resting on the belief that

> [a] fiduciary endeavoring to influence the selection of a successor must do so with an eye single to the best interests of the beneficiaries. Experience has taught that, no matter how high-minded a particular fiduciary may be, the only certain way to insure full compliance with that duty is to eliminate any possibility of personal gain.[51]

Judge Friendly's sweeping declaration about the lessons of hard experience has more confidence than confirmation behind it. A principle that personal gains may not influence the transfer of control would proscribe any sale of control blocs of shares, yet the law universally allows such sales. It is more accurate to say that the fiduciary principle bans the sale of office, while allowing the sale of control, because control sales have built-in guarantees of the buyer's good intentions but office sales do not. One who buys a controlling bloc of shares cannot hurt the corporation without hurting himself too. Even a looter cannot gain if he holds a substantial bloc of shares. Those shares would diminish in value as a result of looting and would be forfeit when the offense was revealed. Substantial share ownership acts as a bond for honest conduct. One who buys an office may obtain control too cheaply.[52]

The law appears to be consistent with this characterization of the rationale for the rule against selling offices. Managers may agree, as part of the sale of a controlling block of shares, to turn over their offices.[53] In such cases part of the premium reflects the value of the office. Managers also may accept payment for recommending that the shareholders approve a

50. In general, an agent may not sell his position of authority. *Cf.* RESTATEMENT (SECOND) OF AGENCY § 18 (1958) (restriction on ability of agent to delegate his authority).

51. Rosenfeld v. Black, 445 F.2d 1337, 1342 (2d Cir. 1971) (Friendly, C.J.), *cert. denied*, 409 U.S. 802 (1972).

52. Offices presumably would sell for their value to the incumbent, including any value attributable to the incumbent's ability to extract profits and perquisites. It is possible to argue that because the incumbent would insist on full payment for value, only a buyer who could put the firm's assets to better use would be able to meet the incumbent's demands. *See* Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960). On this view there is no reason to prohibit the sale of office. But this would be an accurate assessment only if managers now could fully extract the value of their positions. As we emphasized in the text, they cannot: markets for control and managerial services constrain them.

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

merger, when the payment is disclosed and the managers simultaneously sell their own shares.[54] The sale of office violates the fiduciary principle only when the office is sold by itself.[55]

D. *Freezeout Transactions*

Freezeouts of minority shareholders serve a variety of purposes. The freezeout of minority shareholders soon after a transfer in control allows the bidder to capture a disproportionate share of the gains from the acquisition; the elimination of minority shareholders in a subsidiary corporation may facilitate various economies of operation and eliminate conflict of interest problems; going private directly reduces agency costs and the costs attributable to public ownership.

It used to be very difficult to force a shareholder to disinvest involuntarily, because courts viewed share ownership as a form of vested right that could not be taken without consent. Because this rule of unanimity created intolerable holdout problems and frustrated many efficient corporate transactions, it was ultimately jettisoned in favor of a rule that allowed the majority to freeze out minority shareholders.[56] Under the modern view, the shareholders' only entitlement is to demand an appraisal of their shares, a remedy that does not give dissenting shareholders any element of value attributable to the transaction from which they dissent.[57]

Within the last few years, however, freezeout transactions have come under greater scrutiny by courts and increasing attack by scholars. It has been suggested that freezeouts are unfair to the shareholders and lack a business purpose. Both suggestions find support in the Delaware Supreme Court's recent decision in *Singer v. Magnavox Co.*[58]

Development Corp. made a tender offer for the common stock of Magnavox Co. The initial price was $9 per share, and 84.1 percent of the stock was tendered. Development then merged Magnavox with T.M.C. Development, a wholly-owned subsidiary of Development, paying $9 for every outstanding share. The result of this two-step process was that every original shareholder of Magnavox received $9 whether or not he tendered, and Development obtained all of the common stock. Development told the

54. Nelson v. Gammon, 647 F.2d 710 (6th Cir. 1981).

55. Similarly, shareholders may sell their votes when the sale is coupled with an "interest" (e.g., a pledge) in stock, but they may not sell their votes if no interest is conveyed. Votes would go too cheaply if they could be bought, because votes are all but worthless to individual shareholders even though valuable in the aggregate. *See Responses of a Target's Management to Tender Offers, supra* note 6, at 1171.

56. *See* Carney, *supra* note 20, at 77-97; Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624 (1981).

57. *See, e.g.*, DEL. CODE ANN., tit. 8, § 262(h) (1981); *infra* p. 731.

58. 380 A.2d 969 (Del. 1977).

non-tendering shareholders that they had the right to appraisal under Delaware law. Some shareholders, however, spurned the appraisal and sought an injunction, contending that the merger was unfair and did not serve a valid business purpose because it allowed Development to keep "a disproportionate amount of the gain [Development] anticipated would be recognized from consummation of the merger."[59]

Development argued that the shareholders' only right was to the value of the existing investment, and that this right was fully protected by the appraisal remedy. The court, however, stated that shareholders had a legally protected right in the form of their investment as well as in its value. Thus the court held that a trial was necessary on the questions whether there was a business purpose for the merger, and whether $9 was a fair price. Because the directors of Magnavox, the nominees of Development, owed fiduciary duties to the shareholders, the price paid in the freezeout must satisfy "entire fairness"[60] as well as the appraisal standard.

We find it hard to follow the court's reasoning. Invocation of the fiduciary principle does not answer the question whether shareholders would contract for (and fiduciaries thus must provide) some sharing of gains, and the court begged this central question in *Singer*. Moreover, after begging the question, the court left "entire fairness" undefined—the term has no readily apparent meaning, and the court gave it none. Perhaps the price must exceed $9 to be entirely fair, but the court did not say so; indeed, it did not foreclose the possibility that $8 or even $5 would have been entirely fair. It left these matters to the resolution of the chancellor.

Singer is an unsatisfactory case, which may explain why courts in other states have been hesitant to embrace its holding[61] and why the case has a checkered career even within Delaware. Although at least one of the Delaware Supreme Court's decisions suggests that *Singer* requires gain-sharing,[62] the court has held that a merger may be approved when all of the gain accrues to one firm;[63] that the appraisal standard continues to exclude

59. *Id.* at 978.

60. *Id.* at 980.

61. *See, e.g.*, Yanow v. Teal Indus., 178 Conn. 262, 422 A.2d 311 (1979) (rejecting Singer outright); Deutsch v. Blue Chip Stamps, 116 Cal. App. 3d 97, 172 Cal. Rptr. 21 (2d Dist. 1981) (apparently rejecting *Singer*); Gabhart v. Gabhart, 370 N.E.2d 345 (Ind. 1977) (adopting modified version of *Singer*; holding that courts must inquire into business purpose but may not inquire into entire fairness). *But see* Klurfeld v. Equity Enter., 79 App. Div. 2d 124, 436 N.Y.S. 2d 303 (2d Dept. 1981) (apparently following *Singer*). For a critique of *Singer* as well as other recent developments in Delaware corporation law, see Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware Corporation Law*, 76 NW. U.L. REV. 913 (1982).

62. Lynch v. Vickers Energy Corp., 429 A.2d 497 (Del. 1981) (applying remedy for perceived fraudulent statements at time of merger; upper bound of remedy is full value of shares to the acquiring corporation); *see also* Harman v. Masoneilan Int'l, Inc., 442 A.2d 487 (Del. 1982) (favorably citing *Lynch* in merger case; holding that majority shareholders have duty not to misrepresent facts in obtaining approval).

63. Tanzer v. International Gen. Indus., 379 A.2d 1121 (Del. 1977).

elements of value attributable to the transaction that provokes the dissent;[64] that a case commenced under the banner of *Singer* may be settled under the usual appraisal standards;[65] and that a shareholder who invokes the appraisal remedy may not also challenge a merger as "unfair."[66] This series of cases led Vice Chancellor Brown to declare in *Weinberger v. UOP, Inc.*[67] that *Singer* probably did not change the law at all.[68]

Singer's business purpose test also appears to be vacuous. In *Tanzer v. International General Industries*,[69] the court held that a business purpose is present if the transaction is beneficial to one of the firms. Thus, the party implementing the freezeout can assert that gains to itself are the basis for the transaction. Business purpose is absent only when *both* parties lose on the deal, a situation that cannot be common. This test actually is more lax than our fiduciary principle, which requires that no shareholder be made worse off by the deal, and thereby ensures that the transaction produces net gains.

Cases applying the *Singer* business purpose test illustrate the relationship between the maximization of anticipated gain and our fiduciary principle. One case held, for example, that a firm could freeze out an obnoxious shareholder just because he was a troublemaker; the gains from freeing the time of managers to run the firm rather than to deal with the troublemaker supplied the business purpose.[70]

64. Bell v. Kirby Lumber Corp., 413 A.2d 137 (Del. 1980) (pure going-private transaction).

65. Fins v. Pearlman, 424 A.2d 305 (Del. 1980).

66. Dofflemyer v. W.F. Hall Printing Co., 432 A.2d 1198 (Del. 1981).

67. 426 A.2d 1333 (Del. Ch. 1981), *aff'd*, No. 58, 1981 (Del. Feb. 9, 1982).

68. *Id.* at 1342-43. Vice Chancellor Brown's decision suggests that *Singer* simply restates the fiduciary principle as we have described it, with a twist. The acquiring corporation may not offer a pittance and leave the shareholders with the burden of activating the appraisal remedy. It must, instead, offer as an initial matter whatever price it concludes would be established in appraisal. A requirement of up-front payment shortens the delay that often attends the appraisal process, and the shift in the burden relieves individual shareholders, whose interests may be small, of much of the expense and uncertainty in seeking appraisal. *Singer*, as Vice Chancellor Brown has construed it, overcomes the defects often perceived in the appraisal process, *see* M. EISENBERG, *supra* note 4, at 69-84; *Corporate Fair Shares*, *supra* note 4, at 304-07; Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223 (1962), but does not require gain sharing. So understood, the "entire fairness" standard of *Singer* can be reconciled with the fiduciary principle of maximizing shareholders' expected wealth. A preferable method for reducing the expense and uncertainty of the appraisal remedy, however, would be simply to modify certain rules in appraisal proceedings. *See infra* note 96. A modified appraisal rule would give minority shareholders who believed they did not receive the value of their investment an effective remedy but would not grant them the ability to frustrate or delay beneficial corporate control transactions by bringing injunctive suits.

The opinion of the Supreme Court of Delaware in *Weinberger* sheds little light on the matter. The court recited some of the facts and concluded that the "record justifies the vice chancellor's conclusion that the cash-out price was fair" (slip op. at 4). The court did not discuss the legal standards informing the fairness decision. Justice Duffy, in dissent, would have characterized the transaction as a liquidation subject to gain-sharing, but he did not address other questions.

69. 379 A.2d 1121 (1977).

70. Coleman v. Taub, 638 F.2d 628 (3d Cir. 1981) (applying Delaware law).

In *Dower v. Mosser Industries*[71] the Third Circuit found a business purpose when minority shareholders were eliminated in order to increase the profits of a new venture. Mosser was contemplating an expansion program when it discovered that it could obtain the necessary financing only if Ecolaire, which owned 93% of Mosser's stock, guaranteed Mosser's obligations. Ecolaire was unwilling to take 100% of the risk in exchange for 93% of the gain, and it decided to freeze out Mosser's minority shareholders. The court found that there was a legitimate business purpose for the freezeout because Ecolaire's desire to capture all of the gain was itself legitimate—the fiduciary's desire to avoid sharing supplied the reason for the transaction. The court clearly adopted the *ex ante* wealth maximization approach advocated in this paper.[72]

When viewed in its entirety, therefore, the law has not imposed any general requirement of gain-sharing in freezeout transactions.[73] The fiduciary principle of maximizing anticipated wealth allows the dominant stockholder to set the terms of a freezeout, so long as all investors receive at least the market value of their interests. Moreover, the cases have not drawn a distinction in this respect between different types of freezeout transactions.

Nonetheless, numerous commentators have proposed gain-sharing rules for freezeouts. William Carney, for example, maintains that compensation of the minority at market value is inadequate because the minority may value its shares more highly than either the majority or the market.[74] If the minority values its shares at $30 even though the market price is $10, the argument runs, they may lose more than the majority gains, and the transaction may decrease value. This argument is flawed, however, because it assumes that different shareholders place different values on the

71. 648 F.2d 183, 189 (3d Cir. 1981) (applying Pennsylvania law, but decided on assumption that Delaware law was useful guide).

72.

> Ecolaire, which was risking its capital, wanted to reap all of the benefits of its investment. . . .
>
> The heart of plaintiff's . . . argument is that the elimination of the minority through a merger is inherently unfair. But the fiduciary duty owed by the majority . . . does not prevent a cash out under Pennsylvania law . . . .
>
> The defendants in this case established that the price offered for the stock of the minority holders was the same as that given in a recent arms length transaction. They also showed that the timing of the merger was related to the planned expansion of Mosser. The plaintiffs allege that because the proposal has not been carried out, there was fundamental unfairness in the defendants' assertion that the financing needs of Mosser were a valid business reason. However, the plaintiffs did not show that at the time of the merger there was not intention to proceed with the project or that it will not be done in the future. Their argument therefore is not persuasive.

648 F.2d at 189-90. The court's approach is entirely the language of *ex ante* wealth maximization.

73. *But see* Mills v. Electric Auto-Lite Co., 552 F.2d 1239 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977) (attempt to implement a gain-sharing rule); *infra* note 80 (discussing *Mills*).

74. Carney, *supra* note 20, at 112-18.

same investment. If this were the case, the minority shareholders (or others who placed the $30 value on the shares) would purchase the shares held by the remaining investors. Investors can make mutually beneficial trades until those holding any given firm's stock have reasonably homogenous expectations about its performance, and there is little risk that the pessimistic investors in a firm can use freezeout transactions to exploit optimists.[75]

Victor Brudney and Marvin Chirelstein suggest special sharing rules for two-step acquisitions. Under their proposal, a follow-up merger is fair if (a) the bidder's intent to merge is stated at the time of the offer, and (b) the bidder pays the same price for the shares acquired by merger as it paid for those tendered.[76] These conditions, they argue, ensure that gains are fairly apportioned and that the tender process acts as a surrogate for an equitable vote on the terms of the acquisition.

Although the tender price has all the earmarks of arms-length bargaining, and the premium over market price shows that the tender offeror believes he can put the acquired assets to better use, it does not follow that he should pay the same price for shares acquired later. By ameliorating the free-rider problem, a two-price offer facilitates transfers of control to those who can manage assets more effectively.[77] The fiduciary principle of maximizing shareholders' expected wealth therefore does not interdict two-price offers. What Brudney and Chirelstein describe as "deception and 'whipsaw' "[78] under a two-price offer is actually nothing more than compensation to those who facilitate the movement of control at some risk.[79] Thus, our fiduciary principle requires no more than that the price

75. The data suggest that investors have uniform expectations. *See* Scholes, *The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179 (1982). *See also* Miller & Modigliani, *Dividend Policy, Growth and the Valuation of Shares*, 34 J. BUS. 411 (1961).

76. *Corporate Freezeouts, supra* note 4, at 1359-65.

77. *See supra* pp. 708-11. DuPont's recent bid for Conoco is an example of how a two-price offer can be used to address the free-rider problem. DuPont offered $98 per share in cash for 51 percent of the shares and a stock package worth $77 for any untendered shares (or tendered shares in excess of 51 percent). The two-price structure of the offer induced investors to tender but harmed no one because everyone had an opportunity to accept the cash price. DuPont's two-price offer was announced explicitly, but the nature of the announcement should not matter. To the extent the fiduciary principle permits unequal allocation of gains, *every* offer is a two-price offer: one explicit premium price, and a second price as low as the governing rule permits. (The bidder may, of course, elect to pay more; if that were its intention, it could so announce.) *See* Radol v. Thomas, 14 SEC. REG. & L. REP. (BNA) 789 (S.D. Ohio 1982).

78. *Id.* at 1361.

79. Brudney and Chirelstein may have assumed that some shareholders subjectively value the stock more than the tender price and fear that, if they do not tender at once, they will fare even worse in a subsequent freezeout. The assertion that shareholders have multiple subjective values for stock, however, is doubtful. *See supra* note 75. It is far more likely that those with high estimates of a firm's value will buy the stock of other investors than that the pessimists will bid for the stock held by optimists.

for untendered shares be at least as high as the market price of the target's stock before news of the tender offer becomes available.

Brudney and Chirelstein also suggest that "fairness" requires any gains from the merger of a parent corporation and a subsidiary to be calculated and shared among all investors according to the pre-merger ratio of the equity investments in the two firms. For the reasons we have covered above, this proposal also deters value-increasing transactions. Moreover, the suggestion that sharing promotes "fairness" is dubious.[80] How does the controlling shareholder know what the gains will be in order to apportion them fairly? How can "synergy gains"—the subject of the Brudney and Chirelstein sharing proposals—be separated from the ordinary return on the time, effort and resources that the controlling firm put into accomplishing the merger, or from the opportunity costs of the controlling shareholder? Must minority shareholders then give back the premium recieved, or more? What if the merger results in a loss rather than a gain? Why does fairness require sharing in proportion to equity value rather than in proportion to total asset value or some other standard? There is simply no acceptable standard of fairness, which is one more reason why the cases and our fiduciary principle do not require sharing.[81]

With regard to going-private transactions,[82] some commentators have

80. The Seventh Circuit in Mills v. Electric Auto-Lite Co., 552 F.2d 1239, 1248 (7th Cir.), *cert. denied*, 434 U.S. 922 (1977), attempted to implement the Brudney & Chirelstein gain-sharing proposal in the context of a parent-subsidiary merger. For a critique of *Mills*, and more generally of the practical problems with the Brudney & Chirelstein proposal, see Lorne, *A Reappraisal of Fair Shares in Controlled Mergers*, 126 U. PA. L. REV. 955, 964 n.29, 970-87 (1978). *Mills* has attracted no following. Delaware has rejected *Mills* explicitly, Tanzer v. International Gen. Indus., 402 A.2d 382, 394 (Del. Ch. 1979), and the Supreme Court has interpreted federal standards of fairness under the Investment Company Act to allow unequal allocation in controlled mergers. E.I. Du Pont de Nemours & Co. v. Collins, 432 U.S. 46 (1977).

81. Because there is no acceptable standard of fairness, the gain-sharing rule advocated by many commentators would resurrect some of the costs of the old rule requiring unanimous consent among shareholders for major corporate changes. That rule was abandoned because it gave every shareholder a veto that he could use to attempt to extract a larger part of the gains. These efforts were very costly. Although it might be possible to obtain everyone's consent through extended negotiations, the costs of these negotiations are wasteful. *See* D. MUELLER, PUBLIC CHOICE 19-27 (1979), for an excellent description of the problems created by unanimity rules. Firms incorporated in states that did not require unanimous consent accordingly prospered relative to others. There is little reason to suppose that the costs of negotiating and litigating a "fair" sharing of gains are significantly less than the costs of obtaining unanimous consent to major corporate changes. But no matter how the costs compare, any expenditures that do no more than reshuffle the gains from an existing transaction are wasteful. The prospect of such expenditures will cause some otherwise beneficial control transactions to fall through. The prospective acquirer of control will be concerned both about the expenditures involved in defending its price as fair and about the chance that a court will order it to pay more—perhaps so much more that the total payments exceed the available gains.

82. We do not discuss at length the argument that going-private transactions or other freezeouts decrease shareholders' wealth by imposing a taxable transaction. In many situations—for example, a freezeout at a price below the price at which the shares were originally purchased—this will not be the case. Moreover, the shareholder has no absolute right to control the timing of taxable transactions. A shareholder may be the subject of a taxable transaction in a liquidation or exchange offer even if he objects to the transaction.

taken the extreme position of advocating a flat prohibition. One argument, heard from the SEC and other sources, is that the freezeout price is unfair, even though above market, when it is below the price at which the shares were sold to the public.[83] The implicit assumption is that insiders somehow bilked the public into paying too much—or perhaps have confused the market so that the current price is too low—and should not be permitted to profit by their chicanery. Those who make that argument both underestimate the efficiency of the stock market and misconceive the importance of past stock prices. In an efficient capital market, the full informational value of prior prices is incorporated into today's price, and the fact that the firm's price was once high does not indicate that it will rise again.[84] A freezeout price above the current market price is no less beneficial to shareholders because the price was once higher, and the person paying the above-market price cannot hope to profit unless the transaction is value-increasing.[85]

Another argument against going-private transactions, advanced by Brudney and Chirelstein, is that "[t]he costs of monitoring management's conduct are incurred for the *benefit* of the public stockholders, and it hardly rests with the fiduciary to cite the saving of those costs as a reason for terminating the beneficiaries' interest without their consent."[86] This argument confuses monitoring costs with the benefit that monitoring produces. Monitoring may be beneficial on balance, but this does not mean that the same or greater economic benefit cannot be obtained at lower expense by going private.[87] The firm may go private, realize the savings,

83. *Corporate Freezeouts, supra* note 4, at 1366; Toms, *Compensating Shareholders Frozen Out in Two-Step Mergers*, 78 COLUM. L. REV. 548, 554 n.18, 567-68 (1968); Note, *Going Private*, 84 YALE L. J. 903, 931 (1975). The SEC has embodied this approach in Rule 13e-3, 17 C.F.R. §§ 240.13e-3, 240.13e-100 (1981), which requires that a firm about to go private disclose information concerning the transaction and state an opinion about the transaction's fairness. Rule 13e-3 thus requires either a statement that the transaction is unfair (which will lead to an injunction under *Singer*) or a statement that the transaction is fair, which can be challenged in federal court as a material and untrue statement. The damned-if-you-do-and-damned-if-you-don't quality of the Rule makes it an obstacle to the achievement of shareholders' welfare. See Note, *Regulating Going Private Transactions: SEC Rule 13e-3*, 80 COLUM. L. REV. 782 (1980), for a compelling argument that the Rule is not authorized by statute.

84. For a brief discussion of the efficiency of markets, see *Responses of a Target's Management to Tender Offers, supra* note 6, at 1165-68.

85. It might be argued that insiders may be able to pay more than the market price and nevertheless profit even though the transaction is not value-increasing. If insiders could sell to the market at a high price, mismanage the firm to depress the price, freeze out the public shareholders at a low price not reflecting the firm's future profitability, and then end the mismanagement, insiders might profit. The flaw in this argument is that it assumes that insiders can trick the market. Other investors, either before the attempt to go private or when the going-private transaction itself leaks information to the market, will analyze what the firm's future prospects are under improved management. If insiders attempt to go private at a price less than the firm's future prospects indicates, the firm in all likelihood will be the subject of a higher bid. *See infra* note 92.

86. *Corporate Freezeouts, supra* note 4, at 1366.

87. Presumably Brudney and Chirelstein would not outlaw close corporations. But the same con-

and share them with the former public investors.[88]

Brudney and Chirelstein further argue that going private should be prohibited because such transactions create an unacceptably high chance that public stockholders will be cheated.[89] They claim that the fiduciary principle should be interpreted "as *not* permitting insiders unilaterally to condemn the stock of public investors . . . no matter how high the condemnation price."[90] In other words, Brudney and Chirelstein apparently argue that the interest of shareholders in receiving more money is irrelevant, and that other interests are more important. Although the argument appears to be implausible on its face,[91] it is difficult to evaluate because they do not say what other interests are involved, or how important these might be. They offer no cogent reason why public shareholders should be consigned to hold their certificates when they can profit as a result of a value-increasing going private transaction.

Perhaps the hostility to going-private transactions is based on the fear that the controlling shareholder is exploiting inside information. If a firm makes a valuable mineral discovery, for example, and this information is not yet reflected in the price of the firm's shares, a controlling shareholder might be able to reap a considerable gain by freezing out the minority, even though the value of the firm is not increased. But this possibility should not serve as a justification for banning going-private transactions. First, its likelihood is probably exaggerated.[92] Second, the possibility of insiders profiting is a well-known risk for which investors can demand

siderations that explain a firm's decision not to go public also may explain a decision in other circumstances to go private—the costs of public ownership outweigh the benefits.

88. Moreover, as we argue above, the sharing can be done prospectively—the chance of obtaining these gains will be reflected in the price of shares. It is not necessary to spread the gain explicitly when the firm actually goes private.

89. *Corporate Freezeouts*, *supra* note 4, at 1368.

90. *Id.* at 1367.

91. For a powerful critique of the Brudney and Chirelstein analysis of going-private transactions, *see* Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183 (1979).

92. In the famous case of Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947), for example, minority shareholders alleged that the controlling shareholder unlawfully attempted a freezeout transaction without disclosing that the value of tobacco, the firm's principal asset, had tripled. The court held that the planned transaction constituted a breach of fiduciary duty. In fact, however, it is very unlikely that the increase in the price of tobacco, a commodity with a readily ascertainable price, was really inside information not reflected in the firm's stock price. *Zahn* makes sense only if the shareholders were unaware of the quantity or kind of tobacco held by the firm, which would be known to insiders, and then only if the ignorance affected their decision concerning conversion between classes of shares. Perhaps they were ignorant, but the court did not discuss the problem.

The going-private transaction itself may leak information to the market and thereby decrease the risk of abuse of inside information. In that case outsiders may be expected to produce a higher bid and prevent the insiders from buying the firm too cheaply. This happened recently when a syndicate made a bid of $25 per share for Fuqua Industries, exceeding the management's going-private offer of $20. *See* WALL ST. J., Aug. 18, 1981, at 4, col. 2.

compensation.[93] Finally, there are specific legal rules that prohibit insider trading.[94] Banning going-private transactions because of the risk of exploitation of inside information would be as irrational as banning sales of control to prevent looting—the solution is far worse than the problem.

E. *The Appraisal Remedy*

Statutes and cases routinely require certain minimum payments to the investors that are affected by a corporate control transaction. These minimum payments, codified in most states by the appraisal statute, require that shareholders receive the equivalent of what they give up but do not require sharing of the gain from the change in control. The Delaware statute is the most explicit, providing that the court "shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation" of the event giving rise to appraisal rights.[95]

The appraisal standard reflects the economic principles we have discussed above.[96] The fiduciary principle provides that gains need not be shared as long as every investor receives at least what he had before. As a general rule, the fiduciary principle is satisfied if some investors receive a premium over the market price of their shares, and other investors do not suffer a loss.

One might argue, however, that reliance on pre-transaction value to protect investors is inadequate because that value depends on the rules for corporate control transactions. If the fiduciary principle permits a freezeout of shareholders at a low price, the argument goes, then shares will sell for a low price in the market, and a requirement that shareholders be paid a low price is not of much use. The point is useful but ultimately

93. *See* Easterbrook, *supra* note 9; Scott, *Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy*, 9 J. LEGAL STUD. 801 (1980).

94. *E.g.*, Strong v. Repide, 213 U.S. 419 (1909). The appraisal remedy also provides a safeguard against freezeouts motivated by a desire to exploit inside information.

95. DEL. CODE ANN., tit. 8, § 262(h) (1981). Model Business Corporation Act § 81 (a)(3) is similar but less explicit about the value arising from the expectation of a gain-creating transaction. It provides that " '[f]air value' of shares means their value immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of such corporate action unless such exclusion would be inequitable." The Act does not define "inequitable." *Cf.* United States v. Cors, 337 U.S. 325 (1949) (in an eminent domain case, condemnee's compensation does not include increase in property value that results from government's project); Chicago & N.W. Trans. Co. v. United States, No. 81-2195 (7th Cir. Apr. 26, 1982) (Posner, J.) (railroad not entitled to any increment of value attributable to special position or needs of the acquiror).

96. The major defect in the appraisal remedy is the practical difficulty of asserting it. Because there are often significant delays in securing an award, parties must bear their own costs, and benefits obtained inure equally to all shareholders who dissent, there are strong incentives not to seek an appraisal. These difficulties would be minimized if successful dissenters were paid costs including attorneys' fees.

misleading. First, the argument is based on the erroneous premise that rules for corporate control transactions allow investors to be frozen out at an artificially low price. Values in appraisal proceedings are typically determined by reference to a weighted percentage of asset, earnings and market price values. This procedure greatly reduces the chance that shareholders will receive less than the pre-transaction value of their investment, and there is no evidence that shareholders are undercompensated in appraisal proceedings. Moreover, even if the rules for corporate control transactions allowed shareholders to be frozen out at an artifically low price, the prospect of a cash-out at a low price would lead purchasers to pay less in the market. Purchasers still would obtain the ordinary rate of return on their investments. If they were then cashed out at more than the current price of their shares—even if that price is "depressed"—they would obtain more than an ordinary rate of return on their money.

Suppose, however, that a firm's shares trade at "depressed" prices not because of the prospect of a cash-out but because the shareholder in control of the firm uses that control to prevent other investors from receiving the benefits of the enterprise. Perhaps he siphons all profits to himself in exorbitant salaries and perquisites, leaving nothing for other investors. This siphoning may be open to attack on the usual grounds, just as theft by managers is open to attack. If the diversion of profits is sufficiently subtle that it escapes effective challenge in light of the business judgment rule, however, the controlling shareholder may be able to depress the value of others' investments perpetually. Does it then follow that pre-transaction market value is the wrong standard to use in corporate control transactions?[97]

We think not. If the controlling party has the ability to depress prices forever, the helpless investors will be delighted to receive an extra penny for their shares and would not assert a claim for more, if such a claim would prevent the change of control. Moreover, the shareholders suffer their loss when the wastrel becomes entrenched because the lower profit expectation is immediately reflected in lower share prices. People who buy shares after the existing control group is entrenched will receive an ordinary return on their investment. If a control change in the future is accompanied by a premium payment to these owners, they receive a windfall, and the other shareholders who sold in the interim receive nothing.[98] We can think of no argument for such windfalls when part of the cost is

97. *See Corporate Fair Shares*, *supra* note 4, at 306 (argument that reliance on pre-transaction market value is inappropriate in this situation).

98. *Cf.* Bangor Punta Operations v. Bangor & Aroostook R.R. Co., 417 U.S. 703 (1974) (person who purchases shares after alleged waste of corporate assets has been completed may not recover for loss; situation is the same even if corporation, under new control, brings suit in its own right).

the suppression of at least some otherwise beneficial transactions.[99]

F. *Corporate Opportunities*

We conclude this section with a brief look at the rules governing corporate opportunities. An opportunity is a business venture of some sort, and the allocation of an opportunity within a family of affiliated corporations, or between a corporation and an officer, is a control transaction as we have used that term.

Given the survey of the law to this point, it is not surprising that there is no sharing principle in the law of corporate opportunities. A parent corporation may allocate a business opportunity to itself, for example, even though public shareholders in a subsidiary believe that this is unfair.[100] A corporation also may allocate an opportunity to one of its managers. The "corporate opportunity doctrine", far from forbidding such allocations, simply requires that the opportunity be presented to and passed on by the firm's directors or other officers. The firm is free to decline to pursue the opportunity, releasing it to a director or officer. Such releases are common when an employee of the firm has an invention or an idea for a new product that he holds in higher esteem than does the firm. The classic corporate opportunity doctrine cases deal with undisclosed conversions of opportunities; they are to corporate control transactions as theft is to salary.

A number of scholars have decried the state of the law, proposing that current rules be replaced with doctrines of equitable sharing[101] or even absolute bans on the allocation of opportunities to parent corporations or corporate managers. Victor Brudney and Robert Clark contend, for example, that the prospect of overreaching by managers is so great that nothing save prohibition could protect the interests of shareholders.[102]

One response to these proposals is that they will deter the undertaking of some value-increasing ventures, or cause them to be undertaken inefficiently. Moreover, in most cases there is no agency cost ("conflict of interest") problem requiring attention. When managers decide whether to allocate an opportunity to a parent or a subsidiary, the allocation decision will reflect the managers' best judgment about which firm can best develop the opportunity because the same people effectively control both firms. The managers' interests in allocation coincide with shareholders'

99. *See supra* pp. 709-10 (example in which highly unequal division of gains was necessary to induce holder of control to surrender position that gave him access to profits and perquisites).

100. *See* Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970); Myerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967).

101. *See* Cary, *supra* note 4, at 679-83.

102. Brudney & Clark, *supra* note 4.

interests—each wants the venture to be exploited by the corporate structure that can do so best, because that result will generate the greatest profits, and thus the highest share prices for investors and the highest salaries for managers.

Much of the existing literature assumes that a parent corporation will allocate corporate opportunities to itself to avoid sharing of the gains with minority shareholders of the subsidiary corporation. Brudney and Clark, for example, argue that this danger is so great that corporate opportunities should presumptively be awarded to the subsidiary corporation.[103] The argument is defective because it ignores the possibility of side payments. Assume that a corporate opportunity is worth $100 to a 70% owned subsidiary but only $80 to the parent. It might appear that the parent would allocate the opportunity to itself even though it could use the opportunity less profitably, because the $80 gain is greater than the $70 (70% x $100) gained if the opportunity is allocated to the subsidiary. But the parent corporation could gain more than $80 by allocating the opportunity to the subsidiary and charging it some amount between $11 and $30. The charge could be explicit or implicit. That is, the parent's other dealings with the subsidiary could somehow be adjusted to compensate it for the release of the opportunity—transfer pricing between parents and subsidiaries is extremely flexible.[104] Thus the opportunity would be allocated to the firm that could use it more efficiently, and all parties, including the minority shareholders of the subsidiary, would benefit as a result.[105]

The same is true when managers take opportunities for themselves. Assigning the opportunity to the manager may reduce agency costs by enabling the manager to receive a greater part of the marginal gains produced by his efforts. The manager would view the business opportunity as just another form of compensation similar to (but more risky than) salary, bonuses, and stock options. Managers properly take opportunities for themselves when they can exploit them more profitably than the firm. The increase in the value of the opportunity creates the possibility of a mutually beneficial transaction between manager and firm: the manager takes the venture, and the firm reduces the manager's other compensation.

Such a transaction is the equivalent of a decision to hire the manager only part-time, leaving him free to pursue other things during the rest of his time. Indeed, part-time employment is common in labor markets.

103. *Id.*

104. Indirect evidence suggests that devices to transfer gains between affiliated firms exist and are used frequently. Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 54 J. BUS. 345, 346 (1980).

105. *See* Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960).

Sometimes firms want to hire only one or two percent of a person's time, and they obtain such labor inputs from independent contractors (e.g., law firms and architects). Sometimes firms want 100% of the agent's time. But figures in between are sensible too. Law schools typically hire approximately 50% of professors' time, giving them four months in the summer and some time off during the year to do as they please (consulting, travel, teaching elsewhere, even writing). Part-time employment arises when, at the margin, a person's time is more valuable to some other employer or to the agent himself (pursuing other projects or simply taking life at leisure) than to the firm. The part-time employee compensates the firm through a reduced salary.

This might appear misleading, because executives who take opportunities typically do not reduce their salaries on the spot or explicitly accept part-time employment. But managers' time commitments are flexible; taking the opportunity may coincide with a reduction from 60 to 50 hours spent on the firm's business each week. The salary reduction may be part of an *ex post* settling up[106] with the firm as the employee receives a lower bonus or a lower salary for the future. The adjustment also may come *ex ante* because employees will accept a lower salary from a firm that allows its officials to exploit business opportunities on the side. Either way, the executive will pay for what he takes.

It will not do to say that executives have "bargaining power" that they use to avoid this settling up. Although managers doubtless can exploit their positions to a degree, they are constrained by labor markets, product markets, and the market for corporate control. No matter how much bargaining power the managers have, they are better off if they do what shareholders prefer and assign the opportunity to the corporation or person that can put it to best use. Such behavior creates a bigger pie, which managers may slice in favor of both investors and themselves. And a ban on the assignment of opportunities to managers would not reduce their bargaining power or facilitate monitoring.

Perhaps it is generally beneficial for managers to abjure opportunities.[107] If so, then they can benefit by promising to allocate all new ventures to the firm. Although it should be relatively easy to reach such contracts, they appear to be rare, which suggests that shareholders' interests coincide with the existing legal rules.

106. The term is from Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

107. The taking of opportunities is similar in some respects to insider trading, and some of the costs of such trading apply to opportunities too. *See* Easterbrook, *supra* note 9 at 332-35. There is nonetheless little reason for a legal rule concerning the use of opportunities. The exploitation of such opportunities by managers with firms' approval is, by assumption, known to the firm, while insiders' trading is easier to keep secret.

IV. The Meaning of Fiduciary Duty in Other Contexts

We have shown that a legal rule allowing unequal division of the gains from corporate control transactions furthers the shareholders' interests, provided that no shareholder be made worse off. We have also shown that existing legal rules, for the most part, are consistent with our analysis. We conclude in this section by briefly discussing and distinguishing several situations where equal division of gains is the norm.

A familiar rule of partnership law is that, unless the partners otherwise agree, profits must be shared equally and no partner is entitled to a salary.[108] The rationale for this rule is clear—because the number of partners is typically small, it is relatively easy for partners to reach contractual agreements relating to particular contributions. If unequal division is necessary to provide an incentive to create gains, the partners can accomplish this by private agreement. Moreover, because partners generally invest much of their human capital in the partnership, they are unable to diversify this part of their investment "portfolio." Partners who are risk averse therefore benefit from a rule of equal division.

Another rule of law is that dividends must be distributed pro rata to each shareholder of the same class in a corporation.[109] There is no tension between this rule and the fiduciary principle in corporate control transactions. Unequal division of the gains resulting from corporate control transactions increases shareholders' welfare by creating an incentive to produce such gains and thereby to add to the value of the firm. The same is not true with respect to dividends. The payment of a dividend is simply a transfer of assets from a firm to its shareholders. No gains are created in the process. Thus a legal rule allowing unequal distribution of dividends might increase the frequency of dividend payments, but this would not increase the value of the firm.[110] On the contrary, a rule allowing unequal division of dividends would make shareholders worse off because they would have an incentive to incur wasteful expenditures by monitoring the withdrawal of assets from the firm. Thus the rule prohibiting unequal payment of dividends, like the fiduciary principle allowing unequal division of gains resulting from corporate transactions, is perfectly consistent with the goal of maximizing shareholders' wealth.

We think that a more complete survey of agency, partnership, and corporate law would reveal that the likelihood of a sharing rule turns on two

108. U.P.A. §§ 18(a), (f) (1914).

109. The rule is not as fundamental as it appears, because it can be evaded by creating a separate class of stock.

110. The classic statement of the argument that divided policy does not affect the value of the firm is Miller & Modigliani, *supra* note 75. For a discussion of the implications of this argument for the legal regulation of dividend policy, see Fischel, *supra* note 24.

things: the probability that unequal divisions would produce gains, and the number of participants in the venture. As either quantum rises, a sharing rule becomes less useful in maximizing the wealth of investors.

Conclusion

We have argued that the fiduciary principle should incorporate a wealth maximization standard, that an unequal division of gains from corporate control transactions facilitates wealth maximization, and that corporation law almost never requires gain sharing. In general, the law is congruent with shareholders' interests in this regard; "fairness" plays little role in the fiduciary principle, and perhaps it should play none.

The Yale Law Journal

Volume 91, Number 4, March 1982

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