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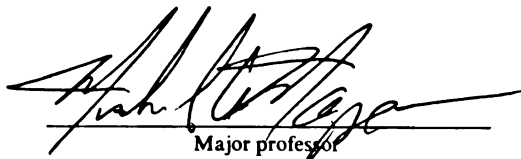
RESOLVING FOREGONE CORPORATE OPPORTUNITIES

presented by

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has been accepted towards fulfillment
of the requirements for

Ph.D. degree in Finance


Major professor

Date August 25, 1993



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RESOLVING FOREGONE CORPORATE OPPORTUNITIES

By

Elvin Carroll Lashbrooke, Jr.

A DISSERTATION

**Submitted to
Michigan State University
in partial fulfillment of the requirements
for the degree of**

DOCTOR OF PHILOSOPHY

Department of Finance and Insurance

1993

ABSTRACT

RESOLVING FOREGONE CORPORATE OPPORTUNITIES

By

Elvin Carroll Lashbrooke, Jr.

Empirical studies show that stock prices are depressed when a corporation announces an equity issue. One ramification of this phenomenon is that managers acting in the best interests of existing shareholders will not finance positive net present value projects with equity issues if the firm does have not sufficient slack or debt capacity to do so. Consequently, the value of the firm is not maximized, and there is a misallocation of resources. One solution to this problem--the spin-off of positive net present value projects is analyzed in the context of the legal environment.

A spin-off generally entails registration of the stock of the subsidiary corporation, and disclosure is required under federal and state law. In the legal context, disclosure of the inside material information resolves the asymmetric information problem at the heart of the misallocation.

The dissertation examines how the market reacts to spin-off announcements and the motivation of managers deciding to spin-off assets.

Analysis of the market reaction to the 158 spin-offs in the sample shows that (1) prior to the announcement date

debt-equity ratios increase, (2) the higher the ratio of current assets to current liabilities, the higher the abnormal returns, (3) the higher (lower) the market value of the firm to the book value of the firm, the lower (higher) the abnormal returns, and (4) firms having market value of the firm to book value of the firm ratios below the sample mean ratio value had higher abnormal returns than firms having market value of the firm to book value of the firm ratios below the mean ratio value. These findings are consistent with the theory predictions.

Finally, it is observed that following a spin-off managers of firms with high debt-equity ratios contract and retrench their firms whereas managers of firms with low debt-equity ratios expand their firms. This behavior is consistent with the theory prediction.

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To my loving wife, Meg, for her unwavering support.

ACKNOWLEDGEMENTS

I wish to thank Dr. Michael A. Mazzeo, Chair of my Dissertation Guidance Committee, for his guidance and valuable assistance in the preparation of this dissertation. I also wish to thank the other members of the committee, Dr. Richard R. Simonds, Dr. John L. O'Donnell, and Dr. Dale L. Domian for their assistance. In addition, I wish to thank the two outside reviewers, Professor Robert Prentice of The University of Texas at Austin and Professor Thomas Bowers of Indiana University. Finally, I wish to thank Dean Richard J. Lewis and Associate Dean James F. Rainey for their support.

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I. Introduction to the Problem

Basic finance theory says that managers should maximize the value of the corporation by investing in all positive net present value projects thereby maximizing the value of the firm and maximizing the wealth of the shareholders. We suspect, however, that managers do not take advantage of all positive net present value opportunities. Several explanations, such as price depression of equity issues and agency costs, have been offered for this phenomenon.

Empirical studies show that stock prices are depressed when a corporation announces an equity issue. Masulis and Korwar,¹ Asquith and Mullins,² Kolodny and Suhler,³ and Mikkelsen and Partch⁴ report such a phenomenon. One explanation of this phenomenon is asymmetric (inside) information and the assumption or belief that managers act in the best interests of the existing (old) shareholders. Managers have information that shareholders and investors do not have. When making an investment decision managers have

¹ R. Masulis and A. Korwar, Seasoned Equity Offerings: An Empirical Investigation, J. OF FINANCIAL ECONOMICS 15, 91-118 (1986).

² P. Asquith and D. Mullins, Jr., Equity Issues and Offering Dilution, J. OF FINANCIAL ECONOMICS 15, 61-90 (1970).

³ R. Kolodny and D. Suhler, Changes in Capital Structure, New Equity Issues, and Scale Effects, J. OF FINANCIAL RESEARCH 8, 127-136 (1985).

⁴ W. Mikkelsen and M. Partch, Valuation Effects of Security Offerings and the Issuance Process, J. OF FINANCIAL ECONOMICS 15, 31-60 (1986).

information concerning the values of the projects and assets in place that is unavailable to others. The possession of inside information coupled with managers acting in the best interests of the existing shareholders results in a suboptimal investment policy.

A firm's value consists of the value of the assets in place plus growth opportunities. Under traditional financial theory, managers should invest in all projects that have a positive net present value ($NPV > 0$). This process maximizes the value of the firm. Evidence that the market does indeed follow the traditional valuation model was supplied by McConnell and Muscarella in 1985.⁵ They found that announcements of unexpected increases (decreases) in capital expenditure resulted in positive (negative) impacts on the market value of the corporation.

If managers pass up growth opportunities, they are not maximizing the value of the firm, and resources are misallocated. However, managers may not always maximize the value of the firm as discussed by Jensen and Meckling⁶ in their seminal paper on agency costs.

This dissertation explores why managers might pass up positive net present value projects and, consequently, not

⁵ J. McConnell and C. Muscarella, Corporate Capital Expenditure Decisions and the Market Value of the Firm, J. OF FINANCIAL ECONOMICS 14, 399-422 (1985).

⁶ M.C. Jensen and W. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure, J. Of FINANCIAL ECONOMICS 3, 305-360 (1976) [Hereinafter referred to as Jensen and Meckling (1976)].

maximize the value of the firm and proposes possible solutions to the problem. Solutions to finance problems tend to be restricted to finance without regard for the legal environment surrounding the problem. Consequently, there is no systematic study of the interaction between finance theory and the law. None of the financial solutions is a totally satisfactory solution to the problem.

Something appears to be missing from the model. One important missing element is the legal environment. This dissertation is intended to be a theoretical paper with emphasis on trying to explain the conflict between finance theory and observed behavior in the context of the legal environment. Similar in style to Roll's Critique of the CAPM, this dissertation compares observed behavior with theory and examines the inconsistencies, considers why these inconsistencies may be important and what causes them, and how they might be resolved. This dissertation places the finance problem of inefficiencies resulting from under-investment in its legal environment. The relationship between finance theory and the law is examined, and both legal and finance solutions are proposed.

The analysis utilizes the Myers and Majluf⁷ model described below and examines the legal ramifications of the assumptions and results.

⁷ S.C. Myers and N.S. Majluf, Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have, J. Of FINANCIAL ECONOMICS 13, 187-221 (1984) [Hereinafter referred to as Myers and Majluf (1984)].

Myers and Majluf create a single period model that shows that under certain conditions firms may pass up positive net present value projects if they must issue equity to finance them. Consider a firm which has a single asset in place and an investment opportunity which must be financed in whole or in part by issuing equity. The firm does not have sufficient cash or other marketable securities on hand to finance the project. Further, there are no taxes, transaction costs, or other market imperfections. Investors are rational. Myers and Majluf assume asymmetric information and that managers act in the best interest of old shareholders who are assumed to be passive, i.e., shareholders do not rebalance their portfolios in response to the firm's actions.

The Myers and Majluf model is a three date model. At $t=-1$, both the market and managers have the same information. At $t=0$, managers receive information concerning the value of the asset in place and project that is unknown to the market. At $t=+1$, the market receives the information that managers received at $t=0$. The value of the asset in place at $t=-1$ is the expected future value, $\bar{A}=E(\tilde{A})$, where the distribution of $\tilde{A}$ is the possible values of the asset in place at $t=0$. Management information received at $t=0$, is the updated estimate 'a' which is the realization of $\tilde{A}$. Similarly, the net present value (NPV) of the project at $t=-1$ is $\bar{B}=E(\tilde{B})$, where $\tilde{B}$ represents the possible NPV's of the project at $t=0$. Management receives the updated estimate,

b, at $t=0$. Both a and b are assumed to be non-negative. S, the amount of slack (cash and equity securities) on hand, is known by both the market and managers. Equity is issued if $0 \leq S \leq I$, where I is the amount of investment needed to finance the project.

Myers and Majluf show that managers will issue equity and invest only if

$$S+a \leq [P/(P+E)](E+S+a+b),$$

where P is the "old shares" market value if stock is issued and $E=I-S$. The old shareholders' share of the firm with investment must be greater than or equal to the value of the firm without investing in the project. If this condition does not obtain, then managers will pass up the positive net present value project and not maximize the value of the firm.

The problem may be seen easily by use of an illustration. Assume that there are two states of nature that can occur and are equally likely. The true state of nature is known to management at $t=0$ but not to investors until $t=+1$.

	State 1	State 2
Asset in Place	a = 150	a = 50
Project NPV	b = 20	b = 10

Further assume that the corporation has no cash but does have \$10 in marketable securities so that slack, S,

equals \$10. The amount of investment needed to finance the project is \$200. The amount of equity needed to be issued to finance the project is the amount of the investment minus the amount of slack.

$$E=I-S=200-10=190.$$

If the corporation were to issue equity securities to finance the project regardless of which state occurs,

$$P=S+\bar{A}+\bar{B}=10+[(150+50)/2]+[(20+10)/2]=125.$$

If state 1 were to occur, the value of the corporation,

$$V_1=E+S+a+b=190+10+150+20=370.$$

The market value is the market value of the old shareholders' stock, P , plus the market value of the new equity, E .

Since the value of the corporation in state 1 is \$370, the old shareholders' aliquot share is

$$[P/(P+E)] \cdot V_1 = [125/(125+190)] \cdot 370 = 146.83.$$

The new shareholders' aliquot share of the corporation is

$$[E/(P+E)] \cdot V_1 = (190/315) \cdot 370 = 223.17.$$

Likewise, if state 2 were to occur, the value of the corporation,

$$V_2=E+S+a+b=190+10+50+10=260.$$

The old shareholders' aliquot share is

$$[P/(P+E)] \cdot V_2 = [125/(125+190)] \cdot 260 = 103.17.$$

The new shareholders' aliquot share is

$$[E/(P+E)] \cdot V_2 = [190/315] \cdot 260 = 156.83.$$

Note that the stock is correctly priced to old shareholders

and new investors.

$$P = \frac{1}{2}(146.83 + 103.17) = 125, \text{ and}$$

$$E = \frac{1}{2}(223.17 + 156.83) = 190.$$

Now, consider the payoffs to the old shareholders.

Payoffs to Old S/H	Issue & Invest (E=190)	Do Nothing (E=0)
State 1	146.83	150
State 2	103.17	50

The optimal strategy is for managers not to issue and invest if state 1 occurs but to do so if state 2 occurs. However, if investors know the strategy, not issuing and investing signals state 1 while issuing and investing signals state 2. Consequently, investors will adjust, and the equilibrium payoffs are

Payoffs to Old S/H	Issue & Invest (E=190)	Do Nothing (E=0)
State 1	--	150
State 2	60	---

Managers will not issue and invest if state 1 occurs, and because investors know it, the market value of the stock, if issued, is now determined as

$$P = S + \bar{A} + \bar{B} = 10 + \frac{1}{2}(60) + \frac{1}{2}(150) = 115.$$

This represents a loss of \$10 over the ex ante price of \$125. Consequently, managers will forgo investment in the positive net present value project to protect the value of

the old shareholders stock.

The Myers and Majluf model may be generalized without changing the result. For simplicity, consider only three stakeholder groups--managers, old shareholders, and new investors (the market). The assumption that managers act in the best interest of all of the old shareholders could be modified to act in the best interest of the controlling shareholder(s) without changing the results.

The updated estimate of the value of the firm's asset, a , is always non-negative because of the limited liability attribute of corporations. In the absence of fraud or watered stock, shareholder losses are limited to the value the corporation's assets; shareholders receive the maximum of zero or the residual value, if positive. There are no restrictions on the sign of the net present value of the real investment opportunity, b .

The value of the firm at the initial point is the sum of the slack plus the value of the asset in place, $V_0 = S + a$. The value of the firm if the project is undertaken and financed with an equity issue is the sum of the market value of the new equity plus the slack plus the updated estimates of the values of the asset in place and the project,

$$V_p = (E + S + a + b).$$

Of which the old shareholders aliquot share of V_p is

$$[P / (P + E)] (E + S + a + b)$$

and the new shareholders aliquot share of V_p is

$$[E / (P + E)] (E + S + a + b).$$

It is important to note that the total value of the firm does not change. What changes is the aliquot shares of the different stakeholders.

The conflict among the stakeholders is as follows: managers will want to maximize the value of the firm by accepting the project if $NPV=b>0$. Old or initial shareholders will want to have at least the same value in the new enterprise as in the old, i.e.,

$$[P/(P+E)]V_p \geq V_o,$$

or restated,

$$[P/(P+E)](E+S+a+b) \geq S+a.$$

New shareholders will want their value in the new enterprise to at least equal the value of the stock, i.e.,

$$[E/(P+E)]V_p \geq E,$$

or restated,

$$[E/(P+E)](E+S+a+b) \geq E.$$

In other words, old shareholders will want to undertake the project only if

$$[E/(P+E)](S+a) \leq [P/(P+E)](E+b)$$

which is equivalent to

$$E+b \geq (E/P)(S+a);$$

while new shareholders (or investors) will only buy if

$$[E/(P+E)](S+a) \geq [P/(P+E)](E+b)$$

which is equivalent to

$$E+b \leq (E/P)(S+a).$$

These conditions can obtain simultaneously only at

$$E+b = (E/P)(S+a)$$

which implies that the stock must be fairly priced in the market. If it is either undervalued or overvalued, one or the other of the stakeholders would object. Old shareholders would want to issue new equity if the stock is overvalued while new investors would balk. New investors want to buy if the stock is undervalued while old shareholders would object to the issue. Managers will want to issue stock if $\text{expected NPV} > 0$. This by itself conveys no information to the shareholders or investors about the value of the stock. However, managers also want to maximize the value of the firm in other ways. This implies that managers will want to issue stock if $\text{expected NPV} > 0$ and the stock is overvalued. If the stock is undervalued, the value of the firm is reduced below fair market value (FMV) so managers will not issue stock. This is in the best interests of the old shareholders.

Investors know that managers would issue stock only if $\text{expected NPV} > 0$ and the stock is overvalued. Issuing stock sends a negative message to the market which causes stock prices to fall. Managers are aware of this and will not issue stock to finance the project even though $\text{NPV} > 0$ to protect the stock value.

In balancing the interests of the old shareholders, managers, and investors, managers will make a suboptimal investment decision if equity must be issued to finance the project. The optimal investment decision under asymmetric information is made if $S \geq I$ in which case managers and

shareholders benefit from undertaking a $NPV > 0$ project and investors have no immediate stake in the outcome.

If debt is issued to finance the project, the managers will invest in the expected $NPV > 0$ project since it would be in the best interest of managers and the shareholders. Again, new shareholders or investors have no immediate stake since no new equity will be issued. The interests of the bondholder-stakeholder group is protected contractually;⁸ otherwise, they are at risk. The law provides little protection to bondholders outside of bankruptcy other than enforcing protective or restrictive covenants⁹ of the bond contract or indenture.

It is not necessary that $b > 0$. The model can explain agency costs associated with managers investing in $NPV < 0$ projects because they have a vested interest in the project or are engaged in empire building. Assume managers expect $b < 0$. Because of the asymmetry of information, only the managers know the value of b . Under this condition, investors would be even more leery of an equity issue and would either not buy or require a substantial discount. Again, an equity issue sends a negative signal to the market. Old shareholders would object to accepting $NPV < 0$

⁸ Trust Indenture Act of 1939, 15 U.S.C. § 77aaa et seq.

⁹ See American Bar Association, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS (1971) for a description of the many different restrictions and covenants used in bond contracts.

projects if they knew about them. Moreover, the condition $E+b=(E/P)(S+a)$ would still have to hold. In balancing the interests of managers, investors, and old shareholders, managers wanting to invest in $NPV<0$ projects would issue new equity only if the stock is overvalued. Investors would not want to buy under these conditions, however, if they knew them. Managers would have no incentive to issue new equity if the stock is undervalued, and old shareholders would object. The net result of balancing the interests of all stakeholder groups is that no equity will be issued to finance the project.

As in the case $b>0$, managers would undertake the project if $S\geq I$. In this case, there are no competing shareholder or investor interests. If the managers consistently undertake $NPV<0$ projects they run the risk of shareholder opposition or become candidates for takeover. If $S<I$, debt financing would avoid problems with equity investors although it increases the risk of bankruptcy. However, shareholder opposition would be reduced because agency costs of monitoring the managers would be shifted to the bondholders who can protect themselves, and indirectly the shareholders, contractually.

Thus, the model explains the observed phenomenon that managers prefer internal financing to outside, and if they must go outside, debt is preferred to equity. The model also accounts for suboptimal investment and some agency costs.

Myers and Majluf (1984) assume that the project evaporates if the firm does not take advantage of it at $t=0$.¹⁰ Parenthetically, they assert that they could just as well assume that delay reduced the project's net present value. Whether their assumption is correct or not can be ascertained by extending their model to a two-period model and examining it.

An investment will be bypassed in the first period and undertaken in the second period only if

$$[P/(P+E)](E+S+a+b_1) < S+a \leq [P/(P+E)](E+S+a+b_2),$$

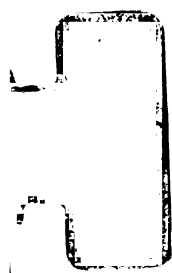
if the value of the asset in place, a , is held constant or if the value of the asset in place is allowed to vary over time only if

$$[P/(P+E)](E+S+a_1+b_1) < S+a_1, \text{ and}$$

$$[P/(P+E)](E+S+a_2+b_2) > S+a_2.$$

where a_i is the updated estimate of the asset in place in period i known to management but not the market in said period and b_i is the updated estimate of the value of the

¹⁰ Contra, Lucas and McDonald created a dynamic, infinite horizon model of a corporation's equity issue decision. They assumed short-term asymmetric information and that managers act in the interests of the shareholders as did Myers and Majluf. They hypothesized that overvalued firms will issue equity to finance a NPV>0 project immediately, whereas an undervalued firm will delay issuing equity to finance a NPV>0 project. Simulations of their model produced the familiar pattern around equity issue announcement dates. Prior to the announcement date stock prices on average exhibited an extended positive abnormal return, but immediately following the announcement, stock prices fell significantly. D. Lucas and R. McDonald, Equity Issues and Stock Price Dynamics, J. OF FINANCE 45, 1019-1043 (1990).



project in period i known to management but not the market in said period. The old shareholders' value in the firm without investment must be greater than their aliquot share of the firm with investment in the first period for there to be no investment; however, for there to be investment in the second period the old shareholders' value in the firm must be less than or equal to their aliquot share of the firm with investment in the second period.

Myers and Majluf, in effect, assert that in every case

$$S+a > [P/(P+E)](E+S+a+b_1) > [P/(P+E)](E+S+a+b_2)$$

if the value of the asset in place is held constant or

$$S+a_1 > [P/(P+E)](E+S+a_1+b_1) \text{ and}$$

$$S+a_2 > [P/(P+E)](E+S+a_2+b_2)$$

if the value of the asset in place is allowed to vary over time.

An argument can be made that projects do indeed go stale. If the project is postponed one period, the net present value will be reduced since it is one period farther away and must be discounted back one additional period. There may be a strategic component in the value of the project concerning product mix, marketing, competition, or timing that is lost if the project is postponed. Postponing the project may increase the risk. More uncertainty will alter the distributions of the values of the asset in place and project. The increased risk will increase the capitalization rate and yield a lower net present value.

Another way to view the situation is to consider the

right to postpone as a call option which expires in the second period. The value of the project in the first period is the net present value of the project plus the value of the call option. In the second period the value of the project is just the net present value of the project. Even if the net present value of the project remained constant, the value of the project is reduced by the value of the call option which is positive; hence, the project is worth less thereby supporting Myers and Majluf's claim.

Nonetheless, a_2 and b_2 are updated estimates of expected values of the distributions of the values of the asset in place and project respectively in period two and may exceed a_1 and b_1 due to economic or other conditions. In which event, holding the amount of slack, S , constant,

$$(1) [P/(P+E)](E+S+a_1+b_1) < [P/(P+E)](E+S+a_2+b_2) < S+a_1 < S+a_2, \text{ or}$$

$$(2) [P/(P+E)](E+S+a_1+b_1) < S+a_1 < S+a_2 \leq [P/(P+E)](E+S+a_2+b_2), \text{ or}$$

$$(3) S+a_1 < S+a_2 \leq [P/(P+E)](E+S+a_1+b_1) < [P/(P+E)](E+S+a_2+b_2), \text{ or}$$

$$(4) [P/(P+E)](E+S+a_1+b_1) < S+a_1 < [P/(P+E)](E+S+a_2+b_2) < S+a_2, \text{ or}$$

$$(5) S+a_1 \leq [P/(P+E)](E+S+a_1+b_1) < S+a_2 \leq [P/(P+E)](E+S+a_2+b_2), \text{ or}$$

$$(6) S+a_1 \leq [P/(P+E)](E+S+a_1+b_1) < [P/(P+E)](E+S+a_2+b_2) < S+a_2.$$

In cases (1) and (4) the project would be abandoned in period one; however, in case (2), investment in the project should be postponed until period two. In cases (3), (5), and (6), the investment is made in period one, so there is no postponement issue. The point here is that Myers and Majluf's assumption does not hold in all cases. In case (2), the value of the corporation is maximized and old



shareholders are satisfied by postponing the investment until period two.

Now suppose that $b_2 > b_1$ and $a_2 < a_1$ still holding the amount of slack, S , constant, the alternatives are:

- (1) $S + a_2 < [P / (P + E)] (E + S + a_1 + b_1) < [P / (P + E)] (E + S + a_2 + b_2) < S + a_1$, or
- (2) $S + a_2 < [P / (P + E)] (E + S + a_2 + b_2) < [P / (P + E)] (E + S + a_1 + b_1) < S + a_1$, or
- (3) $[P / (P + E)] (E + S + a_1 + b_1) < [P / (P + E)] (E + S + a_2 + b_2) < S + a_2 < S + a_1$, or
- (4) $[P / (P + E)] (E + S + a_2 + b_2) < [P / (P + E)] (E + S + a_1 + b_1) < S + a_2 < S + a_1$, or
- (5) $[P / (P + E)] (E + S + a_1 + b_1) < S + a_2 < S + a_1 \leq [P / (P + E)] (E + S + a_2 + b_2)$, or
- (6) $[P / (P + E)] (E + S + a_2 + b_2) < S + a_2 < S + a_1 \leq [P / (P + E)] (E + S + a_1 + b_1)$, or
- (7) $[P / (P + E)] (E + S + a_1 + b_1) < S + a_2 < [P / (P + E)] (E + S + a_2 + b_2) < S + a_1$, or
- (8) $[P / (P + E)] (E + S + a_2 + b_2) < S + a_2 < [P / (P + E)] (E + S + a_1 + b_1) < S + a_1$, or
- (9) $S + a_2 < S + a_1 < [P / (P + E)] (E + S + a_1 + b_1) < [P / (P + E)] (E + S + a_2 + b_2)$, or
- (10) $S + a_2 < S + a_1 < [P / (P + E)] (E + S + a_2 + b_2) < [P / (P + E)] (E + S + a_1 + b_1)$, or
- (11) $S + a_2 < [P / (P + E)] (E + S + a_1 + b_1) < S + a_1 < [P / (P + E)] (E + S + a_2 + b_2)$, or
- (12) $S + a_2 < [P / (P + E)] (E + S + a_2 + b_2) < S + a_1 < [P / (P + E)] (E + S + a_1 + b_1)$.

No investment would be made in either period in cases (3), (4), and (8). In cases (6), (9), (10), and (12) investment would be made in period one. Investment would be bypassed in period one but made in period two in cases (1), (2), (5), (7), and (11). Again, Myers and Majluf's assumption does not hold in all cases. In four of these cases, (3), (4), (5), and (7), the value of the corporation is maximized and old shareholders are satisfied by postponing the investment until period two. In one-half of these cases involving a reduction in the value of the asset in place in period two,



management is forced to re-evaluate the investment decision in period two.

If we now assume that the value of the project decreases in period two, $b_1 > b_2$, and that the value of the asset in place increases in period two, $a_2 > a_1$, while holding the amount of slack, S , constant then

- (1) $S + a_1 < [P / (P + E)] (E + S + a_1 + b_1) < [P / (P + E)] (E + S + a_2 + b_2) < S + a_2$, or
- (2) $S + a_1 < [P / (P + E)] (E + S + a_2 + b_2) < [P / (P + E)] (E + S + a_1 + b_1) < S + a_2$, or
- (3) $[P / (P + E)] (E + S + a_1 + b_1) < [P / (P + E)] (E + S + a_2 + b_2) < S + a_1 < S + a_2$, or
- (4) $[P / (P + E)] (E + S + a_2 + b_2) < [P / (P + E)] (E + S + a_1 + b_1) < S + a_1 < S + a_2$, or
- (5) $[P / (P + E)] (E + S + a_1 + b_1) < S + a_1 < S + a_2 \leq [P / (P + E)] (E + S + a_2 + b_2)$, or
- (6) $[P / (P + E)] (E + S + a_2 + b_2) < S + a_1 < S + a_2 \leq [P / (P + E)] (E + S + a_1 + b_1)$, or
- (7) $[P / (P + E)] (E + S + a_1 + b_1) < S + a_1 < [P / (P + E)] (E + S + a_2 + b_2) < S + a_2$, or
- (8) $[P / (P + E)] (E + S + a_2 + b_2) < S + a_1 < [P / (P + E)] (E + S + a_1 + b_1) < S + a_2$, or
- (9) $S + a_1 < S + a_2 < [P / (P + E)] (E + S + a_1 + b_1) < [P / (P + E)] (E + S + a_2 + b_2)$, or
- (10) $S + a_1 < S + a_2 < [P / (P + E)] (E + S + a_2 + b_2) < [P / (P + E)] (E + S + a_1 + b_1)$, or
- (11) $S + a_1 < [P / (P + E)] (E + S + a_1 + b_1) < S + a_2 < [P / (P + E)] (E + S + a_2 + b_2)$, or
- (12) $S + a_1 < [P / (P + E)] (E + S + a_2 + b_2) < S + a_2 < [P / (P + E)] (E + S + a_1 + b_1)$.

The investment is made in period 1 in cases (1), (2), (6), (8), (9), (10), (11), and (12). No investment is made in either period in cases (3), (4), and (7). Postponement results in investment in period two only in case (5), but still rejects the Myers and Majluf assumption.

Finally, assume that the values of both the asset in place and the project decline in period two, $b_1 > b_2$ and $a_1 > a_2$, while holding the amount of slack, S , constant then



- (1) $[P/(P+E)](E+S+a_1+b_1) > [P/(P+E)](E+S+a_2+b_2) > S+a_1 > S+a_2$, or
- (2) $[P/(P+E)](E+S+a_1+b_1) > S+a_1 > S+a_2 > [P/(P+E)](E+S+a_2+b_2)$, or
- (3) $S+a_1 > S+a_2 > [P/(P+E)](E+S+a_1+b_1) > [P/(P+E)](E+S+a_2+b_2)$, or
- (4) $S+a_1 > [P/(P+E)](E+S+a_1+b_1) > [P/(P+E)](E+S+a_2+b_2) > S+a_2$, or
- (5) $[P/(P+E)](E+S+a_1+b_1) > S+a_1 > [P/(P+E)](E+S+a_2+b_2) > S+a_2$, or
- (6) $S+a_1 > [P/(P+E)](E+S+a_1+b_1) > S+a_2 > [P/(P+E)](E+S+a_2+b_2)$.

Investment is made in period one in cases (1), (2), and (5). No investment is made in either period in cases (3) and (6). The project is postponed until period two in case (4). The assumption fails to hold in case (4). In no scenario does the assumption hold in all cases.

In the examples above the amount of slack was held constant, but the amount of slack could vary from period to period. Slack could be a function of interest paid on the cash deposits, dividends paid on the market securities held, dividend policy on the corporation's own stock, income from the asset in place, capital gain or loss on the market securities held, and internal expenses. Slack could increase as a result of interest received on the cash deposits, dividends received on the market securities, or capital gains on the market securities. Slack could decrease with dividends paid, capital losses on the market securities, or operating expenses causing a net operating loss. For the sake of simplicity, it is assumed that slack varies exogenously to illustrate the point.

Assume that $S_2 > S_1$ and that a_2 and b_2 exceed a_1 and b_1 respectively due to economic or other conditions. In which

event,

- (1) $[P/(P+E)](E+S_1+a_1+b_1) < [P/(P+E)](E+S_2+a_2+b_2) < S_1+a_1 < S_2+a_2$
- (2) $[P/(P+E)](E+S_1+a_1+b_1) < S_1+a_1 < S_2+a_2 \leq [P/(P+E)](E+S_2+a_2+b_2)$
- (3) $S_1+a_1 < S_2+a_2 \leq [P/(P+E)](E+S_1+a_1+b_1) < [P/(P+E)](E+S_2+a_2+b_2)$
- (4) $[P/(P+E)](E+S_1+a_1+b_1) < S_1+a_1 < [P/(P+E)](E+S_2+a_2+b_2) < S_2+a_2$
- (5) $S_1+a_1 \leq [P/(P+E)](E+S_1+a_1+b_1) < S_2+a_2 \leq [P/(P+E)](E+S_2+a_2+b_2)$
- (6) $S_1+a_1 \leq [P/(P+E)](E+S_1+a_1+b_1) < [P/(P+E)](E+S_2+a_2+b_2) < S_2+a_2$

In cases (1) and (4) the project would be abandoned in period one; however, in case (2), investment in the project should be postponed until period two. In cases (3), (5), and (6), the investment is made in period one, so there is no postponement issue. Again Myers and Majluf's assumption does not hold in all cases. In case (2), the value of the corporation is maximized and old shareholders are satisfied by postponing the investment until period two.

Now assume that the values of both the asset in place and the project decline in period two, $b_1 > b_2$ and $a_1 > a_2$, and $S_1 > S_2$, then

- (1) $[P/(P+E)](E+S_1+a_1+b_1) > [P/(P+E)](E+S_2+a_2+b_2) > S_1+a_1 > S_2+a_2$
- (2) $[P/(P+E)](E+S_1+a_1+b_1) > S_1+a_1 > S_2+a_2 > [P/(P+E)](E+S_2+a_2+b_2)$
- (3) $S_1+a_1 > S_2+a_2 > [P/(P+E)](E+S_1+a_1+b_1) > [P/(P+E)](E+S_2+a_2+b_2)$
- (4) $S_1+a_1 > [P/(P+E)](E+S_1+a_1+b_1) > [P/(P+E)](E+S_2+a_2+b_2) > S_2+a_2$
- (5) $[P/(P+E)](E+S_1+a_1+b_1) > S_1+a_1 > [P/(P+E)](E+S_2+a_2+b_2) > S_2+a_2$
- (6) $S_1+a_1 > [P/(P+E)](E+S_1+a_1+b_1) > S_2+a_2 > [P/(P+E)](E+S_2+a_2+b_2)$

Investment is made in period one in cases (1), (2), and (5). No investment is made in either period in cases (3) and (6).

The project is postponed until period two in case (4). The assumption fails to hold in case (4).

For the remaining four cases $S_1 < S_2$ and $a_1 > a_2$ and $b_1 < b_2$, $S_1 < S_2$ and $a_1 > a_2$ and $b_1 > b_2$, $S_1 > S_2$ and $a_1 > a_2$ and $b_1 < b_2$, and $S_1 > S_2$ and $a_1 > a_2$ and $b_1 > b_2$, there are twenty-four different cases. In all four, $S_1 + a_1 > S_2 + a_2$ or $S_2 + a_2 \geq S_1 + a_1$ and $E + S_1 + a_1 + b_1 < E + S_2 + a_2 + b_2$ or $E + S_1 + a_1 + b_1 \geq E + S_2 + a_2 + b_2$ depending on the magnitude of the individual elements.

- (1) $S_2 + a_2 \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_1 + a_1$
- (2) $S_2 + a_2 \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_1 + a_1$
- (3) $[P / (P + E)] (E + S_1 + a_1 + b_1) \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_2 + a_2 \leq S_1 + a_1$
- (4) $[P / (P + E)] (E + S_2 + a_2 + b_2) \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_2 + a_2 \leq S_1 + a_1$
- (5) $[P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_2 + a_2 \leq S_1 + a_1 \leq [P / (P + E)] (E + S_2 + a_2 + b_2)$
- (6) $[P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_2 + a_2 \leq S_1 + a_1 \leq [P / (P + E)] (E + S_1 + a_1 + b_1)$
- (7) $[P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_2 + a_2 \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_1 + a_1$
- (8) $[P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_2 + a_2 \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_1 + a_1$
- (9) $S_1 + a_1 \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_2 + a_2$
- (10) $S_1 + a_1 \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_2 + a_2$
- (11) $[P / (P + E)] (E + S_1 + a_1 + b_1) \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_1 + a_1 \leq S_2 + a_2$
- (12) $[P / (P + E)] (E + S_2 + a_2 + b_2) \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_1 + a_1 \leq S_2 + a_2$
- (13) $[P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_1 + a_1 \leq S_2 + a_2 \leq [P / (P + E)] (E + S_2 + a_2 + b_2)$
- (14) $[P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_1 + a_1 \leq S_2 + a_2 \leq [P / (P + E)] (E + S_1 + a_1 + b_1)$
- (15) $[P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_1 + a_1 \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_2 + a_2$
- (16) $[P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_1 + a_1 \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_2 + a_2$
- (17) $S_2 + a_2 \leq [P / (P + E)] (E + S_1 + a_1 + b_1) \leq S_1 + a_1 \leq [P / (P + E)] (E + S_2 + a_2 + b_2)$
- (18) $S_2 + a_2 \leq [P / (P + E)] (E + S_2 + a_2 + b_2) \leq S_1 + a_1 \leq [P / (P + E)] (E + S_1 + a_1 + b_1)$



$$(19) S_1 + a_1 \leq [P / (P+E)] (E + S_1 + a_1 + b_1) \leq S_2 + a_2 \leq [P / (P+E)] (E + S_2 + a_2 + b_2)$$

$$(20) S_1 + a_1 \leq [P / (P+E)] (E + S_2 + a_2 + b_2) \leq S_2 + a_2 \leq [P / (P+E)] (E + S_1 + a_1 + b_1)$$

$$(21) S_2 + a_2 \leq S_1 + a_1 \leq [P / (P+E)] (E + S_1 + a_1 + b_1) \leq [P / (P+E)] (E + S_2 + a_2 + b_2)$$

$$(22) S_2 + a_2 \leq S_1 + a_1 \leq [P / (P+E)] (E + S_2 + a_2 + b_2) \leq [P / (P+E)] (E + S_1 + a_1 + b_1)$$

$$(23) S_1 + a_1 \leq S_2 + a_2 \leq [P / (P+E)] (E + S_1 + a_1 + b_1) \leq [P / (P+E)] (E + S_2 + a_2 + b_2)$$

$$(24) S_1 + a_1 \leq S_2 + a_2 \leq [P / (P+E)] (E + S_2 + a_2 + b_2) \leq [P / (P+E)] (E + S_1 + a_1 + b_1)$$

No investment would be made in either period in cases (3), (4), (8), (11), (12), and (15). Investment would be made in period one in cases (6), (9), (10), (14), (16), (18), (19), (20), (21), (22), (23), and (24). Investment would be postponed until period two in cases (1), (2), (5), (7), (13), and (17).

Myers and Majluf's assumption does not hold whether the amount of slack is held constant or allowed to vary from period to period.

An illustration of case 13, where $S_1 < S_2$, $a_1 < a_2$, and $b_1 > b_2$, provides some insight into the problem. Consider a two-period model using the framework and numbers for period 1 from the one-period illustration above.

Asset in Place	State 1	State 2
Period 1	150	50
Period 2	155	53

Project (NPV > 0)	State 1	State 2
Period 1	20	10
Period 2	18	8



Note that the project becomes stale, $b_{11} > b_{21}$ and $b_{12} > b_{22}$, and the value of the asset in place increases in value as a result of economic conditions such as increased market share. Assume that $S_1=10$, as in the one-period illustration and that $S_2=15$, as a result of an increase in market value of the marketable securities held as slack. $I_1=200$ and $I_2=202$ as a result of increased costs. The amount of equity needed to be issued is

$$E_1 = I_1 - S_1 = 200 - 10 = 190, \text{ and}$$

$$E_2 = I_2 - S_2 = 202 - 15 = 187.$$

Therefore,

$$P_1 = S_1 + \bar{A}_1 + \bar{B}_1 = 10 + 100 + 15 = 125, \text{ and}$$

$$P_2 = S_2 + \bar{A}_2 + \bar{B}_2 = 15 + 104 + 13 = 132.$$

In period 2, if state 1 occurs, old shareholders' aliquot share of the corporation's value, V_{21} , computed as

$$E_2 + S_2 + a_{21} + b_{21} = 187 + 15 + 155 + 18 = 375$$

is

$$[P_2 / (P_2 + E_2)] \cdot V_{21} = [132 / (132 + 187)] \cdot 375 = 155.17.$$

If state 2 occurs in period 2, old shareholders' aliquot share of the value of the corporation, V_{22} , computed as

$$E_2 + S_2 + a_{22} + b_{22} = 187 + 15 + 53 + 8 = 263$$

is

$$[P_2 / (P_2 + E_2)] \cdot V_{22} = (132 / 319) \cdot 263 = 108.83.$$

The payoff matrix for old shareholders in period 1 is



Period 1 Payoffs to Old S/H	Issue & Invest (E=190)	Do Nothing (E=0)
State 1	146.83	150
State 2	103.17	50

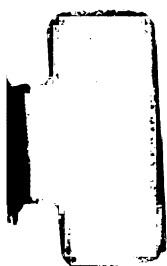
The payoff matrix for old shareholders in period 2 is

Period 2 Payoffs to Old S/H	Issue & Invest (E=187)	Do Nothing (E=0)
State 1	155.17	155
State 2	108.83	53

Recall from the one-period model that managers did not issue and invest in the first period. The optimal strategy in this case of the two-period model is not to issue and invest in period 1 if state 1 occurs but to issue and invest if state 2 occurs. Since this signals investors that state 2 occurred, the payoffs were adjusted downward, and, consequently, managers did not issue and invest regardless of state.

In period 2, the optimal strategy is to invest regardless of which state occurs. However, if investors believe that managers are following the same strategy as in period 1, the payoff matrix is adjusted as follows:

Period 2 Payoffs to Old S/H	Issue & Invest (E=187)	Do Nothing (E=0)
State 1	--	155
State 2	26	---



This adjustment results in a market value of

$$P_2 = 15 + \frac{1}{2}(155) + \frac{1}{2}(26) = 105.5$$

whereas the ex ante value of the corporation is \$132. This represents a loss of \$26.50 because of the misleading signal of period 1 strategy when in fact the same strategy is not being employed in both periods. Because of the false signal managers should not issue and invest if operating in the best interests of the old shareholders.

If investors know managers' strategy in both periods, no information is conveyed by issuing and investing in period 2 because managers will issue and invest in period 2 regardless of which state occurs. The ex ante value of \$132 is not affected. In this case, with full disclosure of managers' strategy, managers should issue and invest because the old shareholders' stock value is not affected.

This set of circumstances raises the question of whether or not any reliable information can be consistently signalled in both periods. Extension of Myers and Majluf's model to a two-period model undercuts their equilibrium solution based on the issue and invest signal. If the signal is not reliable from period to period or conveys no information, no equilibrium solution can be determined and the only reliable value is the ex ante market value at $t=0$.

One solution may be to couple the assumption that managers act in the best interest of the old shareholders with a condition that the stock be overvalued in the market. In this case, no investment would be made in period 1 acting

in the best interest of the old shareholders, and no investment would be made in period 2 unless state 2 occurred in which event the stock is overvalued. Investors knowing this strategy would place a value of \$105.50 on the old shareholders' stock if managers issued and invested instead of the true value of \$108.83; consequently, managers would not issue and invest in period 2 either.

Even in a two period model, the basic problem remains. Managers acting in the best interest of the old shareholders may forgo investment in positive net present value projects if the old shareholders' aliquot share of the firm value with investment is less than the value of the firm without investment. Because the signal may not be consistent from period to period or convey no information, the asymmetric information aspect of the problem remains to be solved by other means.

Pure financial solutions are discussed in Chapter II which is a review of the relevant finance literature attempting to solve the Myers and Majluf model problem. None of the financial solutions is a satisfactory solution to the problem. Something is missing from the model. One important missing element is the legal environment. Several possible solutions to the problem utilizing both legal and financial aspects are presented in Chapter III. Chapter IV discusses the spin-off and equity carve out solution with particular attention to asymmetric information. An analysis of the assumption that managers act in the best interests of

the old shareholders is presented in Appendix A. Appendix B discusses the merger and tender offer solution with particular attention to the asymmetric information problem. Chapter V presents empirical evidence of efficacy of the spin-off solution. The dissertation concludes in Chapter VI.

II. Literature Review

The existence or assumption of asymmetric information lies at the heart of much of the related work. One of the early papers addressing this issue is by Akerlof¹ (1970) who addressed the problem of buying a 'lemon' when buyers cannot verify the quality of the product being sold. Because buyers cannot verify the quality of the product, they demand a discount. The result is that sellers with a high quality product will not enter the market at a discount leaving only sellers of a low quality product in the market. The market breaks down when both buyers and sellers of a high quality product avoid the market. As Myers and Majluf (1984) point out, the difference between their paper and Akerlof's is that the seller is not offering a single good but a partial claim in two different goods--the asset in place and the project.

Myers² in a precursor of Myers and Majluf (1984) examined the question presented by the existence of the tax shield that if corporate borrowing is so beneficial why do firms not have 100 percent debt in their capital structure. The value of a corporation consists of the sum of the market values of the assets in place and the present value of future growth opportunities. Myers treats the future growth

¹ G.A. Akerlof, The Market for 'lemons': Quality and the Market Mechanism, QUARTERLY J. OF ECONOMICS 84, 488-500 (1970).

² S.C. Myers, Determinants of Corporate Borrowing, J. OF FINANCIAL ECONOMICS 5, 147-175 (1977).

opportunities as call options to make future investments. The ultimate value of the firm depends on further discretionary investment by the firm. He assumes that managers act in the best interest of the shareholders and that capital markets are perfect and complete. Risky debt is issued only for investment not held as cash or used to purchase other assets. The firm value is maximized by borrowing less than the maximum amount of debt that the firm can support. Consequently, corporate debt in excess of the optimal amount can reduce the value of the firm. There is no incentive to finance all good future investments with debt in excess of the optimal amount. Positive net present value projects are not undertaken, and the value of the firm is not maximized. The suboptimal investment policy is an agency cost induced by the risky debt. He speculates that projects spoil because they may be firm specific, generated by experience curves, learning by doing, or other similar phenomena. This may be the basis for utilizing a one period model in Myers and Majluf (1984).

Another article based on asymmetry of information is by Leland and Pyle.³ They assert that investment in projects may not be undertaken for lack of venture capital if information can not be conveyed costlessly and effectively. Good quality projects will not be financed unless

³ H. Leland and D. Pyle, Information Asymmetries, Financial Structure and Financial Intermediaries, J. OF FINANCE 32, 371-387 (1977) [Hereinafter referred to as Leland and Pyle (1977)].



information can be conveyed indirectly. The signal to the market is the willingness of the entrepreneur with inside information to invest. The higher the percentage that the entrepreneur is willing to invest in the project the higher the quality of the project. Hence, the value of the firm increases with the percentage of the firm held by insiders. This creates welfare costs since insiders hold a greater percentage of the firm than they would otherwise hold without asymmetry of information. The drawbacks of this paper are that they assume that the investment decision already has been made, the only resource of the firm is an asset in place, and there is a single signal on which the equilibrium price is determined. Further, it is not geared toward widely-held, public corporations where insiders hold insignificant amounts of common stock.

Stiglitz and Weiss⁴ provide an economic underpinning for nonclearing markets based on information asymmetry. They show that in equilibrium a loan market may be characterized by credit rationing. The inability of banks to identify 'good' borrowers results in screening devices such as interest rates being utilized. High interest rates induce firms to undertake projects with lower probabilities of success but higher payoffs when successful. At the equilibrium interest rate which maximizes the bank's

⁴ J.E. Stiglitz and A. Weiss, Credit Rationing in Markets with Imperfect Information, AMERICAN ECONOMIC REVIEW Part I, 71, 393-410 (1981).



expected return supply of funds does not equal demand. A higher interest rate needed to clear the market would result in a lower rate of return to the bank; hence, there is no incentive for banks to continue to loan money even at higher rates so credit is rationed.

Miller and Rock⁵ develop a signalling model based on net dividends. There are significant announcement effects which result from asymmetry of information. An unexpected increase in dividends is interpreted by the market as good news concerning future prospects of the firm. An unexpected decrease in dividends is interpreted as bad news. The important part of the paper here is that Miller and Rock show that earnings, dividend, and financing announcements are closely related. Because of the net dividend concept the financing announcement effect is the dividend announcement effect with the sign reversed.

Brennan and Kraus⁶ assert that the Myers and Majluf (1984) problem can be solved costlessly by an appropriate choice of financing strategy that signals the real prospects of the firm. They derive the attributes that the securities must have to be able to costlessly signal the market. They also claim that if an equity issue is used to refund debt in addition to financing the project that the market value of

⁵ M.H. Miller and K. Rock, Dividend Policy under Asymmetric Information, J. OF FINANCE 40, 1031-1051 (1985).

⁶ M. Brennan and A. Kraus, Efficient Financing under Asymmetric Information, J. OF FINANCE 42, 1225-1243 (1987).



the firm drops less than when equity is issued solely to finance the project. Their results are restricted and require a certain compatibility between the nature of the information asymmetry and the set of financing strategies available which in turn may rely on the pre-existing capital structure of the firm.

Bradford⁷ makes a one period model extension of Leland and Pyle (1977). Here the firm has common stock outstanding and an existing asset. The firm is considering issuing new stock and investing in another asset. There are two signals, the decision to invest and the percentage of the issue purchased by insiders. Unlike Myers and Majluf, Bradford lets insiders trade at the issue price. He asserts that insiders will buy or sell common stock if the capital gain from the trade is greater than the cost of the trade. Equilibrium occurs when insiders can no longer gain from an incremental transaction. The market then uses the information observed to form a pooling equilibrium price for the common stock. The market value is higher when insiders can trade both before and after the announcement than if they are prohibited from trading. The share price of a manager-owner may increase, decrease, or not change with the announcement of a new issue. Leland and Pyle (1977) and Bradford deal only with firms where insiders can trade in or

⁷ W.D. Bradford, The Issue Decision of Manager-Owners under Asymmetric Information, J. OF FINANCE 42, 1245-1260 (1987).



hold substantial portions of the firm's equity. Their analysis does not apply to the widely-held, public corporation where managers own a *de minimis* amount of the firm's outstanding equity or situations where insider trading would be prohibited under the securities laws.



III. Possible Solutions

There are two aspects to the problem--asymmetric information and managers acting in the best interest of the old shareholders. Solutions to either part solve the entire problem. If managers act in the best interest of the corporation rather than in the interests of the old shareholders, they will maximize the value of the corporation by taking advantage of all positive, net present value opportunities. On the other hand, if the market had the same information as managers, the stock would be fairly priced reflecting the true value of the corporation and there would be no short term price depression disadvantageous to the old shareholders.

It is the assumption that managers act in the best interests of the old shareholders that makes the financing decision matter. Myers and Majluf (1984) present three possible assumptions about managerial behavior:

- (1) Management acts in the interests of *all* shareholders, and ignores any conflict of interest between old and new shareholders.
- (2) Management acts in old shareholders' interest and assumes they are *passive*.
- (3) Management acts in old shareholders' interest, but assumes they rationally *rebalance* their portfolios as they learn from the firm's actions.

It is generally assumed that managers act in the best interest of the old shareholders because that is what is

taught in financial theory to would be managers and what the law demanded. The law and financial theory, however, have diverged so that it may no longer be assumed that managers act or should act in the best interest of the old shareholders. Indeed, the law may require them to do otherwise. Two of the three possible assumptions about managerial behavior concern the old shareholders. Myers and Majluf chose assumption number (2) because it offered the best explanation as to why stock prices fall on an announcement of a new equity issue and why debt issues have a lesser impact on stock prices and because they assert that they "cannot judge the assumption's realism." The assumption's realism may be tested by examining case law involving breaches of fiduciary duty and the business judgment rule.

Unfortunately, an examination of the assumption or belief that managers act in the best interest of the old shareholders in the context of the legal environment does not provide a satisfactory solution to the problem. The issue is whether or not the assumption has any basis in the law. The law and financial theory have diverged or are diverging on this issue. Since the law, particularly the case law, is a mirror of reality, if the law does not support this assumption, it is unjustified. There is a conflict between finance theory and law on this issue. Managers are under a legal obligation to act in the best interest of the corporation even if it is to the detriment



of the shareholders. Of course, managers could be ignorant of the legal requirement or actually be knowingly in violation. In either event, the problem remains. If managers do act in the best interests of the old shareholders, what remedy is there? In the first instance, the law relies on the old shareholders to compel managerial compliance with the law through elections of directors, derivative suits, and proxy fights. Election of directors and the derivative suit are purely legal remedies while the proxy fight is both a finance and legal remedy. It can hardly be expected, however, that the old shareholders would use any of these remedies to act against their own short-term best interests. Consequently, the law must rely on outsiders to protect the corporation's best interest

An outsider who knows or suspects that a corporation has unused positive net present value projects that would increase the value of the corporation may acquire stock in the corporation and then bring a shareholder derivative suit to force the directors to invest and maximize the value of the corporation. A shareholder's derivative suit is an action by a shareholder in behalf of the corporation. The purpose of the derivative suit is to prevent abuse of directors' authority by providing a mechanism whereby a shareholder may sue on behalf of the corporation when the directors refuse to pursue the corporation's legal rights. The business judgment rule, however, is a major obstacle to shareholder derivative suits.

Proxy fights may be evidence that managers forgo positive net present value projects and that some shareholders, outsiders, believe that the corporation would be worth more if new managers were installed who would invest in these opportunities. Dodd and Warner¹ found that there is significant price appreciation associated with proxy contests consistent with the improved management hypothesis. The Dodd and Warner findings are consistent with the hypothesis here that managers often forgo positive net present value opportunities and underinvest resulting in a suboptimal value of the corporation. Outsiders undertaking proxy contests know or suspect that such opportunities exist and attempt to obtain control and take advantage of these unfinanced opportunities increasing the value of firm. This can account for market price appreciation in anticipation of such increase in value.

If managers do in fact act in the best interests of the old shareholders and thereby fail to maximize the value of the corporation by forgoing positive net present value projects, the law of corporate governance currently does not provide an effective solution to the problem. Effective remedies must be sought in the marketplace. A leveraged buyout or going private transaction, merger, tender offer, spin-off, or equity carve out offers such a solution. A

¹ Dodd, P. and J. B. Warner, On Corporate Governance: A Study of Proxy Contests, J. OF FINANCIAL ECONOMICS 11, 401-438 (1983).



complete discussion of the assumption of acting in the interest of the old shareholders in the context of the legal environment is contained in Appendix A.

The primary approach to solving the problem of forgone corporate opportunities is to solve the asymmetric information problem. There are several legal and finance avenues that could be explored. Among them are leveraged buyouts or going private transactions, mergers and tender offers, and spin-offs and equity carve outs. First, there is a brief description of avenues that are not directly followed. Finally, the selected avenue is briefly discussed, and the rationale for choosing it provided.

Asymmetric information in the legal environment is controlled in large part by state and federal securities laws. Asymmetric information exists in the main to protect the firm's proprietary interest in the project. Disclosure to competitors could prove fatal. Full disclosure is only required under certain circumstances which acknowledges the corporation's right to maintain the confidentiality of proprietary information. Potential solutions to the problem such as a leveraged buyout or going private transaction, merger, spin off, equity carve out, or tender offer are affected by state corporation law and federal and state securities law. These effects and what that tells us about the asymmetric information problem are examined.

Managers who do not maximize the value of the firm may find themselves as targets of takeovers. If the acquiring

corporation had sufficient slack or debt capacity to finance shelved positive net present value projects, a merger or other type of acquisition would increase the value of the combined firms. However, the asymmetric information problem still exists. How would a corporate raider know that managers have unfinanced positive net present value projects available? Some signaling mechanism would have to be employed so that slack poor firms could signal slack rich firms that they have positive net present value projects shelved. A full discussion of takeovers as a solution to the problem is contained in Appendix B.

A leveraged buyout or going private transaction solves the asymmetric information problem. A leveraged buyout or going private transaction involves the purchase of the entire public stock issue of a corporation by its management. Since management has the information advantage in the first instance, a leveraged buyout or going private transaction does not depend on asymmetric information. Hypothetically, managers may acquire the firm in a leveraged buyout or going private transaction to avoid the conflict with the old shareholders over issuing new equity to finance positive net present value projects. Having acquired the corporation, managers will then finance the forgone positive net present value opportunities and increase the value of the corporation. This hypothesis is consistent with empirical studies of announcement effects of leveraged buyouts and going private transactions. DeAngelo, DeAngelo,



and Rice² reported highly significant two-day abnormal stock returns of 22.4 percent around the announcement date. The study indicates that there is under-investment in firms subject to a leveraged buyout or going private transaction. The leveraged buyout or going private transaction is not pursued as a solution beyond this because as a result of the leveraged buyout or going private transaction the firm is no longer a publicly held corporation subject to the securities laws and is no longer traded in the market and is, therefore, unobservable.

If a firm has positive net present value projects which managers decide not to finance because of the effect on old shareholders, some projects may be spun-off or carved out and offered to investors without regard to the interests of the old shareholders. Offering such projects as spin-offs may signal the market that they are positive net present value projects. Empirical studies by Miles and Rosenfeld (1983),³ Schipper and Smith (1983),⁴ Hite and Owers (1983),⁵

² DeAngelo, H., L. DeAngelo, and E. Rice, Going Private: Minority Freezeouts and Stockholder Wealth, J. OF LAW AND ECONOMICS 27, 367-401 (1984).

³ Miles, J. A. and J. D. Rosenfeld, The Effect of Voluntary Spin-off Announcements on Shareholder Wealth, J. OF FINANCE 38, 1597-1606 (1983).

⁴ Schipper, K. and A. Smith, Effects of Recontracting on Shareholder Wealth, J. of FINANCIAL ECONOMICS 12, 437-467 (1983).

⁵ Hite, G. L. and J. E. Owers, Security Price Reactions Around Corporate Spin-off Announcements, J. OF FINANCIAL ECONOMICS 12, 409-436 (1983).

Copeland, Lemgruber, and Mayers (1986),⁶ and Schipper and Smith (1986)⁷ all found significant positive price effects around a spin-off or equity carve out announcement date. When compared to the significantly negative price effects surrounding a seasoned equity issue announcement, it appears that the market views either a spin-off or equity carve out as a positive event. The results of these studies are consistent with the hypothesis offered here. The presence of unfinanced, positive net present value projects means that the value of the corporation is not maximized. Managers who want to maximize the value of the firm without depressing the market price of the stock by issuing new equity to finance the projects can spin-off the project or projects or carve them out. The result is an increase in value of the firm. A spin-off or equity carve out is arguably in the best interest of the old shareholders.

A spin-off or equity carve out may not be a viable solution under all sets of circumstances. The particular circumstances of the project and firm must be carefully considered before a spin-off or equity carve out is undertaken. For example, projects that require heavy capital investment may not be amenable to spin-offs or

⁶ Copeland, T. E., E. F. Lemgruber, and D. Mayers, Corporate Spin-offs: Multiple Announcement and Ex-date Abnormal Performance in Copeland, ed., MODERN FINANCE AND INDUSTRIAL ECONOMICS, Chapter 7 (1987).

⁷ Schipper, K. and A. Smith, A Comparison of Equity Carve Outs and Seasoned Equity Offerings, J. OF FINANCIAL ECONOMICS 15, 153-186 (1986).

equity carve outs. Likewise, projects that are part of a product mix or firm specific may not easily lend themselves to spin-offs or equity carve outs. Characteristics of firms likely to use the spin-off or equity carve out solutions are hypothesized, and empirical verification undertaken.

The rationale for studying mergers, spin-offs, and equity carve outs as solutions to the problem is that they are large capital investment decisions involving disclosure requirements of securities laws. Moreover, they are capable of being observed and are large enough in capital terms to react to. Consequently, spin-offs and equity carve outs are the solution pursued in this dissertation.

Chapter IV analyzes financial and legal aspects of the spin-off and equity carve out solution to the asymmetric information problem. Chapter V provides further empirical evidence of the efficacy of the spin-off solution. Chapter VI concludes and summarizes.



IV. Spin-off and Equity Carve Out Solutions

This chapter examines the spin-off and equity carve out solutions to the problem in terms of both financial and legal effects. A spin-off or equity carve out avoids having to issue new equity of the corporation to finance positive net present value projects which depresses the market value of the old shareholders' stock.

If a firm has positive net present value projects which managers decide not to finance with equity because of the effect on old shareholders' market value, some projects may be spun-off or carved out and offered to investors without regard to the interests of the old shareholders. Offering such projects as spin-offs or equity carve outs may signal the market that they are positive net present value projects. Empirical studies by Miles and Rosenfeld (1983),¹ Schipper and Smith (1983),² Hite and Owers (1983),³ Copeland, Lemgruber, and Mayers (1986),⁴ and Schipper and

¹ Miles, J. A. and J. D. Rosenfeld, The Effect of Voluntary Spin-off Announcements on Shareholder Wealth, J. OF FINANCE 38, 1597-1606 (1983).

² Schipper, K. and A. Smith, Effects of Recontracting on Shareholder Wealth, J. of FINANCIAL ECONOMICS 12, 437-467 (1983).

³ Hite, G. L. and J. E. Owers, Security Price Reactions Around Corporate Spin-off Announcements, J. OF FINANCIAL ECONOMICS 12, 409-436 (1983).

⁴ Copeland, T. E., E. F. Lemgruber, and D. Mayers, Corporate Spin-offs: Multiple Announcement and Ex-date Abnormal Performance in Copeland, ed., MODERN FINANCE AND INDUSTRIAL ECONOMICS, Chapter 7 (1987).



Smith (1986)⁵ all found significant positive price effects around a spin-off or equity carve out announcement date. When compared to the significantly negative price effects surrounding a seasoned equity issue announcement, it appears that the market views spin-offs and equity carve outs as positive events. The results of these studies are consistent with the hypothesis offered here. The presence of unfinanced, positive net present value projects means that the value of the corporation is not maximized. Managers who want to maximize the value of the firm without depressing the market price of the stock by issuing new equity to finance the projects can spin-off the project or projects or carve them out. The result is an increase in value of the firm and the old shareholders' interest.

A. Financial

In a spin-off, the original corporation generally creates a new corporate entity, although an existing corporation may be used, to which it transfers part of the assets of the original corporation in exchange for the stock of the newly-created corporation. The newly-created corporation's stock is distributed to the shareholders of the original corporation. The stock distribution is essentially a stock dividend to the old shareholders. The spin-off may be a tax free 'D' reorganization if it meets

⁵ Schipper, K. and A. Smith, A Comparison of Equity Carve Outs and Seasoned Equity Offerings, J. OF FINANCIAL ECONOMICS 15, 153-186 (1986).

the requirements of section 368(a)(1)(D) of the Internal Revenue Code of 1986. Since government tax policy favors 'D' reorganizations, spin-offs may be the preferred solution when taxes are considered; however, tax consequences are ignored for purposes of this discussion.

A divestiture involves the sale of a portion of the assets of a corporation to a third party in exchange for cash or other consideration. Typically, the third party is an existing firm or corporation that will utilize the acquired assets in its operation or create a new division. The particular type of divestiture of interest here is the equity carve out in which a part of the original corporation is sold to outsiders through an equity offering. Part of the assets of the original corporation are transferred to a wholly owned subsidiary either newly-created or existing. The stock of the subsidiary is sold to outsiders. In an equity carve out the old shareholders of the original corporation no longer have an interest in the subsidiary. The difference between a spin-off and equity carve out with respect to the old shareholders is that in a spin-off the old shareholders hold stock in both the original corporation and the subsidiary while in an equity carve out the old shareholders hold stock only in the original corporation.

The motivation for a spin-off or equity carve out is to separate the original corporation's assets. Separation of assets may be desirable to separate profitable from unprofitable assets or operations, to separate incompatible

divisions, to focus the market's attention on the individual assets rather than the aggregate, to defend against a hostile takeover bid, or to dispose of assets that cannot otherwise be sold at an adequate price. A spin-off or equity carve out may not be desirable if there is a symbiotic relationship between the assets, divisions, or operations. For example, if the original corporation's divisions are capital intensive it might not be cost effective to duplicate the capital expenditure necessary to make the subsidiary viable on its own. A spin-off or equity carve out may be indicative of inefficient or inexperienced management. Management may not be capable of managing a large operation or multiple divisions but quite capable of managing a smaller operation. The project to be spun-off or carved out may be outside the expertise of existing management and better left to new management with the requisite expertise.

State corporation law governs the procedure for accomplishing the spin-off or equity carve out. Initially, the board of directors must decide to spin-off or carve out the assets or projects. If the spin-off or equity carve out constitutes a sale or exchange of all or substantially all the assets other than in the usual and regular course of business, shareholder approval may be required. What constitutes all or substantially all the assets is subject to both quantitative and qualitative analysis. The way the model is set up in this dissertation the issue would turn on

the relative sizes of a and b.

Miles and Rosenfeld⁶ suggested that a voluntary spin-off announcement could increase the value of the original corporation (1) by eliminating negative synergies affecting future cash flows, (2) by expanding the opportunity set available to investors and providing more choice between dividends and capital gains, and (3) by a wealth transfer from bondholders to stockholders. They studied 55 spin-off announcements from 1963 through 1980 using a mean-adjusted returns technique and found significant positive abnormal returns immediately surrounding the announcement date. This finding is in contrast to generally negative abnormal returns preceding sell-off announcements.⁷ Although spin-offs and sell-offs are similar events producing similar results in terms of restructuring and positive price share effects following the announcement date, the period preceding the announcement date shows different effects. One explanation may be that although similar the underlying circumstances producing a spin-off or sell-off are quite different and, therefore, cannot be treated as equivalent transactions.

⁶ J.A. Miles and J.D. Rosenfeld, The Effect of Voluntary Spin-off Announcements on Shareholder Wealth, J. OF FINANCE 38, 1597-1606 (1983) [Hereinafter referred to as Miles and Rosenfeld (1983)].

⁷ See Masulis and Korwar, note 1 supra; Asquith and Mullins, note 2 supra; and Mikkelsen and Partch, note 4 supra.

Schipper and Smith⁸ investigated shareholder wealth effects of voluntary spin-offs from 1963 to 1981. They used a market model with a pre-event estimation period to estimate returns over a two day announcement period. Significantly positive abnormal returns consistent with Miles and Rosenfeld's findings were found. Unlike Miles and Rosenfeld, they found no abnormal price behavior in the four months preceding the announcement date. There was virtually no evidence of wealth transfers between bondholders and shareholders. Moreover, they determined that one of the sources of the gains is increased productivity as a result of smaller size and diversity of assets under a single management lending credence to the inefficient management hypothesis for spin-offs.

In another 1983 article, Hite and Owers⁹ also found significant abnormal two day announcement period returns. However, their findings were not uniformly positive. They found evidence of positive price performance in the preannouncement period. Like Schipper and Smith (1983), they rejected the bondholder expropriation theory. An important part of this study for this dissertation is that

⁸ K. Schipper and A. Smith, Effects of Recontracting on Shareholder Wealth, J. OF FINANCIAL ECONOMICS 12, 187-221 (1983) [Hereinafter referred to as Schipper and Smith (1983)].

⁹ G.L. Hite and J.E. Owers, Security Price Reactions Around Corporate Spin-off Announcements, J. OF FINANCIAL ECONOMICS 12, 409-436 (1983) [Hereinafter referred to as Hite and Owers (1983)].

they divided their sample into four groups based on stated motivation for the spin-off. The four groups consisted of (1) spin-offs designed to facilitate mergers, (2) spin-offs based on specialization, (3) spin-offs used as a defensive tactic against regulators or antitrust authorities, and (4) a catchall group. The second subgroup where specialization was the stated motive for the spin-off had the largest excess returns. This is significant in terms of this dissertation's view of the spin-off announcement as a signal of the value of the unfinanced positive net present value project. Spinning-off the positive net present value project produces specialization. The original corporation continues with the asset in place, a, while the new subsidiary has the project, b.

Copeland, Lemgruber, and Mayers¹⁰ studied spin-offs and sought to correct for post-selection bias by selecting a sample based on announcements rather than completed spin-offs (11 percent were not completed). Their findings are consistent with other studies that there are significant positive announcement effects before and after the announcement date.

Schipper and Smith¹¹ also studied equity carve outs.

¹⁰ T.E. Copeland, E.F. Lemgruber, and D. Mayers, Corporate Spin-offs: Multiple Announcements and Ex-Date Abnormal Performance in MODERN FINANCE AND INDUSTRIAL ECONOMICS (T.E. Copeland ed.), Ch. 7 (1987).

¹¹ K. Schipper and A. Smith, A Comparison of Equity Carve Outs and Seasoned Equity Offerings, J. OF FINANCIAL ECONOMICS 12, 153-186 (1986) [Hereinafter referred to as

Their focus was a comparison of stock price reactions for issues of seasoned equities and equity carve outs. A market model with a pre-event estimation period was used.

Significant positive returns were found in equity carve outs over the five day announcement period which consisted of the five days immediately preceding the announcement date.

Seasoned equity issues showed the usual negative results over the five day announcement period. These negative results are explained as negative signals about future growth or profits and overvalued stock in the market.

Disclosed motives for equity carve outs are similar to motives given for spin-offs with one notable exception. An equity carve out may be used to finance growth of the subsidiary without adversely affecting the value of the original corporation's stock by issuing equity. Schipper and Smith found support for this hypothesis.

Schipper and Smith's 1986 article represents one solution to the asymmetric information problem described in Chapter I. An equity carve out for the purpose of financing growth of the newly-created subsidiary results in significant positive share price reactions. The announcement may have a signaling effect that overcomes part of the asymmetric information problem.

The announcement may signal that a positive net present value project exists and is being carved out, but it may not

Schipper and Smith (1986)].

convey any price information. Of the seventy-six carve out Wall Street Journal announcements in Schipper and Smith's (1986) sample thirty-seven were announcements of anticipated carve outs with varying amounts of information disclosed in the announcement while the remaining thirty-nine were announcements that the offering documents had been filed with the Securities and Exchange Commission, thirty-three of which announcements followed the filing date by one to three days. Material information concerning the project, its value, cash flows, etc. were already public information when the announcement was made. Assuming a semi-strong efficient market means that the public announcement carried little or no information content for the thirty-nine filed with the Securities and Exchange Commission. This may explain why Schipper and Smith's cumulative average prediction errors for the seventy-six carve out announcements leveled off in the post-announcement period (day -1 to day +40). All of the relevant material information had already been disseminated for more than one-half of their sample. This may also account for the sharp increase in cumulative average prediction errors in the immediate two day pre-announcement period rather than a sharp increase on the announcement date and immediate post-announcement period. Schipper and Smith did not divide their sample into those announcements made after SEC filing and anticipation announcements. Such a division would separate the signalling effect from the disclosure effect.

All of the above results are consistent with the hypothesis presented in this dissertation. Managers faced with having to forgo positive net present value projects in the interest of the old shareholders may take advantage of these opportunities by spinning-off or carving out the projects. The result of which is an increase in the value of the corporation and in the old shareholders' wealth.

A spin-off results in the old shareholders holding stock in both the original corporation and the subsidiary. The value of the original corporation's stock is the sum of the amount of slack retained, S_o , and the updated estimated value of the asset in place, a . $V_o = S_o + a$. The value of the subsidiary's stock is the sum of the amount of slack transferred to the subsidiary, S_b , and at a minimum the expected value of the project which is known to the market, $\bar{B}$. $V_b = S_b + \bar{B}$. In the aggregate, the minimum value of the old shareholders' stock in both the original corporation and the subsidiary equals the sum of the values.

$$V = V_o + V_b = S_o + S_b + a + \bar{B} = S + a + \bar{B}.$$

With full disclosure, $V = S + a + b$.

In an equity carve out, the old shareholders hold stock only in the original corporation. The value of the stock of the original corporation is equal to the amount of slack retained in the original corporation plus the value of the asset in place plus the cash or other consideration received for the stock of the subsidiary. At a minimum, the value of the stock of the subsidiary is equal to the sum of the

amount of slack transferred to the subsidiary and the expected value of the project.

Hence, at a minimum

$$V = V_0 + V_1 = S_0 + a + S_1 + \bar{B} = S + a + \bar{B}.$$

Old shareholders are better off by either spinning-off the project or carving out the project since without the spin-off or carve out the old shareholders have value of $S+a$.

With the spin-off or carve out they have at least

$S+a+\bar{B} > S+a$. In the case of full disclosure, $V = S+a+b$, old shareholders receive the true value of the original corporation.

Because of the announcement effect, the value of the subsidiary's stock, V_1 , in the hands of the old shareholders or third party outsiders is greater than the amount of slack transferred plus the expected value of the positive net present value project. $V_1 > S_1 + \bar{B}$. If the updated estimated value of the project were known to the market through disclosure documents filed with the Securities and Exchange Commission, the market price of the subsidiary's stock on issue should be close to $S_1 + b$.

Given the fact that the announcement signal's value may be limited by prior disclosure in filings with the Securities and Exchange Commission the disclosure requirements of the Securities Act of 1933 take on added significance. The disclosure requirements for an initial public offering of the stock of the newly-created subsidiary whether created for a spin-off or equity carve out provide

an incentive for truthful disclosure and contribute to the solution of the asymmetric information problem by providing the updated estimate of the positive net present value project.

B. Public Offerings of Securities

1. Federal Regulation

a. Registration

The Securities Act of 1933 regulates the registration and initial sale of securities by an issuer. The primary purpose of the act is to provide full disclosure of all material facts so that the investor may make an informed decision concerning the investment. Registration is a time-consuming, expensive, and complex task not to be undertaken lightly. Nonetheless, registration costs will be ignored for purposes of this chapter.

The thrust of the Securities Act of 1933 is to provide the ordinary investor with all relevant and material facts necessary to make an informed investment decision. Hence, registration is a disclosure process designed to elicit that information for the benefit of the investor. Unlike many state securities commissions, the United States Securities and Exchange Commission does not pass on the worth or desirability of a particular issue.

The registration statement is really two documents: The prospectus is the selling document provided to all potential purchasers, and Part II contains other information and exhibits not furnished to potential purchasers but kept

on file by the commission and made available for public inspection. Section 7¹² of the Securities Act of 1933 prescribes the information that must be included in the prospectus.

Registration is accomplished by filing one of the prescribed forms. Form S-1 is the basic form required for registration when no other form is prescribed or authorized. Form S-1 requires the greatest degree of disclosure of all registration forms primarily because the users of form S-1 have little or no previous contact with the Securities and Exchange Commission.

In 1979, the commission adopted a new form S-18, for use by small issuers. The disclosure requirements are essentially the same as for form S-1 except that the format is simpler and it is not keyed to regulation S-K¹³ which regulates disclosure requirements under both the Securities Act of 1933 and the Securities Exchange Act of 1934. Form S-18 could be used only by issuers who were not registered under the Securities Exchange Act of 1934 and only for cash offerings or \$7.5 million or less. Form S-18 was filed at the nearest commission regional office rather than with the commission in Washington, D.C. In 1992, the Securities and Exchange Commission adopted Regulation S-B which removed the \$7.5 million limit on small business issues. Form SB-2

¹² 15 U.S.C. § 77g (1988).

¹³ 17 C.F.R. Part 229 (1991).

replaces and is patterned after Form S-18.

In addition to the forms and instructions contained within it, regulation C, which consists of rules 400-499,¹⁴ provides registration procedures and general forms.

One of the more important sections of the registration statement is Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A).¹⁵ This section has become even more important given the recent heavy emphasis on it by the Securities and Exchange Commission. The MD&A requirements changed dramatically in 1989. The contents and explanation of the MD&A are found in Item 303 of regulation S-K and Release No. 33-6835.¹⁶ Since 1989 in several studies of MD&A's of 500 companies, the commission found noncompliance in almost every case. Release No. 33-6835 in part says that the

MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company. The Item asks management to discuss the dynamics of the business and to analyze the financials.¹⁷

Its purpose is to help the investor make an informed judgment based on trends and future performance of the corporation. This section analyzes results of operations in

¹⁴ 17 C.F.R. §§ 230.400 - 230.499 (1991).

¹⁵ Item 303, Regulation S-K, 17 C.F.R. § 229.303 (1991).

¹⁶ 54 Fed. Reg. 22427 (May 25, 1989).

¹⁷ Id.

terms of historical events as well as trends which may be expected to continue into the future and affect future performance. The corporation's liquidity position (slack in terms of the model) and financial condition including capital resource commitments must be disclosed. Before 1989 forward looking information was encouraged but not mandated. After 1989 it is mandatory under the following test:

Where a trend, demand, commitment, event or uncertainty is known, management must make two assessments:

(1) Is the known trend, demand, commitment, event or uncertainty likely to come to fruition? If management determines that it is not reasonably likely to occur, no disclosure is required.

(2) If management cannot make that determination, it must evaluate objectively the consequences of the known trend, demand, commitment, event or uncertainty, on the assumption that it will come to fruition. Disclosure is then required unless management determines that a material effect on the registrant's financial condition or results of operations is not reasonably likely to occur.

Each final determination resulting from the assessments made by management must be objectively reasonable, viewed as of the time the determination is made.¹⁸

This certainly implies that management's inside information concerning the updated estimated values of a and b would have to be disclosed in the MD&A section of the registration statement.

Liquidity and capital resources must also be disclosed.

¹⁸ Release No. 33-6835, 54 Fed. Reg. 22427, n.27 (May 25, 1989).

Material commitments for capital resources at the end of the year, known plans or trends in acquisition or disposition of capital resources, changes in mix, changes in cost of capital resources must be disclosed. Amounts and certainty of cash flows over both short and long-term also must be disclosed. Hence, the amount of slack, S , and any expected or anticipated changes in slack would have to be disclosed. Moreover, the net present value of the project, b , must be disclosed since it represents a discounted projected cash flow.

Section 3(b)¹⁹ of the Securities Act gives the commission the authority to exempt certain securities from registration by rules and regulations provided that registration is not in the public interest or for the protection of the investor and that the aggregate amount of the issue is \$5 million or less. Small offerings are included in regulation D²⁰ along with private offerings.

Section 4²¹ of the act provides for transactional exemptions as opposed to providing an exemption for a class of securities. Section 4(2) exempts transactions by an issuer not involving any public offering. The bulk of private placements are with institutional investors, which is consistent with the policy underlying the section 4(2)

¹⁹ 15 U.S.C. § 77c(b) (1988).

²⁰ 17 C.F.R. §§ 230.501 - 230.508 (1991).

²¹ 15 U.S.C. § 77d (1988).

exemption. Registration is required to provide the ordinary investor with information he or she could not otherwise obtain; therefore, investors who have access to the same kind of information that registration would disclose and who are sophisticated investors do not require the protection of the Securities Act of 1933.

To facilitate private offerings, the Securities and Exchange Commission issued rule 146²² in 1974. Rule 146 was a safe harbor provision but was not the exclusive means by which a section 4(2) exemption could be obtained. Rule 146 was not workable; therefore, to simplify matters, rule 146 was repealed in 1982 and regulation D was adopted.²³

Regulation D consists of rules 501-508. No general solicitation or general offering is permitted under regulation D except for rule 504 offerings after 1992. Since the purchase of a security under regulation D is not pursuant to in a public offering, it cannot be resold without registration unless another exemption is available such as under section 4(1) or rule 144 pursuant to section 4(1).²⁴

Rule 504 allows an issuer that is not a reporting company under section 13²⁵ or 15(d)²⁶ of the Securities

²² 17 C.F.R. § 230.146 (1974).

²³ Regulation D also superseded Rules 240 and 242 under Section 3(b), Securities Act of 1933.

²⁴ 17 C.F.R. § 230.144 (1991).

²⁵ 15 U.S.C. § 77m (1988).

Exchange Act to sell an aggregate of \$1,000,000 of securities in any twelve-month period to any number of purchasers without providing any information to the purchasers. Any issuer except an investment company or company registered under the Securities Exchange Act of 1934 may use this exemption.

Rule 505 allows aggregate sales up to \$5 million in any twelve-month period to any number of accredited investors and up to thirty-five other purchases. An accredited investor is defined in rule 501 as:

1. Any bank, insurance company, investment company, or employee benefit plan
2. Any business development company
3. Any charitable or educational institution having assets of more than \$5 million
4. Any director, executive officer, or general partner of the issuer
5. Any natural person with a net worth individually or with a spouse of more than \$1 million
6. Any person with an annual income of more than \$200,000 in each of the two most recent years or had joint income with the spouse of more than \$300,000 in those years and reasonably expects to maintain that level of income in the current year.
7. Any trust with total assets in excess of \$5 million.
8. Any entity in which all the equity owners are accredited investors.

Rule 505 is not available to an investment company or an issuer disqualified from using regulation A by rule 252.²⁷ If there is a nonaccredited purchaser certain information required by rule 502 must be furnished to all purchasers.

²⁶ 15 U.S.C. § 78o(d) (1988).

²⁷ 17 C.F.R. § 230.252 (1991).

If the issuer is not registered under the Securities Exchange Act of 1934 (not subject to the reporting requirements of section 13 or 15(d)), (1) the same kind of information required in Part II of form 1-A if the offering amount is \$2 million or less, (2) the information required in Part I of form S-18 if the offering amount is between \$2 million and \$7.5 million, or (3) if the offering exceeds \$7.5 million, the information required in Part I of a registration statement on the form that the issuer is entitled to use must be provided. If the issuer is registered, (1) the most recent annual report to shareholders and proxy statement; (2) updated information from reports or documents filed with the commission since the distribution of the annual report or registration, a brief description of the securities being offered, the use of the proceeds, and any material changes in the issuer's affairs not otherwise disclosed; or (3) information from the last annual report on form 10-K to the commission or registration statement whichever is the more recent required to be filed must be provided.

Rule 506 provides that any issuer may sell an unlimited amount of securities to any number of accredited investors and up to 35 other purchasers if, prior to the sale, the issuer reasonably believes that each nonaccredited purchaser or his or her purchaser representative has such knowledge or experience in financial and business matters that he or she is capable of evaluating the merits and risks of the

prospective investment. The information required by rule 502 must be disclosed to nonaccredited purchasers.

Notices of sales pursuant to regulation D must be filed with the commission under rule 503. An issuer who restricts sales solely to accredited investors in an aggregate amount of \$5 million or less may take advantage of the section 4(6) exemption as an alternative to regulation D.

For business organizations that are local in nature and not proximate to a state line, the intrastate exemption is available. Section 3(a)(11)²⁸ provides for an exemption for securities offered or sold solely to residents of a single state or territory in which the issuer is a resident and is conducting business or, if the issuer is a corporation, in which the issuer is incorporated and is doing business. Intrastate offerings may make use of the mails or other interstate commerce facility. The exemption is not based on the jurisdictional requirements of the Securities Act of 1933.

The rationale for the intrastate exemption is local financing through local investment. The exemption is strictly construed according to its rationale, and an offer or sale to a single nonresident destroys the exemption for all.²⁹ The offering will remain exempt under the intrastate exemption if no resales are made to nonresidents for at

²⁸ 15 U.S.C. § 77c(a)(11) (1988).

²⁹ See, Preliminary Notes to Rule 147. 17 C.F.R. § 230.147 (1991).

least nine months after the initial distribution is completed.³⁰

Regulation A,³¹ which consists of rules 251 to 264, was promulgated under the authority of section 3(b) of the Securities Act of 1933. Regulation A, however, in practice is not an exemption but is rather a simplified registration process for small issues. Regulation A permits an issuer to offer a maximum of \$5 million and any other person to offer a maximum of \$100,000 of the securities during any twelve-month period.

The exemption may not be used by an issuer, underwriter, or other related person convicted of securities offenses, subjected to disciplinary action by the commission, or involved in certain other proceedings within specified periods of the issuance of the securities.

To use regulation A, an offering statement, Form 1-S, must be filed with the regional office of the commission where the issuer has its principal place of business. After 1992, issuers within limits may provide potential investors with pre-offering statements provided they contain certain required information. The Form 1-S, offering statement, was redesigned in 1992 as a question and answer document to simplify the procedure and reduce costs.

Even if the offering is exempt from registration some

³⁰ 17 C.F.R. §§ 230.147 (1991).

³¹ 17 C.F.R. §§ 230.251 - 230.264 (1991).

type of disclosure is required such as in regulation A or D. The information required to be disclosed includes the MD&A. Investors will know the values of S , a , and b , and, therefore, will be able to make an informed decision based on those values. The asymmetric information problem is resolved if managers make the requisite full disclosure. Failure to make the required disclosure may result in civil or criminal liability or both.

An initial public offering of the subsidiary's stock would not suffer the negative market reaction that a seasoned issue encounters.³² Registration of a subsidiary's stock in a spin-off or equity carve out is not as burdensome as registration of a seasoned issue of the corporation.³³ The amount of material that must be disclosed is reduced. Only the project is being transferred to the subsidiary so other inside, proprietary information need not be disclosed. In the model, only the value b need be disclosed not the updated estimate a . Moreover, the market reacts only to the

³² Empirical evidence shows that the aftermarket in an initial public offering is efficient. R. Ibbotson, Price Performance of Common Stock New Issues, J. OF FINANCIAL ECONOMICS 2, 235-272 (1975).

³³ This burden can be reduced by 'shelf' registration. In March 1982, the Securities and Exchange Commission adopted Rule 415 (17 C.F.R. § 230.415 (1991)) which increased the opportunities for shelf registration. Shelf registration allows the issuer to file a registration statement covering stock that can be issued over a two year period. Shelf registration avoids the delays involved in filing a registration statement for each new issue within the two year period. A disadvantage of shelf registration is that some of the information may be stale.

value b not the combined estimates of a and b . There is no chance of a reaction to ' a ' causing a mixed signal regarding valuation. Because only the project is being transferred to the subsidiary, the updated estimate b definitely is material information.

Assuming full disclosure the following consequences result. A spin-off results in the old shareholders holding stock in both the original corporation and the subsidiary. The value of the original corporation's stock is the sum of the amount of slack retained, S_a , and the updated estimated value of the asset in place, a . $V_o = S_a + a$. The value of the subsidiary's stock is the sum of the amount of slack transferred to the subsidiary, S_b , and the updated estimated value of the project, b . $V_s = S_b + b$. In the aggregate, the value of the old shareholders' stock in both the original corporation and the subsidiary equals the sum of the values.

$$V = V_o + V_s = S_a + S_b + a + b = S + a + b.$$

In an equity carve out, the old shareholders hold stock only in the original corporation. The value of the stock of the original corporation is equal to the amount of slack retained in the original corporation plus the updated estimate of the value of the asset in place plus the cash or other consideration received for the stock of the subsidiary. The value of the stock of the subsidiary is equal to the sum of the amount of slack transferred to the subsidiary and the updated estimated value of the project. Hence,

$$V=S_0+a+S_0+b=S+a+b.$$

Old shareholders are better off by either spinning-off the project or carving out the project because without the spin-off or carve out the value of the original corporation is $S+a$. Since b is a positive net present value project $S+a+b>S+a$.

b. Liability

Section 5³⁴ of the Securities Act of 1933 makes it unlawful to offer for sale or to sell in interstate commerce or through the mail, a security that is subject to the act unless a registration statement has been filed with the Securities and Exchange Commission or to sell unless a final prospectus has been provided to the purchaser of the security.

Section 12(1) of the Securities Act of 1933 provides an express private cause of action for damages by a purchaser against a seller who offers or sells a security in violation of section 5 or who makes an untrue statement of or omits a material fact by means of the prospectus or any oral communication. Liability under section 12(1) is absolute. Damages under section 12(1) are the amount of the purchase price less any income received on the securities, if the securities are still owned or the "out of pocket" rule if sold.

³⁴ 15 U.S.C. § 77e (1988).

Section 11³⁵ of the Securities Act of 1933 provides for civil liability for misstatements or omissions of material facts in the registration statement or prospectus. This liability extends to the issuer, underwriters, directors, every person who signed the registration statement, specialists or professionals who prepared or certified part of the registration statement, and controlling persons. Civil liabilities imposed under section 11 do not apply to regulation A offerings because of the exemption from registration under section 3(b); however, section 12(2)³⁶ liabilities may be imposed. To be a plaintiff, one must have acquired a registered security. No privity of contract is required.³⁷ The materiality test is the same one used for rule 10b-5 and section 14(e) of the Securities Exchange Act of 1934 and section 17 of the Securities Act of 1933.³⁸ Plaintiff need not prove reliance on the misstatement; however, defendant may assert as a defense that plaintiff knew that the statements were misleading at the time of the acquisition.³⁹ Neither is causation a requirement for a section 11 action; however, defendant may be able to reduce

³⁵ 15 U.S.C. § 77k (1988).

³⁶ 15 U.S.C. § 77l(2) (1988).

³⁷ Huddleston v. Herman & Maclean, 640 F.2d 534 (5th Cir. 1981).

³⁸ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976).

³⁹ Feit v. Leasco Data Processing Equipment Corp., 332 F.Supp. 544 (E.D.N.Y. 1971).

the amount of damages by proving that the loss was caused by something else. Neither scienter nor fraud is required to be proved. Defendants may also assert a due diligence defense. The amount of damages is the "out of pocket" rule, that is, the difference between the purchase price and the depreciated value resulting from the violation.⁴⁰ In no case may the amount of damages exceed the offering price.⁴¹

Section 12(2) is a general civil liability section that applies whether the securities are registered or not. A plaintiff must plead that the defendant knew or should have known of the misleading statement or omission at which point the burden of proof shifts to the defendant. Neither causation nor reliance need be proved. Section 12(2) provides for rescission to recover the purchase price plus interest less any income received if the security is still owned by the plaintiff. If the security is not still owned, plaintiff may sue to recover the purchase price less any income received and less the amount for which the security was sold which is the usual measure of damages.

Section 17 is a general antifraud provision which applies to the sale of any security whether it is required to be registered or not. Section 17 is similar to rule 10b-5 discussed in Chapter 5. The language of rule 10b-5 is

⁴⁰ Marbury Management, Inc. v. Kohn, 629 F.2d 705 (2d Cir. 1980), sub. nom. Wood Walker & Co. v. Marbury Management, Inc., cert. denied, 449 U.S. 1011 (1980).

⁴¹ Section 11(g), Securities Act of 1933, 15 U.S.C. § 77k (1988).

substantially the same as section 17 except that section 17 applies to offers and sales not purchases. There is precedent for implying a private civil cause of action for damages under section 17, thereby circumventing the more stringent requirements of sections 11 and 12 of the Securities Act of 1933 and section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.⁴² The United States Supreme Court has not ruled on this question, although it is highly unlikely that the present conservative court would find such a cause of action. The elements of a section 17 action are the same as for rule 10b-5 except that scienter may not be a requirement. The United States Supreme Court has ruled that in injunction suits that negligence is sufficient for actions under section 17(a)(2) and (3) making scienter only a requirement for section 17(a)(1).⁴³ Damages under an implied civil cause of action would follow the "out of pocket" rule.

Knowing the amount of damages that can be assessed for violation of sections 11, 12, and 17, the cost of lying, i.e., misstating a material fact or omitting a material fact on a registration statement or prospectus, can be calculated. Court costs, attorneys' fees, and other costs

⁴² Osborne v. Mallory, 86 F.Supp. 869 (S.D.N.Y. 1949); Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970). Contra, Dyer v. Eastern Trust and Banking Co., 336 F.Supp. 890 (D.Maine 1971); Gunter v. Hutcheson, 443 F.Supp. 42 (N.D.Ga. 1977).

⁴³ Aaron v. SEC, 446 U.S. 680 (1980)

are not considered. If the managers of the slack poor firm lie and inflate the value of the firm, the gain from lying is the difference between the inflated value, V_i , and the actual or true value, V_t . Based on the inside knowledge of the updated estimates of a and b , the actual or true value of the firm, V_t equals $S+a+b$. The cost of lying, if the purchaser already sold the stock, is the difference between the product of the probability of being caught, p , times the gain and the product of the probability of not being caught, $(1-p)$, times the gain.

$$\text{Cost of Lying} = p(V_i - V_t) - (1-p)(V_i - V_t).$$

Rearranged,

$$\text{Cost of Lying} = (2p-1)(V_i - V_t).$$

It pays to lie if the Cost of Lying is negative, i.e.,

$$(2p-1)(V_i - V_t) < 0.$$

Since $(V_i - V_t) > 0$, otherwise, the lie is not beneficial, it pays to lie if $(2p-1) < 0$ or $p < .5$.

There are no civil penalties assessed under the Securities Act of 1933.

If the purchaser still holds the stock and rescission is the remedy, the cost of lying is the probability of being caught times the purchase price which is the inflated value of the stock less the probability of not getting caught times the gain from lying. No income on the stock is assumed to have been received from the original corporation, nor is interest assessed.

$$\text{Cost of Lying} = pV_i - (1-p)(V_i - V_t).$$

Rearranged,

$$\text{Cost of Lying} = (2p-1)V_1 + (1-p)V_i < 0$$

which must be negative for lying to pay.

Let T be the total number of shares of the subsidiary sold and N_1 be the number of shares that purchasers sold and N_2 be the number of shares that purchasers retained. The total cost of lying is the sum of the prorated costs of lying calculated above.

$$\text{Cost of Lying} = (N_1/T) (2p-1) (V_1 - V_i) + (N_2/T) [(2p-1)V_1 + (1-p)V_i] < 0.$$

$$(N_1/T) (2p-1) (V_1 - V_i) + (N_2/T) [(2p-1)V_1 + (1-p)V_i] < 0$$

$$(N_1/T) (2p-1) (V_1 - V_i) + (N_2/T) [(2p-1)V_1 - (2p-1)V_i + pV_i] < 0$$

$$(N_1/T) (2p-1) (V_1 - V_i) + (N_2/T) [(2p-1)(V_1 - V_i) + pV_i] < 0$$

$$[(N_1/T) + (N_2/T)] (2p-1) (V_1 - V_i) + (N_2/T) pV_i < 0$$

$$(2p-1) (V_1 - V_i) + (N_2/T) pV_i < 0$$

$$[2(V_1 - V_i) + (N_2/T) V_i] p < (V_1 - V_i)$$

$$p < (V_1 - V_i) / [2(V_1 - V_i) + (N_2/T) V_i]$$

If $N_2=0$, all purchasers sold their shares, $p < .5$. If $N_2=1$, all purchasers retained their shares, $p < (V_1 - V_i) / (2V_1 - V_i)$. The upper bound is one-half, $p < .5$. The highest probability of getting caught that makes lying worthwhile is less than one-half.

Managers must determine their subjective assessment of the probability of being caught. If they believe that the probability of being caught is less than fifty percent, they have an incentive to misstate material facts or omit to state material facts, the values of S , a , and, b , in the registration statement or prospectus.

Knowing the cost of lying, the value of the firm, V , may be calculated. The value of the firm is equal to the false inflated value of the firm, V_1 , less the cost of lying.

$$V = V_1 - \text{cost of lying.}$$

$$V = V_1 - [(2p-1)(V_1 - V_i) + (N_2/T)pV_i].$$

$$V = 2(1-p)V_1 + [(2p-1) - (N_2/T)p]V_i.$$

An added incentive to tell the truth is the potential of a fine up to \$10,000 or imprisonment for five years or both for any person who willfully violates the act, its rules, or in a registration statement willfully makes an untrue statement of a material fact or omits to state a material fact required to be stated or necessary to make the statements made not misleading.⁴⁴

2. State Regulation

Part III of the Uniform Securities Act provides for registration of a security prior to offer or sale of the security. There are three alternative registration procedures: notification, coordination, and qualification.

Section 302 of the Uniform Securities Act provides for registration by notification. This is the simplest of the three registration procedures. To qualify for registration by notification, the issuer must (1) have been in continuous operation for at least five years; (2) not have defaulted in the payment of principal, interest, or dividends of any

⁴⁴ Section 24, Securities Act of 1933, 15 U.S.C. § 77x (1988).

security within the three fiscal years immediately preceding the registration; and (3) show an average earnings of at least five percent on its shares of common stock. A copy of the prospectus or other sales materials must accompany the registration form.

Coordination is available to an issuer who has filed a registration statement relating to the same offering with the Securities and Exchange Commission under the provisions of the Securities Act of 1933. Registration by coordination under section 303 is accomplished by filing the required number of copies of the federal prospectus with the state authorities.

Section 304 of the Uniform Securities Act provides for registration by qualification, which is to be used by issuers who do not qualify for notification or coordination. The filing requirements for registration by qualification are roughly similar to those for registration under the Securities Act of 1933. Registration by qualification is not effective until it is approved by the state authority.

Some states require certain documents to be filed even though the security is exempt. It appears that in many states, the exemption is not mandatory but is merely at the discretion of the state authorities. State reaction to the federal exemption for issues not involving a public offering under section 4(2) of the Securities Act of 1933 is not uniform and is uncertain after the adoption of regulation D. Some states adopted the language of section 4(2) of the

Securities Act of 1933 while other states substantially adopted rule 146 in addition to the statutory language of section 4(2). Other states merely coordinate their exemption with compliance with the federal requirements.

Under Sections 306(a)(2)(E) and (F), registration may be denied if the offering tends to work a fraud upon purchasers or if the underwriting compensation, promoter's profits, or options are unreasonable in amount. This represents a significant difference in philosophy between the federal securities laws and the states'. The federal government is primarily concerned with disclosure and makes no value judgment.

Not only must an issuer comply with federal securities law but also must comply with the state securities laws of each state in which the securities will be sold. Exemption from registration under federal securities law does not guarantee exemption under state securities law. Even if the offering is exempt under federal law without disclosure of the values of S , a , and b , it will not necessarily escape such disclosure under state law. Once the inside information concerning the values of S , a , and b is made public under either state or federal securities laws, the asymmetric information problem is resolved.

C. Conclusion

Empirical studies show that the market price of stock increases in the period immediately surrounding an announcement of a spin-off or equity carve out. The market

appears to view such announcements as good news. The spin-off or equity carve out announcement signals the market that in the aggregate the sum of the values of the original and subsidiary corporations is greater than the value of the original corporation prior to the spin-off or equity carve out. Old shareholders are better off if managers spin-off or carve out the positive net present value project rather than retain the project and not finance it to protect the value of the old shareholders' stock.

Generally, a spin-off or equity carve out will require the original corporation to issue stock in the subsidiary corporation either to the old shareholders or for sale to outside third parties. Such an issue entails registration at the federal and state levels unless the security is exempt in which case certain disclosures may have to be made anyway. Disclosure of the inside material information concerning the values of S , a , and b , resolves the asymmetric information problem.

Failure to disclose may result in violations of federal and state securities laws. In light of the penalty structure of the federal securities law, managers have an incentive to disclose the material information if the probability of getting caught lying is greater than or equal to one-half.

Empirical implications of the hypothesis are that a corporation likely to spin-off or carve out equity would have the following characteristics: (1) the corporation

would be undervalued and have unfinanced growth opportunities, (2) it would have a strong ownership structure, (3) the board of directors would have some outside directors, (4) the firm would be over-leveraged; otherwise, it would finance the projects with debt, (5) the firm would be capital intensive which would be a barrier to entry by competitors, (6) spin-off and equity carve out announcements should produce abnormal price returns around the announcement date.

V. Empirical Studies

In this chapter empirical studies undertaken to determine whether or not the theory is supportable in fact are analyzed. This chapter is divided into four parts. First is a description of the database. The second part of this chapter verifies prior studies regarding excess returns on or around the announcement dates. Third, cross sectional analysis is performed to try to determine factors underlying the market reaction. Finally, analysis is performed to try to determine managerial motivation for spin-offs.

A. Database

A search for the word *spin-off* was made on the Dow Jones News/Retrieval Service. The Dow Jones News database consists of the broadtape, Wall Street Journal, and Baron's from June 1, 1979 through December 31, 1991. June 1, 1979 is the beginning date of the Dow Jones News database in the Dow Jones News/Retrieval Service.

To be incorporated in the database the spin-off had to involve a United States corporation spinning-off United States based assets for two reasons. First, data is only available for United States Corporations on CRSP and COMPUSTAT, and second, spin-offs are examined in the context of United States law.

The documents were examined to determine the first public announcement date of a spin-off. In most cases, day

and time of the announcement were found.¹ COMPUSTAT was used to collect company specific parameters for the firms in the sample. This examination yielded 158 firms. The distribution by year is in Table 1, *infra*.

Table 1
Distribution of 158 Sample Spin-off Announcements
by Year 1979-91

Year	Number	Year	Number
1979	5	1986	16
1980	15	1987	16
1981	12	1988	17
1982	8	1989	17
1983	12	1990	11
1984	13	1991	5
1985	11		

The distribution can be divided into distinct periods--1979, 1980 through 1985, 1986 through 1989, and 1990 and 1991. The spin-offs in 1979 occurred after June 1, 1979 which is the beginning date of the Dow Jones News database. The increase in the number of spin-offs occurring from 1986 to 1990 may be a tax effect due to the more favorable treatment of spin-offs under the Tax Reform Act of 1986. Regressions of pre-1986 spin-offs and post 1985 spin-offs on the prediction errors, however, provide no explanation for observed positive abnormal returns. Whether the reduction in the number of spin-offs in 1990 and 1991 is part of a downward trend in the number of spin-offs is not known.

¹ In a few cases the Wall Street Journal Index was used to determine first public announcement date.

B. Wealth Effects and Prior Studies

The market model used is given in (1) and is estimated for each firm over 180 days ending 120 days before the spin-off announcement date.²

$$r_{it} = \hat{a}_i + \hat{b}_i r_{mt} + e_{it}, \quad \text{for } t = -3, -2, -1, 0, +1, +2, +3. \quad (1)$$

where

r_{it} = return on stock of firm i on day t , taken from the CRSP

Daily Stock Returns Tape or the NASDAQ Daily Stock Returns Tape.

$\hat{a}_i$ = market model intercept estimated by ordinary least squares.

$\hat{b}_i$ = slope of the market model estimated by ordinary least squares.

r_{mt} = CRSP or NASDAQ equal-weighted index of returns on stocks on day t .

e_{it} = residual return to stock i on day t .

Estimated intercept and slope coefficients from (1) are used to compute prediction errors for 154 firms in the sample during the 7 day event period.³

The daily prediction error, u_{it} , for each day $t = -3, -2, -1, 0, +1, +2, +3$ for each sample firm i , is computed by

$$u_{it} = r_{it} - (\hat{a}_i + \hat{b}_i r_{mt}), \quad t = -3, -2, -1, 0, +1, +2, +3 \quad (2)$$

The average prediction errors were computed by

² An alternative 180 day window ending 20 days before the spinoff announcement date was tested. Using this different interval did not alter the results.

³ Missing data on CRSP or COMPUSTAT reduced the sample size from 158.

$$PE_t = (\sum_{i=1}^{N_t} u_{it}) / N_t \quad (3)$$

where N_t is the number of firms with returns available on day t .

The t -statistic is computed by

$$t = (\text{Mean} \times N^{1/2}) / \text{Std Dev.} \quad (4)$$

Schipper and Smith (1983) reported a +2.17 percent average abnormal return for the announcement date for the 92 firms in their sample for the period 1963-81. Miles and Rosenfeld (1983) for the period 1962-80 and Hite and Owers (1983) for the period 1963-81 found two-day average abnormal

Table 2
Table of Prediction Errors

Day ^a	Mean	Std Dev.	Minimum	Maximum	t-Statistic
-3	.00	.03	-.1114	.1780	0.00
-2	.00	.02	-.0596	.1046	0.00
-1	.00	.04	-.2154	.1315	0.00
0	.02	.05	-.1727	.2134	4.96 ^b
+1	.00	.03	-.1490	.1749	0.00
+2	.00	.03	-.1404	.0890	0.00
+3	.00	.02	-.0608	.0917	0.00

^a Day 0 is the announcement date.

^b Significant at the 0.5% level.⁴

returns of +3.3 percent.⁵ The finding here of +2 percent

⁴ The standardized prediction error for the announcement date has a t -statistic of 280.46 which is significant at the 0.5% level.

⁵ A two day period was used because of lack of accuracy regarding the announcement date. In this sample, date and time of the announcement were available for most of

average abnormal returns on the announcement date for the period 1979-90 is consistent with and substantiates the prior studies.

C. Analysis of Market Reaction to Spin-offs

The theory predicts that undervalued firms with high debt-equity ratios and low liquidity (slack) would spin-off. A cross sectional analysis was run to verify the predictions. The standardized prediction error, SPE_0 , is the dependent variable.

$$SPE_0 = \alpha + \beta V \quad (5)$$

where V is a matrix of company specific parameters. Data was collected for the sample firms from COMPUSTAT.

The first test was designed to determine whether or not the market reacts more favorably when undervalued firms spin-off. Two different measures were used. The ratios of market value of equity to book value of equity and market value of the firm to book value of the firm were considered. Both are highly correlated. Market value of the firm to book value of the firm was chosen. Market value of the firm was calculated by subtracting the book value of common equity from total assets and adding the market value of the common stock. Book value of the firm was taken as total assets. Market value of the firm to book value of the firm

the firms; consequently, there is little leakage. Moreover, if the announcement time were late in the afternoon, the next trading day was used as the announcement date. Table 2 verifies this observation. There is virtually no market reaction in the three day periods before and after the announcement.

was computed for three years before and after the year of the spin-off announcement. The mean market value of the firm to book value of the firm ratio for the year before the spin-off announcement is 1.59.

When prediction errors and standardized prediction errors are computed dividing the sample into firms having market value of the firm to book value of the firm ratios greater than or equal to the mean and those less than the mean, the prediction and standardized prediction errors are greater for the sample having market value of the firm to book value of the firm ratios below the mean.⁶ Although the market reacts favorably when a firm spins-off, it reacts more favorably when an undervalued firm spins-off (See Table 3).

Good firms (firms with market value of the firm to book value of the firm ratios above the mean) spin-off growth opportunities which is wealth improving and results in excess returns on the announcement date. Firms with market

⁶ A variable MB5 was constructed as follows:

$$MB5 = \begin{cases} 0, & \text{if } MVBV_{i1} < 1.59 \\ 1, & \text{if } MVBV_{i1} \geq 1.59 \end{cases}$$

to test whether or not firms having a market value of the firm to book value if the firm ratio above or below the mean had greater market responses. A market value of the firm to book value of the firm ratio equal to one was tested, and there was no quantitative difference. By using the mean rather than one, possible industry effect is avoided. Moreover, a mean equal to 1.59 indicates that the sample consisted of relatively good firms.

value of the firm to book value of the firm ratios below the

Table 3
Significance of Division at the Mean⁷

	MVBV ₁ <Mean	MVBV ₁ ≥Mean
Prediction Error	.02	.01
Number in Sample	119	32
The difference in the two groups is statistically significant at the 10 percent level.		

mean spin-off assets in place. This may be the result of spinning-off losers or concentrating on the core business which in either event evokes a greater wealth response from the market.

Several proxies for liquidity were examined. Among them were cash and short term investments divided by total assets, the change in earnings per share divided by the market value per share, the current ratio defined as the ratio of current assets to current liabilities, dividend payout ratio defined as dividends divided by net income, and working capital defined as current assets less current liabilities. All are highly correlated. The ratio of current assets to current liabilities was chosen because the current ratio yields a better indicator of the ability of a

⁷ The same pattern is obtained when the sample is divided into those firms having a market value of the firm to book value of the firm in the year prior to the announcement date greater than or equal to one and those less than one.

firm to invest. Of the different choices only the current ratio and working capital take current liabilities into consideration. Current liabilities directly affect the ability of a firm to invest. The current ratio is a better measure than working capital because it removes the magnitude of the difference and firm size from consideration. A variable for the change in the ratio of the current assets to current liabilities was computed.

A multiple regression of market value of the firm to book value of the firm ratio for the year prior to the announcement year ($MVBV_{1,t}$) and the change in the current ratio from the year before the announcement year to the year of the announcement date ($CR_{1,0}$) was run on the standardized prediction error (SPE_0) for the announcement date. The results show that the change in the ratio of current assets to current liabilities from the year before the announcement date to the year of the announcement date is positively correlated with the standardized prediction error in the year of the announcement date. The higher the change in liquidity is; the higher is the excess return. This is significant at the 5 percent level. Given an increase in liquidity prior to the spin-off announcement date, the market reacts more favorably to the spin-off announcement. The greater the increase in liquidity the greater is the abnormal return. Insufficient liquidity (slack) to finance positive net present value ($NPV > 0$) projects may have been depressing stock values before the spin-off. The market

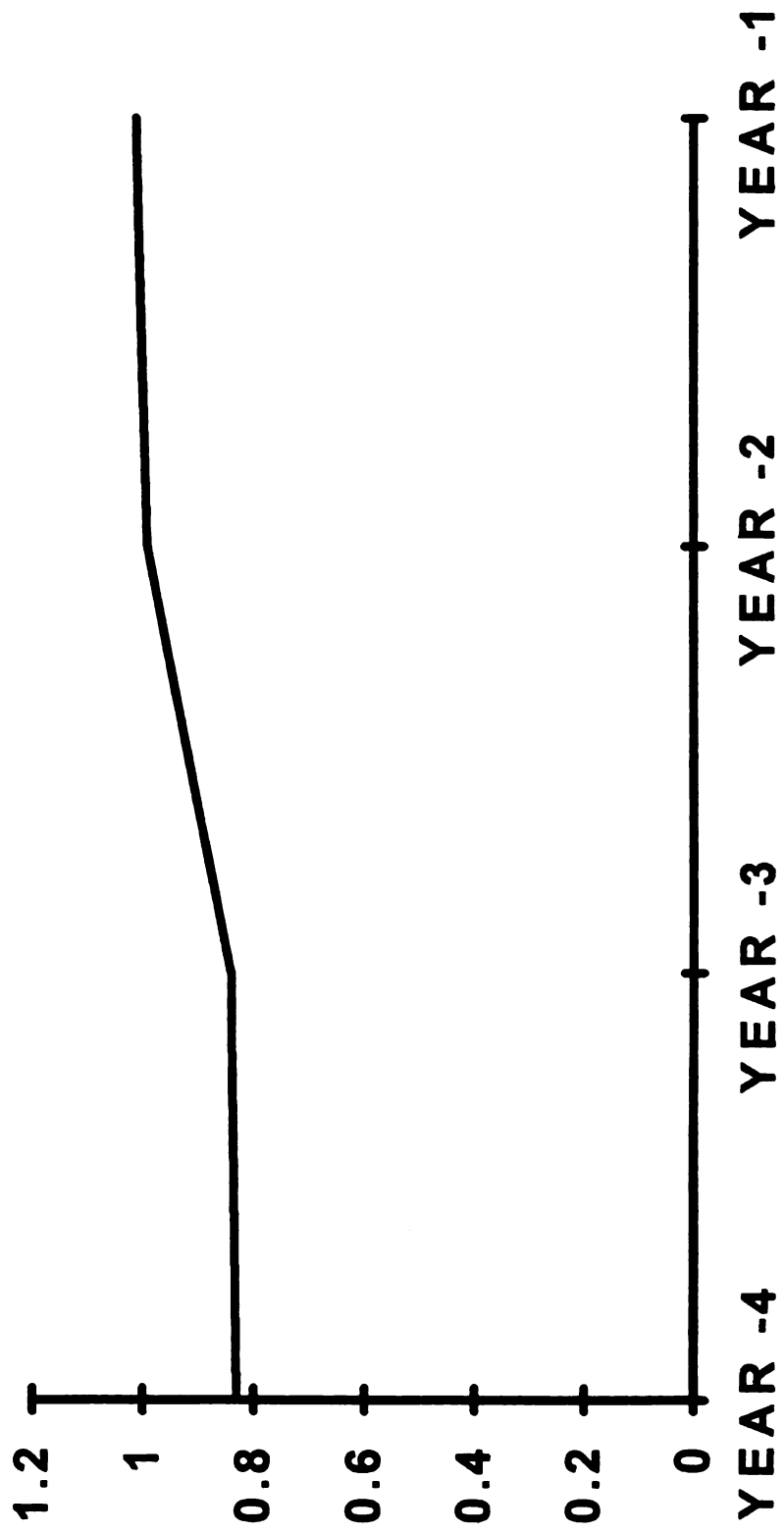
value of the firm to book value of the firm ratio for the year prior to the announcement date is negatively correlated with the standardized prediction error for the year of the announcement date. This is significant at the 5 percent level. The lower the market value of the firm to book value of the firm ratio is; the higher is the excess return. Again, the market reacts more favorably when less valued firms spin-off.

Table 4
Multiple Regression $MVBV_{-1}$ and $CR_{-1,0}$
on SPE_0 where $N=137$

Variable	β	t	t Sig
$CR_{-1,0}$	1.041474	2.279	.0242
$MVBV_{-1}$	-1.113469	-2.057	.0416
Constant	1.376928	5.357	.0000

Debt-equity ratios were computed by dividing the book value of the long term debt by the market value of the equity. A debt-equity ratio also was computed by dividing the book value of the long term debt by the book value of the equity. Using this measure created some negative ratios because of negative entries for owners' equity. Eliminating the firms with negative debt-equity ratios reduced the number of firms in the sample but, nonetheless, produced a similar pattern of increasing debt-equity ratios and analyzed. The debt-equity ratios, however, provided no explanation of the abnormal returns. However, consistent with the theory, debt-equity ratios increased in the years

FIGURE 1
DEBT TO EQUITY RATIOS FOR YEARS PRIOR TO THE
ANNOUNCEMENT PERIOD



before the announcement year (See Figure 1). One explanation may be that firms spin-off projects because they cannot finance them through increased debt.

The findings in this part are consistent with the theory prediction that the market should react more favorably when less valued firms spin-off, signalling the market that the firm has positive net present value projects that it is not otherwise able to finance through internal funds or new debt.

D. Motivation of Managers

Seventy-two of the spinoff announcements in the sample gave a reason for the spin-off. Twenty-five firms spun-off to restrict their activities to the core business. Seven firms spun-off to generate funds or restructure debt. Seven firms spun-off assets in connection with an acquisition. Twenty-six spun-off losers. Six spin-offs were the result of court or regulatory agency orders. One spin-off was the result of bankruptcy or liquidation.

The sample was divided by reason(s) for the spin-off. Sample firms that spun-off losers and the sample of firms that either spun-off losers or spun-off to generate funds or restructure debt produced significant results. Regression of firms which announced that they were spinning-off losers on the prediction error for the announcement date produces positive correlation with the prediction error significant at the 5 percent level. When this group is augmented with firms which announced they were restructuring debt or

generating cash, the results are still significant at the 5 percent level. The market reacts positively to favorable news.

In addition to what managers said they were doing in public announcements, an analysis was made to determine the mind-set of managers of firms that spin-off. Do managers of firms that spin-off act in a way consistent with the theory? Part of the hypothesis is that firms with high debt-equity ratios not being able to finance acquisitions or new positive net present value projects by additional debt refrain from issuing equity to finance acquisitions or net present value projects. Consequently, a high debt-equity ratio prior to the spin-off implies that there would be a reduction in total assets after the spin-off. Firms with lower debt-equity ratios would still be able to finance acquisitions or positive net present value projects with debt after the spin-off, and, hence, there would be an increase in total assets. Approximately one-half the firms increased their total assets in the announcement year while the other half showed a reduction in total assets. An analysis was performed to determine whether or not the debt-equity ratio is related to the change in total assets. When the market value debt-equity ratio for the year before the announcement is regressed on the percentage of change in total assets in the announcement year, the percentage of change in total assets is inversely related to the debt-

equity ratio.⁸ Firms with lower (higher) debt-equity ratios had higher (lower) percentages of change in total assets.

Table 5
Regression of Debt-Equity Ratio of Year₁ on the
Percentage Change in the Total Assets in Year₀

Variable	β	t-statistic	t Sig
Debt-Equity ₁	-.040563	-2.378	.0186
Constant	.090073	2.353	.0199

The results are consistent with the theory. Managers of firms with low debt-equity ratios expand while managers of firms with high debt-equity ratios do not.

⁸ To verify that firms with positive changes in total assets were the firms with lower debt-equity ratios, a regression was run on a dummy variable, DCHGTA, where

$$DCHGTA = \begin{cases} 0, & \text{if the change in total assets is negative} \\ 1, & \text{if the change in total assets is nonnegative.} \end{cases}$$

Although there is a loss of some power, this regression substantiates the conclusion that firms with low debt-equity ratios expand while firms with high debt-equity ratios contract and retrench.

VI. Conclusions

Empirical studies show that stock prices are depressed when a corporation announces an equity issue. One ramification of this phenomenon is that managers acting in the best interests of existing shareholders will not finance positive net present value projects with equity issues if the firm does not have sufficient slack or debt capacity to do so. Consequently, the value of the firm is not maximized, and there is a misallocation of resources. One solution to this problem--the spin-off of positive net present value projects is analyzed in the context of the legal environment.

Generally, a spin-off or equity carve out will require the original corporation to issue stock in the subsidiary corporation either to the old shareholders or for sale to outside third parties. Such an issue entails registration at the federal and state levels unless the security is exempt in which case certain disclosures may have to be made anyway. Disclosure of the inside material information concerning the values of the asset-in-place, a , the growth opportunity, b , and slack, S , resolves the asymmetric information problem.

Failure to disclose may result in violations of federal and state securities laws. In light of the penalty structure of the federal securities law, it was calculated that managers would have an incentive to disclose the material information if the probability of getting caught

lying is greater than or equal to one-half.

Empirical implications of the hypothesis are that a corporation likely to spin-off or carve out equity would have the following characteristics: (1) the corporation would be undervalued and have unfinanced growth opportunities, (2) it would have a strong ownership structure, (3) the board of directors would have some outside directors, (4) the firm would be over-leveraged; otherwise, it would finance the projects with debt, (5) the firm would be capital intensive which would be a barrier to entry by competitors, (6) spin-off and equity carve out announcements should produce abnormal price returns around the announcement date.

Empirical studies show that the market price of stock increases in the period immediately surrounding an announcement of a spin-off or equity carve out. This result is verified in Chapter V. The market views such announcements as good news. The spin-off or equity carve out announcement signals the market that in the aggregate the sum of the values of the original and subsidiary corporations is greater than the value of the original corporation prior to the spin-off or equity carve out. Old shareholders are better off if managers spin-off or carve out the positive net present value project rather than retain the project and not finance it to protect the value of the old shareholders' stock.

Analysis of the market reaction to the 158 spin-offs in

the sample shows that (1) prior to the announcement date debt-equity ratios increase, (2) the higher the ratio of current assets to current liabilities, the higher the abnormal returns, (3) the higher (lower) the market value of the firm to the book value of the firm, the lower (higher) the abnormal returns, and (4) firms having market value of the firm to book value of the firm ratios below the sample mean ratio value had higher abnormal returns than firms having market value of the firm to book value of the firm ratios below the mean ratio value. These findings are consistent with the theory predictions that (1) firms with high debt-equity ratios cannot finance positive net present value projects by issuing more debt and, therefore, spin-off the project, (2) that undervalued firms spin-off, signalling the market that the firm has unfinanced growth opportunities, and (3) that insufficient liquidity (slack) to finance positive net present value projects may have been depressing stock values prior to the spin-off.

Finally, it is observed that following a spin-off managers of firms with high debt-equity ratios contract and retrench their firms whereas managers of firms with low debt-equity ratios expand their firms. This behavior is consistent with the theory prediction that high debt-equity ratios constrain managers actions. Managers of such firms are unable to expand by taking advantage of growth opportunities.

APPENDICES

APPENDIX A

Assumption of in the Old Shareholders Best Interests

This part examines the assumption that managers act in the best interests of the "old" shareholders in making corporate investment decisions. To determine the validity of the assumption, certain aspects of corporation law and its development are analyzed. An analysis is made of fiduciary duties owed in both state corporation acts and court decisions, particularly Delaware corporation law because of its preeminence in the field of corporation law; the business judgment rule; corporate social responsibility; and state corporate constituency statutes.

Early in American jurisprudence, Chief Justice John Marshall described a corporation as follows:

A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creation of law, it possesses only those properties which the charter of creation confers upon it, either expressly, or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created.¹

Modern corporation law allows the object of a corporation's creation to be any lawful purpose.² Such lawful purpose must be for profit since by definition a

¹ Dartmouth College v. Woodward, 4 Wheat. 518, 636 (1819).

² MODEL BUSINESS CORP. ACT § 3 (1979); REVISED MODEL BUSINESS CORPORATION ACT § 3.01(a).

business corporation is "for profit."³ In microeconomics and finance, it is a tenet of the theory of the firm that firms are profit maximizers.⁴ The central paradigm of corporate finance is that corporate managers maximize profits which in turn maximizes the value of the corporation which in turn maximizes shareholder wealth.⁵ Recent developments in the law, however, are eroding this paradigm. The trend towards corporate social responsibility, changes in the object of the fiduciary obligations and the business judgment rule by the courts, and corporate constituency statutes that allow corporate managers to consider the interests of other stakeholders such as creditors, employees, and the community undermine the profit and value maximization assumptions of traditional corporate financial theory.

Clearly, the law and corporate financial theory have diverged. Since corporations are juridical persons and exist only in contemplation of the law, managers are constrained by the law. This part explores the divergence

³ Id. MBA § 2(a); RMBA § 1.40(4).

⁴ H. VARIAN, MICROECONOMIC ANALYSIS 6 (2d ed. 1984); T. COPELAND & J. WESTON, FINANCIAL THEORY AND CORPORATE POLICY 18 (3d ed. 1988).

⁵ See e.g., T. COPELAND & J. WESTON, FINANCIAL THEORY AND CORPORATE POLICY 18, 401, 553, 667, 743 (3d ed. 1988), Myers & Majluf, Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have, J. OF FINANCIAL ECONOMICS 13, 187-221, 191 (1984), Masulis, The Effects of Capital Structure Change on Security Prices, J. OF FINANCIAL ECONOMICS 8, 139-178, 140 (1980).

of corporation law and corporate financial theory from the Berle and Dodd debate to the corporate constituency statutes and the constraints placed on managers' decision-making process by the law.

A. Separation of Ownership and Control

Many problems encountered in corporate financial theory and corporation law are rooted in the separation of ownership and control.⁶

Control has passed from ownership hands into the hands of management, management personnel is more highly specialized and selected for professional competence; its motivations are substantially different from those of the owner-capitalist; and its area of discretionary action and the character of the limitations that bound their area differ markedly from those relevant to the enterprises of an earlier capitalism.⁷

The non-profit maximization theory in the economic literature is largely associated with corporations where ownership is separated from control.⁸ Corporations are owned by shareholders who do not run them, and run by

⁶ Berle and Means traced the evolution of modern corporate structure as it shifted from shareholder to management control. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 127-152 (1932). In this article, "control" means managerial decision or operating control not the absence of a controlling shareholder or block.

⁷ Mason, The Apologetics of Managerialism, J. OF BUSINESS 31, 1-11, 1 (1958).

⁸ See F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 32-33, (2d ed. 1980) (discussing the separation of ownership and control and its effects).

managers who do not own them.⁹ The depersonalization of the shareholders' relation to the corporation was explained by Berle and Means in the following terms:

The spiritual values that formerly went with ownership have been separated from it. Physical property capable of being shaped by its owner could bring him direct satisfaction apart from the income it yielded in more concrete form. It represented an extension of his own personality. With the corporate revolution, this quality has been lost ¹⁰

Shareholders are no longer owners in the traditional sense. They have become merely investors in corporate equity securities.¹¹ The shareholder-investor's interest in the enterprise is limited to capital appreciation and income.¹²

It may be open to debate whether or not there has been a separation of ownership and control as maintained by Berle and Means and others. The typical individual shareholder has never really been anything but an investor looking only for income and capital appreciation. Moreover, there is no separation of ownership and control in the vast majority of corporations that are family-owned or closely-held. The

⁹ Ownership of a small percentage of the corporation's stock by managers does not undercut the analysis, because managers still control property they do not own: the percentage of the corporation owned by shareholders other than management.

¹⁰ A. BERLE & G. MEANS, supra note 6, at 60-67.

¹¹ See P. BLUMBERG, THE MEGACORPORATION IN AMERICAN SOCIETY: THE SCOPE OF CORPORATE POWER 11 (1975).

¹² See Hetherington, Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility, 21 STAN. L. REV. 248, 271 (1969).

question of separation of ownership and control really only arises with respect to the relatively few large, public corporations. When interlocking directorates, acquisitions, institutional investors, and family blocks (including foundations) are considered, a controlling interest is held by a relatively small group of individuals or institutions. The real question is just how active are these controlling shareholders? Are they active enough that managers must accede to their wishes?

Myers and Majluf (1984) in their model assume that managers act in the best interest of the old shareholders, although they admit that they have no theory why. One theory is that corporations are not as diversely held as hypothesized in managerialism theory. Old shareholders may have power because there exists a small group of shareholders (individuals, foundations, other corporations, or institutions) that hold a controlling interest in virtually every major publicly held corporation in the United States today. Institutional investors alone hold more than \$6.5 trillion or approximately 53 percent of the country's equity. There is currently great debate among institutional investors as to their proper role in corporate governance. Edward V. Regan, the New York state comptroller and sole trustee of the New York state public pension fund, is alarmed that pension funds, particularly the California Public Employees Retirement System (Calpers), may get involved in corporate governance issues which have nothing

to do with providing benefits to retirees. He advocates a passive investor role.¹³ The California system (Calpers) and other institutional investors are advocating active participation in corporate governance.¹⁴

Controlling shareholders elect the board. Often, their representatives control the board of directors. They give managers a free hand to operate within certain limits, one of which concerns the value of the controlling shareholders' stock.

This scenario would seem to support the Myers and Majluf assumption that managers act in the interest of the old shareholders, if by old shareholders they mean "old controlling" shareholders. It also raises the specter of minority shareholder oppression which is the subject of a great number of corporate fiduciary and business judgment rule cases. The following analysis takes both theories of control into account.

B. The Parting of the Ways

In the first part of the Twentieth Century, both corporate financial theory and the law espoused a profit maximization paradigm. In microeconomics, it is a tenet of the theory of the firm that firms are profit maximizers.¹⁵

¹³ See James A. White, New York's Regan to Pensions: Hands Off, Wall St. J., C1, cols. 3-5, Sept. 13, 1991.

¹⁴ The National Law Journal, Monday, December 2, 1991, p.23, cols. 2 & 4.

¹⁵ H. VARIAN, MICROECONOMIC ANALYSIS 6 (2d ed. 1984).

Profit maximization is justified on the grounds that if competitive firms did not maximize profits they would be inefficient and hence would be forced out of business by the efficient firms.¹⁶ Monopolists are presumed to be profit maximizers by virtue of their position.¹⁷ Moreover, if the shareholders of a corporation were able to directly run the corporation they would opt for profit maximization and its corresponding cost minimization. Corporate financial theory further holds that maximizing profits maximizes firm value which in turn maximizes shareholder wealth.¹⁸ The landmark case of *Dodge v. Ford Motor Co.*¹⁹ was decided in 1919. In *Dodge*, the court addressed whether a corporation organized for profit could divert its profits from the shareholders to society-at-large. The court drew a distinction between incidental humanitarian expenditure of corporate funds for the benefit of employees and a general purpose plan to benefit humankind.²⁰ The court unequivocally stated:

A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the

¹⁶ Id.

¹⁷ Id.

¹⁸ See T. COPELAND & J. WESTON, FINANCIAL THEORY AND CORPORATE POLICY 18, 401, 553, 667, 743 (3d ed. 1988).

¹⁹ 204 Mich. 459, 170 N.W. 668 (1919).

²⁰ Id. at 506-507, 170 N.W. at 684.

nondistribution of profits among stockholders in order to devote them to other purposes....[I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others....²¹

As corporations grew in size and complexity and ownership was separated from control, the law had to evolve to reflect these changes in the infrastructure of Twentieth Century American society.

Under agency law a corporation can only act through agents.²² Since a corporation can only act through agents, it must necessarily have the capacity to appoint them; however, its status as principal confers no consciousness or individual being.²³ In general, the officers and employees of a corporation are its agents.²⁴ The corporation's agents owe their allegiance to the corporation, not the directors.²⁵ However, corporate finance textbooks and articles continue to assert erroneously that managers are

²¹ Id. at 507, 170 N.W. at 684.

²² W. SELL, AGENCY 13 (1975).

²³ Id.

²⁴ See H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 586, 593-94 (3rd ed. 1983) (discussing officers as agents of corporations).

²⁵ Id. at 586-606 (discussing the duties of officers as agents of the corporation).

the agents of the shareholders.²⁶

The board of directors situation is rather unique. Although shareholders elect and can remove directors, the directors are not agents of the shareholders, and the shareholders are not principals.²⁷ The directors are not agents of the corporation because of their statutory powers of management; they are not subject to control by anyone, which is a requirement of the principal-agent relationship.²⁸ Since the law of agency deals with the relationship between principal and agent and since directors are neither principals nor agents, new law had to be created or old law modified to deal with the relationship between director and corporation.

1. The Fiduciary Relationship

Based on their analysis of a series of early corporation cases, Adolf Berle and Gardiner Means contend that:

[A]ll powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears. The use of the power is subject to equitable

²⁶ See, e.g., T. COPELAND AND J. WESTON, FINANCIAL THEORY AND CORPORATE POLICY 17, 19 (3d ed. 1988); Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, AEA Papers and Proceedings 76, 323-329, 323 (May 1986); Jensen & Meckling, Agency Costs and the Theory of the Firm, J. OF FINANCIAL ECONOMICS 3, 305-360, 309 (1976).

²⁷ W. SELL, AGENCY 20 (1975).

²⁸ Id.

limitation when the power has been exercised to the detriment of their interest, however absolute the grant of power may be in terms, and however correct the technical exercise of it may have been....And that, in every case, corporate action must be twice tested: [F]irst by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a *cestui que trust* to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary.²⁹

In effect, Berle and Means believed that corporate law, in substance, was a branch of the law of trusts.³⁰ The fiduciary concept in corporation law can, in fact, be traced back to its roots in the Law of Trusts.³¹ Acknowledging, however, that this position was more theory than practice Berle and Means stated:

"In fact, if not in law, at the moment we are thrown back on the obvious conclusion that a shareholder's right lies in the expectation of fair dealing rather than the ability to enforce a series of supposed legal claims."³²

The position advocated by Berle and Means previously was adopted in Delaware when the Chancellor in *Bodell v. General Gas and Electric Corporation*³³ held that while not

²⁹ A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 248 (1932) (emphasis added).

³⁰ *Id.* at 275. See also Berle, Corporate Powers as Powers in Trust, 44 HARV. L. REV. 1049 (1931).

³¹ See A. SCOTT, *THE LAW OF TRUSTS* § 170 (duty of loyalty) and § 174 (duty of care) (3d ed. 1967).

³² A. BERLE & G. MEANS, *supra* note 6, at 276.

³³ 15 Del. Ch. 119, 132 A. 442 (1926).

"trustees in the strict sense of the term, yet for convenience [directors] have been described as such."³⁴ Since then, in Delaware, directors have stood in the position of fiduciaries.

The fiduciary relationship consists of two duties: the duty of care and the duty of loyalty. Delaware courts impose a third duty of obedience which from an analytic standpoint is a subdivision of the duty of loyalty.³⁵ Justice Cardozo described the fiduciary duty in his now famous quote: "Not honesty alone but the punctilio of an honor the most sensitive, is then the standard of behavior."³⁶ This is but the beginning of the problem for as Justice Frankfurter aptly said: "But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary?"³⁷ This is the crux of the matter. To whom are corporate officers and directors fiduciaries?

This question was the topic of the debate between Adolf Berle and E. Merrick Dodd. Berle defended traditional corporate financial theory that corporate management

³⁴ Id. at 129, 132 A. at 446.

³⁵ *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939), *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *Revlon, Inc. v. MacAndrews & Forbes Holding*, 506 A.2d 173 (Del. 1986).

³⁶ *Meinhard v. Salmon*, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

³⁷ *SEC v. Chenery Corp.*, 318 U.S. 80, 85 (1943).

exercises its powers solely for the benefit of the shareholders.³⁸ Dodd argued for a broader exercise of corporate powers contending that management should exercise its powers in behalf of a broader constituency.³⁹ Moreover, he argued that the corporate purpose extended beyond merely making a profit for shareholders.⁴⁰ The debate ended in 1954 when Berle capitulated and agreed that the corporate trust extended to the entire community and not solely for the benefit of shareholders.⁴¹ Although the Berle-Dodd debate ended with Dodd's view prevailing, corporate financial theory still embraces Berle, and there are lingering elements of the debate in corporation law today.

Corporation statutes are generally consistent as to whom the fiduciary duty is owed. A very few corporation statutes extend the duty to both the corporation and shareholders.⁴² The majority of modern corporation statutes following the Model Business Corporation Act impose the fiduciary duty on officers and directors for the benefit of the corporation.

³⁸ Berle, Corporate Powers as Powers in Trust, 44 HARV. L. REV. 1049 (1931).

³⁹ Dodd, For Whom are Corporate Managers Trustees, 45 HARV. L. REV. 1145 (1932).

⁴⁰ Id.

⁴¹ A. BERLE, THE 20TH CENTURY CAPITALIST REVOLUTION 169 (1954).

⁴² "[F]iduciary relation to the corporation and to its shareholders... ." N.C. BUS. CORP. ACT § 55-35. See also S.C. BUS. CORP. ACT § 33-13-150.

A director shall discharge his duties as a director,...., in a manner he reasonably believes to be in the best interests of the corporation.⁴³

The drafters of the model act and state legislatures have taken the modern position that the duty is owed to the corporation not to any particular constituent stakeholder group.

It is in the case law where most of the remnants of the Berle-Dodd debate exist. There is a line of cases holding that the fiduciary duty runs to the shareholders. These cases typically involve insider trading,⁴⁴ oppression of minority shareholders,⁴⁵ and a purchase or sale of control.⁴⁶ Although couched in terms of fiduciary duties

⁴³ ALI-ABA REVISED MODEL BUSINESS CORP. ACT § 8.30; H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 613 (3rd ed. 1983).

⁴⁴ See, e.g., *Jacquith v. Mason*, 99 Neb. 509, 156 N.W. 1041 (1916), *Dawson v. National Life Insurance Co.*, 176 Iowa 362, 157 N.W. 929 (1916), *Childs v. RIC Group, Inc.*, 331 F.Supp. 1078 (N.D. Ga. 1970), aff'd per curiam 447 F.2d 1407 (5th Cir. 1971) (Inside information held in trust for benefit of shareholders under Georgia law.), *Sampson v. Hunt*, 222 Kan. 268, 564 P.2d 489 (1977), *Weatherby v. Weatherby Lumber Co.*, 94 Idaho 504, 492 P.2d 43 (1972). According to Henn and Alexander these cases constitute the minority rule that a duty is owed to shareholders in insider cases. H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 648 (3rd ed. 1983).

⁴⁵ H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 651-56 (3rd ed. 1983). *Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977). *Tanzer v. International General Industries, Inc.*, 379 A.2d 1121 (1977).

⁴⁶ H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 656-61 (3rd ed. 1983). *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

owed to shareholders, these cases can be explained as breaches of fiduciary duties owed to the corporation as a whole where "corporation as a whole" encompasses all intracorporate groups. Favoring one intracorporate group to the detriment of another is a breach of duty owed to the corporation as a whole.⁴⁷ Moreover, many of these cases involve discrimination among different groups of shareholders; therefore, it is only logical that the courts should speak of duties owed to the shareholders rather than the corporation. But, even where the fiduciary duty is extended to the shareholders it has not been extended exclusively to them. For example, a fiduciary duty is owed to creditors in a financially troubled corporation⁴⁸ even though no duty is owed creditors in a financially healthy corporation.⁴⁹

The formulation of the fiduciary concept by the Delaware Supreme Court appears in *Guth v. Loft, Inc.*⁵⁰

⁴⁷ H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 652 (3rd ed. 1983). There is a minority view that wealth transfers from other stakeholders, bondholders for example, are permitted if not encouraged. See *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

⁴⁸ See *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *CFTC v. Weintraub*, 471 U.S. 343, 355 (1985); *Clarkson Co. Ltd v. Shaheen*, 660 F.2d 506 (2d Cir. 1981), cert. denied, 445 U.S. 990 (1982); *Credit Lyonnais Bank N.V. v. Pathe Communications*, Civ. 12150, 1991 Del. Ch. Lexis 215 (Dec. 30 1991).

⁴⁹ *Simons v. Cogan*, Civil Action No. 8890 (Del. Ch. Dec. 2, 1987).

⁵⁰ 5 A.2d at 510 (1939).

There the court held that while directors are not technically trustees, they stand in a fiduciary relationship with the corporation and its stockholders. The court imposed a duty of undivided and unselfish loyalty to the corporation.⁵¹ The subsequent discussion of fiduciary duty refers to the corporation and does not further mention the stockholders. Of course, there was no need to mention the stockholders at all since the case involved an appropriation of a corporate opportunity. One may speculate that shareholders were included because in 1939 the interests of the corporation and its owners were considered to be the same. Guth has been cited for the fiduciary concept by the Delaware courts ever since. The unresolved question was: what if there is a conflict between loyalty to the corporation and the stockholders. Can undivided loyalty to the corporation be divided between the corporation and its stockholders if their interests diverge? The Delaware Supreme Court would not answer that question for fifty years when it decided *Paramount Communications v. Time, Inc.*⁵²

Paramount is of particular importance in this analysis. Justice Horsey clearly distinguished between the corporation as an entity and the shareholders.⁵³ His opinion suggests that the fiduciary duty is owed to the corporate entity not

⁵¹ 5 A.2d at 510.

⁵² 571 A.2d 1140 (Del. 1989).

⁵³ *Id.* at 1150.

the shareholders.⁵⁴

Time distinguishes the stance taken by the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc.*⁵⁵ which expressly denied that other constituencies were owed a fiduciary duty by management under certain conditions. The situation in *Revlon* involved a hostile takeover by Pantry Pride. The *Revlon* board of directors engaged in defensive tactics to thwart the Pantry Pride takeover. Of particular importance is that the board acted to protect noteholders at the expense of the shareholders. The notes had been issued as a defensive measure. Hence, *Revlon* involves an intracorporate allocation of value. The court did not prohibit the board from considering constituencies other than the shareholders.

[W]hile concern for various corporate constituencies is proper when addressing a takeover threat, that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders.⁵⁶

This concession by the Delaware Supreme Court is a step toward liberalization of the fiduciary concept although the court continued to quote the language from *Guth v. Loft, Inc.*⁵⁷ that the fiduciary duty is owed to the corporation

⁵⁴ Id.

⁵⁵ 506 A.2d 173 (Del. 1986).

⁵⁶ 506 A.2d at 176.

⁵⁷ 5 A.2d at 510.

and its shareholders. The concept of concern for other constituencies comes out of *Unocal Corp. v. Mesa Petroleum Co.*⁵⁸ Mesa argued that action by the Unocal directors in opposing its two tier tender offer for Unocal stock was a violation of the fiduciary duty Unocal owed to all of its shareholders of which Mesa was one. The Delaware Supreme Court said that the board of directors could be legitimately concerned with "the impact [of the tender offer] on 'constituencies' other than shareholders (i.e. creditors, customers, employees, and perhaps even the community generally)." This language is similar to the corporate constituency statutes of other states.⁵⁹

The interesting aspect of *Revlon* is that the court declared that the initial duty of the board in the face of the takeover was to preserve the corporation as an entity. As long as that was the case, the duty was owed to the corporate entity. When it became apparent to the board that the corporate entity could not be preserved, its duty shifted to maximize the firm's value at a sale for the benefit of the shareholders. The shareholders take priority only after the board's obligations to the corporation are fulfilled. Once the corporation goes on the auction block the board's duty is to maximize shareholder value and concern for non-shareholder interests is not appropriate

⁵⁸ 493 A.2d 946 (Del. 1985).

⁵⁹ See infra notes 93-96 and accompanying text.

when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.

Time also involved a hostile takeover. The plaintiff shareholders relying on *Revlon* argued that *Time's* board of directors' decision to merge with Warner imposed a fiduciary duty to maximize immediate share value and not erect unreasonable barriers to further bids (*Paramount's*).⁶⁰ The court distinguished *Time* from *Revlon* by noting that *Time's* corporate integrity was being maintained and that *Time* was not to be dismembered on the auction block. Hence, the *Revlon* rule was not triggered.

The Court of Chancery in its opinion below posed the pivotal question of utmost importance in this dissertation.

Under what circumstances must a board of directors abandon an in-place plan of corporate development in order to provide its shareholders with the option to elect and realize an immediate control premium?⁶¹

The Delaware Supreme Court responded by relying on 8 Del. C. § 141 which vests corporate control and management in the board of directors and by distinguishing *Revlon*. The duty imposed on directors under Delaware law to manage the business and affairs of the corporation includes a "conferred authority to set a corporate course of action, including time frame, designed to enhance corporate

⁶⁰ 571 A.2d at 1149.

⁶¹ 571 A.2d at 1149.

profitability." Further, "the question of 'long term' versus 'short term' values is largely irrelevant because directors, generally, are obligated to chart a course for a corporation which is in its best interests (the corporation's) without regard to a fixed investment horizon." (Emphasis added.)

Second, absent a set of facts as in *Revlon*, a board of directors is "not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."⁶² In the light of these statements by the Delaware Supreme Court, managers who pass up positive net present value projects and thereby fail to maximize the value of firm in the interests of the old shareholders violate their fiduciary duty to the corporation and could be held accountable under Delaware law.

Although *Time* directly involved a takeover, there is no reason to believe that the extension of the fiduciary duties would be restricted to this context particularly in light of the language quoted in the prior paragraph. This case is extremely important because of the status of Delaware corporation law in the field. The duty originally imposed for the benefit of the shareholders has been transferred to the corporation as a whole. To say that the fiduciary duty is owed to the corporation is equivalent to saying that a fiduciary duty is owed to all stakeholders composing the

⁶² 571 A.2d at 1150.

corporation. The shift from shareholders to corporation is in fact a broadening of the scope of fiduciary beneficiaries rather than a narrowing. The assumption that managers act in the best interest of the old shareholders is losing its support in the law. Indeed, in Delaware, it may be gone. The case law trend is toward finding a duty owed to the corporation as a whole.

2. Business Judgment Rule

The business judgment rule is the logical extension of the fiduciary relationship's transference from the shareholders to the corporation as a whole. Management is compelled to act in the best interests of the corporation. The business judgment rule applies not only to directors but also officers and controlling shareholders collectively referred to as management.⁶³

The Delaware Supreme Court states that the business judgment rule is

a presumption that in making a business decision the directors of a corporation acted in good faith and in the honest belief that the action taken was in the best interests of the company.⁶⁴

Note that only the "company" is mentioned. There is no mention whatsoever of the stockholders. In this respect, the business judgment rule moved ahead of the fiduciary

⁶³ H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 663 (3rd ed. 1983).

⁶⁴ Aronson v. Lewis, 473 A.2d 805, 812 (Del. Sup. 1984).

concept in the Delaware courts.

Delaware has adopted a more stringent business judgment rule for takeover situations because of an "omnipresent specter" that the directors may be acting in their own best interests rather than the best interests of the corporation and shareholders.⁶⁵ The court imposed an "enhanced" duty calling for an initial judicial determination before the business judgment rule is applicable. In Delaware, directors in a takeover situation must show that they had reasonable grounds to believe that there existed a danger to corporate policy and effectiveness because of another person's stock ownership. This enhanced duty is shown by good faith and reasonable investigation particularly if done by a majority of independent outside directors.

Care must be taken in discussing the business judgment rule which has been created by courts for evidentiary purposes in cases involving alleged misconduct by management.⁶⁶ The business judgment rule is a standard of proof which creates a presumption that the board of directors acted in good faith and in furtherance of the best

⁶⁵ Unocal Corp. v. Mesa Petroleum Co., 493 A.2d at 954.

⁶⁶ See H. HENN & J. ALEXANDER, LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 661-663 (3rd ed. 1983) (summarizing the business judgment rule). See also Manning, The Business Judgment Rule in Overview, 45 OHIO ST. L.J. 615 (1984).

interests of the corporation after exercising due care.⁶⁷ The purpose of the business judgment rule is to protect directors from continuously having to justify to shareholders their decisions made in the ordinary course of business.⁶⁸ This is true even if the decisions turn out to be wrong, provided the directors acted in good faith and exercised due care.⁶⁹ Courts are reluctant to substitute their judgment for that of boards of directors because courts perceive the boards as possessing skills, information, and judgment not possessed by the courts.⁷⁰

The business judgment rule protects only boards that act in good faith in accord with their duty of loyalty,⁷¹ but only a duty of loyalty to the corporation not the shareholders. If the directors are disinterested, in all probability they will be deemed to have acted in good

⁶⁷ See, e.g., *Tate & Lyle PLC v. Staley Continental, Inc.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,764 (Del. Ch. 1988).

⁶⁸ *BNS, Inc. v. Koppers Co.*, 683 F.Supp 458, 473 (D. Del. 1988).

⁶⁹ *Mathes v. Cheff*, 41 Del. Ch. 166, 175, 190 A.2d 524, 529 (1963), rev'd on other grounds, 41 Del. Ch. 494, 199 A.2d 548 (1964).

⁷⁰ *Auerbach v. Bennett*, 47 N.Y.2d 619, 630-31, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); *Solash v. Telex Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep (CCH) ¶¶ 93,608, 97,722 (Del. Ch. Jan. 19, 1988).

⁷¹ H. HENN & J. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* 661 (3rd ed. 1983) (discussing business judgment rule).

faith.⁷² However, if the directors are not disinterested and are beneficiaries of the action, they will have breached their duty of loyalty, and the business judgment rule will not protect them.⁷³ If the plaintiff is able to establish that the board did not act in good faith or breached its duty of due care, the burden of proof shifts to the defendant directors to show that the transaction was entirely or intrinsically fair.⁷⁴

The business judgment rule really represented a shift from shareholders to the corporate entity when it was

⁷² Beard v. Elster, 39 Del. Ch. 153, 165, 160 A.2d 731, 738 (1960).

⁷³ See, e.g., Maldonado v. Flynn, 597 F.2d 789, 794 n.7 (2d Cir. 1979), on remand, 477 F.Supp. 1007 (S.D.N.Y. 1979); Beard v. Elster, 39 Del. Ch. 153, 160 A.2d 731 (1960); Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971) (directors found to be disinterested). See also, e.g., Galef v. Alexander, 615 F.2d 51 (2d Cir. 1980); Clark v. Lomas & Nettleton Fin. Corp., 625 F.2d 49 (5th Cir. 1980), cert. denied, 450 U.S. 1029 (1981); Grynberg v. Farmer, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,683 (D. Colo. Oct. 8, 1980) (directors found to be interested).

⁷⁴ "[The] plaintiff ... must be able to make specific allegations of malfeasance or bad faith. Where an improper motive is claimed, plaintiff must allege that it was the sole or primary reason for the directors' actions." Eldridge v. Tymshare, Inc., 186 Cal. App. 3d 767, 777, 230 Cal. Rptr. 815, 820 (1986). "At a minimum, the Delaware cases require that the plaintiff must show some sort of bad faith on the part of the defendant." Johnson v. Trueblood, 629 F.2d 287, 293 (3d Cir. 1980), cert. denied, 450 U.S. 999 (1981). "Once a plaintiff demonstrates that a director had an interest in the transaction at issue, the burden shifts to the director to prove that the transaction was fair and reasonable to the corporation." Treadway Cos. v. Care Corp., 638 F.2d 357, 382 (2d Cir. 1980).

developed in the thirties.⁷⁵ In Delaware, the business judgment rule was formulated in the fifties.⁷⁶ It has taken more than thirty years for the fiduciary relationships to catch up to the business judgment rule.

3. Social Responsibility and Third Party Beneficiaries

The internal relationships between officer, shareholder, and corporation are governed by the law of agency, the fiduciary concept including the business judgment rule, and state corporation laws.⁷⁷ Now courts are considering the relationship between the corporation and society. The theory of corporate social responsibility is developing in the wake of concerns about the environment, product safety, and social justice.

A corporation is private property owned by the shareholders and operated for their benefit.⁷⁸ The traditional or classical view of corporate social responsibility⁷⁹ is that corporations are to make profits

⁷⁵ See *Walker v. Man*, 142 Misc. 277, 253 N.Y.S. 458 (Sup. Ct. 1931); *Epstein v. Schenck*, 35 N.Y.S.2d 969 (Sup. Ct. 1939).

⁷⁶ See *Gottlieb v. Heyden Chemical Corp.*, 33 Del. Ch. 82, 90 A.2d 660 (Del. Sup. 1952) and *Glassberg v. Boyd*, 35 Del. Ch. 293, 116 A.2d 711 (Ch. 1955).

⁷⁷ See *supra* parts 1 and 2.

⁷⁸ 204 Mich. 459, 170 N.W. 668, 684 (1919).

⁷⁹ See *Eisenberg, Corporate Legitimacy, Conduct, and Governance--Two Models of the Corporation*, 17 CREIGHTON L. REV. 1 (1983); *Engel, An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1 (1979); *Epstein*,

for their shareholders.⁸⁰ Nonetheless, there always has been some constraint on the means, but no constraint on the goal. The profit motive remains the ultimate legal purpose for which persons form corporations.

At common law, it is a tenet of sovereignty that a government may regulate the manner in which citizens use their own private property, when necessary for the common good.⁸¹ As the Supreme Court of the United States stated:

Property does become clothed with a public interest when used in a manner to make it of public consequence, and affect the community at large. When, therefore, one devotes his property to a use in which the public has an interest, he, in effect, grants to the public an interest in that use, and must submit to be controlled by the public for the common good, to the extent of the interest he has thus created. He may withdraw his grant by discontinuing the use; but, so long as he maintains the use, he must submit to the

Societal, Managerial, and Legal Perspectives on Corporate Social Responsibility--Product and Process, 30 HASTINGS L.J. 1287 (1979); Hetherington, Fact and Legal Theory: Shareholders, Managers, and Corporate Social Responsibility, 21 STAN. L. REV. 248 (1969); Mangrum, In Search of a Paradigm of Corporate Social Responsibility, 17 CREIGHTON L. REV. 21 (1983); Mashaw, Corporate Social Responsibility: Comments on the Legal and Economic Context of a Continuing Debate, 3 YALE L. & POL'Y REV. 114 (1984); Solomon & Collins, Humanistic Economics: A New Model for the Corporate Responsibility Debate, 12 J. CORP. L. 331 (1987) (discussing theoretical aspects of corporate social responsibility).

⁸⁰ Dodge v. Ford Motor Company, 204 Mich. 459, 170 N.W. 668, 684 (1919). Also see M. FRIEDMAN, CAPITALISM AND FREEDOM 133-136 (1962) (providing a good discussion of directors responsibility to make profits for their shareholders).

⁸¹ See Munn v. Illinois, 94 U.S. 113, 125 (1876) (stating the common law position).

control.⁸²

More recent case law requires that corporate directors recognize that there are other interests to be considered aside from the interests of shareholders. A watershed in the case law regarding corporate social responsibility was reached in *A. P. Smith Manufacturing Co. v. Barlow*,⁸³ in 1953. A. P. Smith Manufacturing Company had regularly contributed to the local community chest and occasionally to Upsala College.⁸⁴ In 1951, the board of directors adopted a resolution to contribute to the Annual Giving to Princeton University.⁸⁵ The justification was the usual sound investment, business purpose rhetoric.⁸⁶ The court, picking up the thread of the common law as articulated in *Munn v. Illinois*, carried the common law further, stating: "It seems to us that just as the conditions prevailing when corporations were originally created required that they serve public as well as private interests, modern conditions require that corporations acknowledge and discharge social as well as private responsibilities as members of the communities within which they operate."⁸⁷

⁸² *Id.* at 126.

⁸³ 13 N.J. 145, 98 A.2d 581 (1953).

⁸⁴ *A. P. Smith Manufacturing Co.*, 98 A.2d at 582.

⁸⁵ *Id.*

⁸⁶ *Id.* at 583.

⁸⁷ *Id.* at 586.

Significantly, the court held not only that the gift had been made in the reasonable belief that it would advance the interests of the corporation, but also the court added that the gift would aid the public welfare and advance the interests of the plaintiff as a part of the community in which the gift operates.⁸⁸ This was an extension of the common law,⁸⁹ although the court was careful to say that the charity in question was not a pet charity of the directors in furtherance of personal, rather than corporate, ends.⁹⁰ Corporations were authorized to further social welfare.

More recent cases tend toward a social responsibility theory for corporations.⁹¹ Nonetheless, the profit motive remains the driving force behind corporate existence, and social responsibility is constrained by reasonableness.⁹²

State legislatures are also taking an active role in the expansion of the scope of fiduciary duties. Approximately one-half of the states not including Delaware

⁸⁸ Id. at 590.

⁸⁹ Id.

⁹⁰ Id. Apparently, a different result would have been reached if the charity were a pet personal one of the directors.

⁹¹ See, e.g., Theodore Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969) (adopting a social responsibility theory).

⁹² "[T]he test to be applied in passing on the validity of a gift such as the one here in issue is that of reasonableness...." Id. at 405.

have enacted "corporate constituency" statutes.⁹³ These statutes appear to be reactions to the takeover mania of the 1980's and shifts from individual to institutional investors. A typical provision permits the board of directors when considering the best interests of the corporation to include not only shareholders but also, to the extent deemed appropriate, employees, suppliers, customers, creditors, the community in which the corporation is located, short- and long-term interests of the corporation, and all other pertinent factors.⁹⁴ Moreover, no one group or interest need be considered the dominant or controlling interest or factor.⁹⁵ Most of these corporate constituency statutes are permissive, not mandatory and, hence, vest great discretion in the board of directors. Five of the states restrict the constituency statutes to takeover situations while the rest apply to all decisions of

⁹³ Ariz. Rev. Stat. Ann. § 10-1202 (1987); Conn. Gen. Stat. § 33-313 (1961); Fla. Stat. § 607.111 (1975); Ga. Code Ann. §14-2-202 (1989); Haw. Rev. Stat. § 415-35 (1983); Idaho Code § 30-1702 (1988); Ill. Rev. Stat. ch. 32, para. 8.85 (1987); Ind. Code § 23-1-35-1 (Burns 1986); Ky. Rev. Stat. Ann. § 271B.12-210 (Baldwin 1988); La. Rev. Stat. Ann. § 12:92 (West 1968); Minn. Stat. § 302A.251 (1982); Me. Rev. Stat. Ann. tit 13, § 716 (1985 & Supp. 1989); Mo. Ann. Stat. § 351.347 (Vernon 1986 & Supp. 1990); Neb. Rev. Stat. § 21-2035 (1988); N.J. Rev. Stat. § 14A:6-1 (10A-1 et seq.); N.M. Stat. Ann. § 53-11-35 (1967); N.Y. Bus. Corp. Law § 717 (McKinney 1987); Ohio Rev. Code Ann. § 1701.59 (Baldwin 1989); 42 Pa. Cons. Stat. Ann. § 8363 (Purdon 1986 & Supp 1990); Tenn. Code Ann. 8-35-204 (1988); and Wis. Stat. § 180.305 (1987).

⁹⁴ Id.

⁹⁵ Id.

the board of directors. Three states require directors to consider other constituencies.* Although how they take other constituencies into account apparently is left up to the board.

What the corporate constituency statutes do show is that state legislatures intend directors to take other constituent stakeholders in addition to shareholders into account when making decisions. Acting in the best interests of the corporation means more than just in the interest of the shareholders. The interests of the corporation and its shareholders are no longer synonymous.

Business ethics scholars are pushing for an even broader extension of corporate social responsibility. The extended stakeholder theory seems to be dominant at the moment. Proponents urge adoption of this theory since it can be accomplished within the framework of managerial capitalism. Ethically responsible management under this theory will take stakeholders other than shareholders into consideration in the decision making process. It is already demonstrated in this dissertation that both legislatures and courts impose this requirement. What distinguishes the approach of business ethics scholars is that they advocate a circle of stakeholders far broader than the corporation. For example, Professor R. Edward Freeman in *Strategic Management: A Stakeholder Approach*, defines a stakeholder

* See, e.g., Conn. Gen. Stat. Ann. § 33-313(e) (West 1990).

as "any group or individual who can affect or is affected by the achievement of the organization's objectives." Such a group could include employees, customers, the community, governments, and markets. This approach calls for some type of balancing or weighting of interests some of which are immediate and others are fairly remote. The degree to which each stakeholder group must or can be taken into consideration is not well-defined and appears to be highly subjective and variable depending on the situation.

Professor Freeman also advocates a multi-fiduciary approach. This approach is particularly troublesome since the fiduciary relationship traditionally has been reserved for special trust or trust like relationships. The duty of undivided loyalty seems incompatible with this approach. Loyalties may change with the situation. Kenneth E. Goodpaster promotes a stakeholder theory that retains the fiduciary relationship between managers and shareholders but advocates an ethical, non-fiduciary relationship between managers and non-shareholder stakeholders.⁹⁷ Professor Goodpaster does not understand that the fiduciary relationship is between the managers and the corporation except in certain intracorporate disputes discussed above.

The primary point to make here is that business ethics scholars and others would move the law even farther away from traditional financial theory and expand the spectrum of

⁹⁷ K. Goodpaster, Business Ethics and Stakeholder Analysis, 1 BUS. ETHICS Q. pp. 61-73 (1990-91).

stakeholder constituency even broader than the courts or legislatures have done to date.

C. Conclusions and Remedies

The assumption that managers act in the best interests of the "old" shareholders is not supported by the law whether one takes the separation of ownership and control or controlling shareholder view. The fiduciary concept has evolved in favor of the corporation as a whole and not any particular stakeholder group. The business judgment rule has consistently required a fiduciary duty to the corporation. Recent developments in corporate social responsibility and corporate constituency statutes broaden the number of stakeholders who may or must be considered rather than maintaining a narrow focus on the shareholders. The development in the case law is particularly important since case law develops in reaction to some action already taken. Acts of managers taking constituencies other than shareholders into consideration in making decisions have been upheld.

If the law is a reflection of managerial action, it has changed dramatically since the days of the Berle-Dodd debate, and corporate financial theory has lagged behind. If managers do not invest in positive net present value projects and thereby fail to maximize the value of the firm, the explanation must be something other than that managers act in the best interest of the old shareholders.

Conversely, the law and managerial action may be at

odds. In which case, managers either through ignorance of the law or in deliberate disregard of the law act in the best interests of the shareholders to the detriment of the corporation. In this instance, the law provides the shareholder derivative suit as a strictly legal remedy. The other potential remedies are the proxy contest and shareholder proposal which are regulated by federal and state securities law.

A shareholder derivative suit is a claim asserted by a shareholder in behalf of the corporation. The shareholder derivative suit is a recognition by the law that corporate directors may not act in the best interests of the corporation by refusing to assert the corporation's legal rights--in this case, by not enforcing the fiduciary duty to act in the best interest of the corporation. The purpose is to prevent abuse of authority by the board of directors. There are two obstacles to use of the derivative suit as a remedy. First, the suit must be brought by a shareholder who in this case is the beneficiary of the directors breach of fiduciary duty to the corporation. Such shareholders are unlikely to bring a shareholder derivative suit which might be detrimental to themselves. The second obstacle is a legal one. The courts have applied the business judgment rule to shareholder derivative suits.* The general rule is that courts will seldom interfere with intra-corporate

* United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917).

decisions.

Federal⁹⁹ and State¹⁰⁰ rules of civil procedure require that prior to bringing a shareholder derivative suit the shareholder must first formally demand that the board of directors pursue the specific legal right of the corporation in question. Failure to make such demand ordinarily results in dismissal. The demand requirement is excused only if it would be futile.¹⁰¹ If demand is futile, the Delaware Supreme Court applies a two-prong test as to whether or not the suit will be dismissed on motion of an Independent Investigation Committee of the Board of Directors.¹⁰² Such a committee generally consists of disinterested outside directors. The first prong is whether or not the committee is independent and acted in good faith after reasonable investigation. The second prong is whether the court in its own independent judgment would come to the same conclusion as the independent committee. In our case, there probably would be no independent, disinterested directors although it is possible.

The use of a shareholder derivative suit requires a shareholder and an independent director interested in acting in the best interest of the corporation instead of the

⁹⁹ Fed. R. Civ. P. 23.1.

¹⁰⁰ See, e.g., Del. Ch. Ct. R. 23.1.

¹⁰¹ Aronson v. Lewis, 473 A.2d 805 (Del. 1984).

¹⁰² Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981).

shareholders. The logical shareholder candidate would be an outsider who recognizing the under-investment would buy common stock in order to bring the shareholder derivative suit. Such a candidate probably would be interested in taking over the corporation.

The second group of potential remedies is the proxy contest and shareholder proposal. An insurgent shareholder may initiate a proxy contest in order to make changes in corporate policy. If successful, the proxy contest would place the insurgent's nominees on the board of directors. However, even if not successful, the board of directors may make proposed policy changes to ward off further attacks. A corporation should be vulnerable to a proxy contest if (1) management owns little or no common stock, (2) the corporation is undervalued (asset value greater than market value of stock), (3) the corporation has a poor performance record such as low earnings or low dividends, (4) the board of directors is not unified providing potential allies on the board.

Proxy contests are regulated by Section 14a of the Securities Exchange Act of 1934 and are quite expensive. Therefore, the difference between the market value of the stock and the asset value including the unfinanced positive net present value projects must exceed the costs of the proxy contest.

An alternative to a proxy contest is a shareholder proposal to invest in positive net present value projects.

Shareholder proposals are governed by Rule 14a-8.¹⁰³ Rule 14a-8 provides that if a shareholder who is entitled to vote at a meeting wishes to make a proposal, such a proposal must be presented to management with notice of intent to present the proposal at the meeting. Management is required to include the proposal unless it demonstrates that the proposal falls within one of the exclusions of the rule.¹⁰⁴ To be eligible to make a shareholder proposal, the shareholder must hold at least one percent of the corporation's outstanding voting stock or \$1,000 in market value.¹⁰⁵ A shareholder may solicit proxies as well as submit proposals. In 1987, the Securities and Exchange Commission eliminated part of the rule that allowed a corporation to omit shareholder proposals from proxy materials.¹⁰⁶ One reason for exclusion which may apply here is that the proposal may be omitted if it concerns operations which account for less than five percent of the corporation's total assets, net earnings, or gross sales unless it is otherwise significantly related to the corporation's business.¹⁰⁷

¹⁰³ 17 C.F.R. § 240.14a-8 (1989).

¹⁰⁴ Rule 14a-8(c)(1), 17 C.F.R. § 240.14a-8(c)(1) (1989).

¹⁰⁵ Rule 14a-8(a)(1), 17 C.F.R. § 240.14a(8)(a)(1) (1989).

¹⁰⁶ Exchange Act Rel. No. 25,217.

¹⁰⁷ 17 C.F.R. § 240.14a-8(c)(5) (1989).

There are two problems which must be overcome. First, the asymmetric information problem wherein the shareholder does not know the updated value of the project. Second, a shareholder willing to act contrary to his or her own short-term best interests. As with the proxy contest and shareholder derivative suit, an outsider with inside information is needed to pursue the remedy.

Acting in the best interests of the shareholders instead of the corporation is not a high risk violation of the law. While the law is explicit with respect to the duties of managers to act in the best interests of the corporation, the law does not provide an adequate remedy for breach of that fiduciary duty. The shareholder derivative suit, proxy contest, and shareholder proposal are not effective because they rely on actions by the very persons who are the beneficiaries of the breach of fiduciary duty. Such legal remedies rely on outsiders with information concerning the updated values of the forgone projects who are willing to invest in the corporation and in expensive legal contests to maximize the value of the corporation. If managers do in fact act in the best interests of the old shareholders and thereby fail to maximize the value of the corporation by forgoing positive net present value projects, the law of corporate governance currently does not provide an effective solution to the problem. Effective remedies must be sought in the marketplace. A merger, tender offer, spin-off, or equity carve out offers such a solution.

APPENDIX B

Merger and Tender Offer Solutions

This part examines the merger and tender offer solutions to the asymmetric information part of the problem in terms of both financial and legal effects. Managers of corporations who do not maximize the value of the corporation by investing in all positive net present value projects may find themselves takeover targets. The hypothesis is: if managers forgo positive net present value projects in the interest of the old shareholders and the corporation's value is suboptimal then the corporation becomes a candidate for a takeover. New management presumably will invest in the forgone opportunities thereby increasing the value of the subsidiary or combined entity.

Finance merger literature can be divided into two groups. The first group consists of the older empirical studies on conglomerate mergers, and the second group can be termed the more modern. Mandelker¹ found that the target firms in his sample earned significantly lower rates of return on equity than other firms over most of the period prior to merger. Mandelker further discovered a significant and steady increase in cumulative residuals for the target corporation over the seven month period preceding the merger. Other studies establish that there is a positive

¹ Mandelker, G., Risk and Return: The Case of Merging Firms, J. OF FINANCIAL ECONOMICS 1, 303-335 (1974).

relationship between merger activity and strong economic growth, i.e., periods of economic and market advances.²

While it is true that mergers do not seem to have generated increases in the value of the acquiring corporation,³ this phenomenon may be explained by Roll's *hubris hypothesis*.⁴ Roll's hypothesis is that managers are over-optimistic in evaluating target corporations as takeover candidates and pay more for the target corporation than they should. This could be a function of the asymmetric information problem.

The asymmetric information problem posed here is quite different from other finance literature dealing with mergers and tender offers. Usually, it is a bidder who has the information advantage rather than the target management.

Giammarino and Heinkel⁵ modelled takeover behavior in 1986. In their model, there is an informed and uninformed bidder in addition to the target corporation all of which are risk neutral. The informed bidder has an information advantage over both the uninformed bidder and the target corporation. The model is highly structured, and the uninformed bidder is given a tactical advantage in the way

² Nelson, R., *MERGER MOVEMENTS IN AMERICAN INDUSTRY 1895-1956* (1959); Reid, S. R., *MERGERS, MANAGERS AND THE ECONOMY* (1968).

³ Mueller, D. C., *The Effects of Conglomerate Mergers*, J. OF BANKING AND FINANCE 1, 315-347 (1977).

⁴ R. Roll, *The Hubris Hypothesis of Corporate Takeovers*, J. OF BUSINESS 59, 197-216 (1986).

⁵ R. Giammarino and R. Heinkel, *A Model of Dynamic Takeover Behavior*, J. OF FINANCE 41, 465-480 (1986).

in which the bidding is structured. Under the Bayesian-Nash equilibrium all actions are optimal, and all bidders and the target managers correctly anticipate the strategies of the other participants. The model generates two distinctive equilibria resulting from different assumptions about the uninformed bidder's behavior. The first assumption is that the uninformed bidder will not present a counter offer when expected payoffs from not bidding and bidding are equal. This is the passive competition case. In this case, the informed bidder may acquire the target corporation for less than its synergistic value. In the second case, the white knight scenario, the uninformed bidder is assumed always to counterbid. A counter bid gives the target corporation a higher price at the expense of the informed bidder.

The Giammarino and Heinkel model gives the target corporation's management a rational basis for rejecting the informed bidder's offer in the hope of getting a higher counterbid from the uninformed bidder. It also accounts for overbidding by the uninformed bidder and loss of the offer if the informed bidder's offer is rejected and a counterbid is not forthcoming, both as a result of asymmetric information.

Hirshleifer and Png⁶ formulated a model with two bidders for the target corporation. They assume that

⁶ D. Hirshleifer and I. P. L. Png, Facilitation of Competing Bids and the Price of a Takeover Target, REV. OF FINANCIAL STUDIES 2, 587-606 (1989).

bidding is costly whereas earlier models assume it was costless.⁷ The objective of the target management is to maximize shareholder value of the stock which implies that target managers would accept the bid if it exceeds the value of the target corporation's cash flows without the merger. The first bidder investigates and formulates a value for the target corporation. The second bidder is alerted by the first bidder's offer. Second bidder must then decide whether to investigate or not and then based on that investigation whether or not to bid. Second bidder investigates only if its expected return from investigation is strictly positive. Bidding is structured in two different ways. The first model is a single bid model. Each bidder may only bid once. Alternatively, in the second model a competing bid may be revised.

Contrary to earlier assumptions⁸ that competitive bidding for a target corporation always resulted in a higher price than a single bid, Hirshleifer and Png show that if bidding is costly, competitive bidding may result in a lower

⁷ See, e.g., A. Shleifer and R. Vishny, Greenmail, White Knights, and Shareholder's Interests, RAND J. OF ECONOMICS 17, 293-309 (1986); M. Fishman, A Theory of Preemptive Takeover Bidding, RAND J. OF ECONOMICS 19, 88-101 (1988).

⁸ See, e.g., L. Bebchuk, The Case for Facilitating Competing Tender Offers, 95 HARV. L. REV. 1028-1056 (1982); F. Easterbrook and D. Fischel, The Proper Role of Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161-1204 (1981); R. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 STAN. L. REV. 819-891 (1981).

price than from a single deterring bid. Under the Hirshleifer and Png model, the Delaware Supreme Court's requirement for an auction in a Revlon type situation may actually be detrimental to the target corporation shareholders.

Target corporation management may affect the outcome by the degree to which it is willing to disclose information to one or the other or both bidders thereby reducing investigation costs. This has the unfortunate effect of lowering the expected price offered for the target corporation and decreasing social welfare.⁹ Under the Hirshleifer and Png model target managers should not disclose the updated estimates of a and b since this would decrease the price offered.

Shleifer and Vishny¹⁰ look at the role of a large shareholder in corporate control. If the shareholders are atomistic, it may not pay any one of them to monitor the performance of the target corporation's management. However, it may be beneficial for a large shareholder to

⁹ Hirshleifer and Png show that the expected price of the target corporation and social welfare increase with the cost of investigation. Conversely, they show that the effect of reducing the cost of investigation is a reduction in the expected price of the target and a reduction in social welfare. Social welfare is defined as the expected valuation of the acquiring bidder minus the second bidder's cost of investigation minus the bidding costs of both bidders. Social welfare increases (decreases) as the cost of investigation increases (decreases).

¹⁰ A. Shleifer and R. Vishny, Large Shareholders and Corporate Control, J. OF POLITICAL ECONOMY 94, 461-488 (1986).

assume a monitoring role. Shleifer and Vishny assume that management is inefficient to the detriment of its shareholders. If the large shareholder discovers inefficiency and can improve the value of the corporation, the large shareholder's return on his or her shares makes up for costs incurred in monitoring and takeover. The bid that the large shareholder makes is a function of the number of shares held by the large shareholder. The larger the holding the smaller the bid premium but the larger the increase in the value of the firm. If the large shareholder can buy anonymously before the takeover bid, he or she can deprive minority shareholders of any gain from the takeover. This has ramifications for disclosure under section 13(d) of the Securities Exchange Act of 1934 which restricts the ability of a large shareholder to buy anonymously.

While the motives for conglomerate merger are still largely unknown, one hypothesis is that diversification reduces product line or industry risk.¹¹ The merged firms have a reduced risk of default which is referred to as the "co-insurance effect." The implication is that a reduction in risk should increase the value of the bonds at the expense of the stockholders. Of course, in a perfect capital market, diversification through conglomerate merger

¹¹ Kim, E. and J. McConnell, Corporate Mergers and the Co-insurance of Corporate Debt, J. OF FINANCE 32, 349-363 (1977); Amihud, Y. and B. Lev, Risk Reduction as a Managerial Motive for Conglomerate Mergers, BELL J. OF ECONOMICS 12, 605-617 (1981).

is unnecessary since shareholders can achieve their own degree of risk through portfolio diversification. Weston, Smith, and Shrieves¹² rejected diversification in a risk reducing sense because they found betas of the merged firms nearly twice as high as the comparable mutual funds. They concluded that conglomerate mergers may reduce product line risk but increase general economic risk. On the other hand, Kim and McConnell¹³ concluded that there was a co-insurance effect but that it was offset by increased use of debt financing. Their findings are consistent with the assumption that managers act in the best interests of the shareholders, at least where there is a conflict between shareholders and bondholders. Amihud and Lev¹⁴ hypothesize that managers engage in conglomerate mergers to diversify their employment risk since human capital is not divisible. The implication is that managers are not acting in the best interests of either the shareholders or the corporation but in their own. This type of activity is more likely to occur in manager-controlled firms rather than owner controlled firms.

¹² Weston, J. F., K. V. Smith, and R. E. Shrieves, Conglomerate Performance Using the Capital Asset Pricing Model, REVIEW OF ECONOMICS AND STATISTICS 54, 357-363 (1972).

¹³ Kim, E. and J. McConnell, Corporate Mergers and the Co-insurance of Corporate Debt, J. OF FINANCE 32, 349-363 (1977).

¹⁴ Amihud, Y. and B. Lev, Risk Reduction as a Managerial Motive for Conglomerate Mergers, BELL J. OF ECONOMICS 12, 605-617 (1981).

Jensen's free cash flow theory¹⁵ has some relevance here since one of the empirical implications of the hypothesis is that acquiring corporations should have free cash flow or excess debt capacity. Jensen asserts that managers have incentives to cause their firms to expand beyond their optimal sizes. Such firms generate large amounts of free cash flow. Free cash flow is cash flow in excess of that needed to fund all positive net present value projects. Rather than pay out the free cash flow to shareholders, managers seek other alternatives, one of which is merger or takeover. Jensen argues that his free cash flow theory predicts that such mergers and takeovers are more likely to destroy rather than create value because managers will undertake low or negative benefit mergers or takeovers just to expend free cash flow rather than create value. This is not the case in the model used in this dissertation. The problem here is that target managers are not funding positive net present value projects and thereby not maximizing the value of the corporation. Under these circumstances a merger or tender offer should create value rather than destroy it.

A. Financial Aspects

A corporation that does not maximize its value by not investing in positive net present value projects may become

¹⁵ M. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, AEA PAPERS AND PROCEEDINGS 76, 323-329 (1986).

a takeover target or could seek out slack rich corporations as suitors to finance projects without issuing equity securities.

A merger or tender offer by a slack rich corporation is assumed to be an all cash transaction so that evaluation of its securities is not an issue. Further, the slack poor corporation has not announced any issue-invest decision regarding the project. The same notation used in the general model described in Chapter I is used throughout.

In this model, it is assumed that target shareholders are atomistic although for purposes of target management acting in the best interest of the its shareholders, the existence of a large shareholder does not alter the result. In a contest for corporate control where the large shareholder is a bidder there may be an effect if the large shareholder has an information advantage. Here it is assumed that no shareholder has an information advantage over any other. The asymmetry of information is between target management which has the information advantage and its shareholders and the market.

First, consider an aggressive, slack rich corporation seeking takeover targets. The assumption of asymmetric information is maintained in that managers of the target, slack poor corporation have inside information about their corporation that the slack rich, acquiring corporation managers do not have. This is the opposite information asymmetry utilized by Giammarino and Heinkel in their 1986

paper and Hirshleifer and Png in their 1989 paper.¹⁶ They assume that an informed bidder has an information advantage over both an uninformed bidder and the target corporation management. Here both sets of managers, acquiring and target, know the distributions of $\bar{A}$ and $\bar{B}$. Only the slack poor, target corporation managers know the updated estimates of a and b .

The slack rich, acquiring corporation could acquire the slack poor, target corporation and sell off its component parts or continue the target's operations by financing the positive net present value project.

First, the asset in place may be sold after acquisition. Under Revlon if the cash poor target corporation is to be put on the auction block and its assets sold, the target management is under an obligation to maximize its shareholders' value. Managers know the updated estimate, a ; hence, they must get at least $S+a$ in the transaction to fulfill their fiduciary duty to the shareholders. The acquiring corporation will only be willing to offer $S+\bar{A}$ in the absence of inside information. A holdout or opposition by the target corporation managers could be interpreted as a signal that the updated estimated value of a exceeds $\bar{A}$. It would be in the best interests of

¹⁶ R. Giammarino and R. Heinkel, A Model of Dynamic Takeover Behavior, J. OF FINANCE 41, 465-480 (1986); D. Hirshleifer and I. P. L. Png, Facilitation of Competing Bids and the Price of a Takeover Target, REV. OF FINANCIAL STUDIES 2, 587-606 (1989).

the shareholders of the target corporation, however, for its management to hold out for a higher value thereby sending a false signal concerning the true values of a . If the acquiring corporation believed the false signal and paid an amount greater than $S+a$ for the target corporation, the shareholders of the slack poor, target corporation would benefit at the expense of the shareholders of the slack rich, acquiring corporation.

Second, a slack rich corporation, one with slack in excess of its needs or opportunities, can acquire one or more slack poor corporations with unfinanced positive net present value projects. Assuming sufficient slack to internally finance the projects such an acquisition would create value and support the notion that the merged corporations have a synergistic value greater than the sum of the parts.¹⁷

¹⁷ This would be true if the managers of the acquiring corporation accurately assessed the value of the target corporation. The empirical studies attempting to measure synergy produce mixed results. See, e.g., P. Halpern, Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers, J. OF BUSINESS 46, 554-575 (1973) and P. Dodd and R. Ruback, Tender Offers and Stock Returns: An Empirical Analysis, J. OF FINANCIAL ECONOMICS 5, 351-373 (1977) supporting the synergy theory. On the other hand, Jensen's free cash flow theory predicates that mergers and takeovers are likely to destroy rather than create value. Jensen's theory asserts that managers spend cash on value destroying mergers rather than distribute that cash to shareholders. M. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, AEA PAPERS AND PROCEEDINGS 76, 323-329 (1986). However, this is not the case here. The target corporation has untapped value in the positive net present value project. A more troublesome problem is presented by Roll's hubris hypothesis. Roll asserts that managers are over-optimistic in evaluating target

Maintaining the assumption of asymmetric information requires that the acquiring corporation know the distributions of $\bar{A}$ and $\bar{B}$ but not the updated estimated values a and b . The offer for the target cash poor corporation would be less than or equal to $S+\bar{A}+\bar{B}$ but greater than the market value of the stock. Such an offer would ex ante make the shareholders of both corporations better off. The target corporation shareholders are better off because the market value of their stock is discounted to less than $S+\bar{A}+\bar{B}$ because of the unfinanced positive net present value project and incomplete information. Moreover, the target corporation shareholders are better off if the offer exceeds $S+a$. In the absence of the merger, the value of the target corporation is the sum of the slack plus the value of the asset in place, $(S+a)$, since the positive net present value project will be not be undertaken. Any offer in the aggregate in excess of $S+a$ increases the value of the target shareholders' claim. Acquiring, slack rich corporation shareholders are better off because they get all or part of the unrealized value of the unfinanced positive net present value project. Such an offer would be acceptable under Delaware law as set out in *Time* and the corporate constituency statutes.

corporations and over-pay. R. Roll, The Hubris Hypothesis of Corporate Takeovers, J. OF BUSINESS 59, 197-216 (1986). For an empirical study showing no synergistic value, see, T. Langetieg, An Application of a Three-Factor Performance Index to Measure Stockholder Gains from Merger, J. OF FINANCIAL ECONOMICS 6, 365-383 (1978).

Managers know the updated estimates a and b ; hence, they must get at least $S+a+b$ in the transaction to fulfill their fiduciary duty to the corporation. Rational acquiring corporation managers should only be willing to offer $S+\bar{A}+\bar{B}$ in the absence of inside information.¹⁸ A holdout or opposition by the target corporation managers could be interpreted as a signal that the updated estimated values of a and b exceed $\bar{A}$ and $\bar{B}$. It would be in the best interests of the shareholders of the target corporation, however, for its management to hold out for a higher value thereby sending a false signal concerning the true values of a and b . If the acquiring corporation believed the false signal and paid an amount greater than $S+a+b$ for the target corporation, the shareholders of the slack poor, target corporation would benefit at the expense of the shareholders of the slack rich, acquiring corporation. Jennings and Mazzeo¹⁹ found that target management resistance increased the likelihood of a revision of the acquiring corporation's offer benefiting the target.

It may be that the updated estimates of a and b are less than $\bar{A}$ and $\bar{B}$. In this case in a non-negotiated merger,

¹⁸ Jennings and Mazzeo show, however, that bidders revise offers in favor of the target even in the face of adverse market reaction to the announcement. R. Jennings and M. Mazzeo, Stock Price Movements around Acquisition Announcements and Management's Response, J. OF BUSINESS 64, 139-163 (1991).

¹⁹ R. Jennings and M. Mazzeo, Stock Price Movements around Acquisition Announcements and Management's Response, J. OF BUSINESS 64, 139-163 (1991).

the target corporation's managers need not oppose the merger to fulfill their fiduciary duty. However, if the acquiring corporation managers observe that the target corporation managers are not opposing the merger, they may take that action as a signal that they overbid for the target corporation and back out, if possible.²⁰ Therefore, even if $a < \bar{A}$ and $b < \bar{B}$, target corporation managers should holdout or oppose the merger in the best interests of the slack poor, target corporation shareholders.

The best strategy for the managers of a target corporation always is to holdout or oppose the merger.²¹ Easterbrook and Fischel²² argued that managers of target corporations should be bound by a "rule of managerial passivity" that would prohibit target managers from soliciting a competing bid or opposing a takeover. The law, however, is to the contrary, a fact they recognized by

²⁰ Proposed acquisitions may fail for a host of reasons such as a lack of response or resistance by the target or the occurrence of a condition precedent which terminates the proposal. Jennings and Mazzeo studied 472 proposed acquisitions between June 1, 1979 and December 31, 1987. A total of 121 or approximately one-quarter of these proposed acquisitions were cancelled. Forty-seven were cancelled by the acquiring corporation alone. *Id.* at 161.

²¹ G. Jarrell and M. Bradley, The Economic Effects of Federal and State Regulation of Cash Tender, J. OF LAW AND ECONOMICS 23, 371-407 (1980) concluding that the effect of federal and state regulation is to raise the price bid for the target corporation.

²² F. Easterbrook and D. Fischel, The Proper Role of a Target's Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161-1204 (1981).

calling for the repeal of the Williams Act.²³ Developments in state corporation law have encouraged target opposition to takeover bids.²⁴ State takeover statutes tend to be paternalistic by protecting local businesses. State legislatures assume that local incumbent managers' interests are identical with the state's public policy.²⁵ This introduces an element of agency costs associated with managers seeking to preserve their own positions. Consequently, their action cannot be used as a signal to the acquiring corporation managers concerning the true value of the target corporation ($S+a+b$). Target corporation shareholders are not harmed since their stock is discounted in the market because of the asymmetric information and unfinanced positive net present value project to less than $S+\bar{A}+\bar{B}$ which is the maximum offer the acquiring corporation should make without inside information. Any merger offer amount between the discounted market value of the target corporation stock and $S+\bar{A}+\bar{B}$ inures to the benefit of the target corporation shareholders. Further, any offer greater than $S+a$, the value of the firm without investment in the project, increases the value of the target shareholders' claim and should be accepted.

²³ 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), and 78n(e) and 78n(f) (1988).

²⁴ See infra notes 113-124 and accompanying text.

²⁵ See, e.g., Icahn v. Blunt, 612 F.Supp. 1400 (W.D.Mo. 1985).

A slack poor corporation may aggressively seek a merger with a slack rich corporation. This action may be interpreted as a signal that the slack poor corporation has an unfinanced, positive net present value project and is seeking outside financing for that project through a merger. Without the investment, the true value of the slack poor corporation is $S+a$; however, the market value of the slack poor corporation is less than or equal to $S+\bar{A}+\bar{B}$. By seeking the merger, the slack poor corporation could be signalling that $S+a+b > S+\bar{A}+\bar{B}$. The problem is that the managers of the slack poor corporation have an incentive to lie.

Assume that $S+a+b < S+\bar{A}+\bar{B}$ and that only the managers of the slack poor corporation know the updated estimates of a and b , the slack poor corporation managers would seek a merger in which they would be willing to accept any amount between $S+a$ and $S+\bar{A}+\bar{B}$ where $S+a < S+a+b < S+\bar{A}+\bar{B}$. The medium of exchange has an effect. Jensen's free cash flow theory predicts that takeovers financed with cash and debt create greater benefits than those financed through the exchange of stock.²⁶ Empirical evidence shows that the market reacts more favorably to cash offers than to stock exchanges.²⁷ In

²⁶ M. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, AEA PAPERS AND PROCEEDINGS 76, 323-329 (1986).

²⁷ P. Asquith, R. Bruner, D. Mullins, Merger Returns and the Form of Financing, Unpublished manuscript. Cambridge, Mass.: Harvard University; Y. Huang and R. Walkling, Target Abnormal Returns Associated with Acquisition Announcements: Payment, Acquisition Form and Managerial Resistance, J. OF FINANCIAL ECONOMICS 19, 329-349

an exchange of stock, target shareholders are at risk on the downside if the acquiring corporation managers overbid; however, if there is synergy from the merger, target shareholders will benefit at the expense of the acquiring corporation shareholders. The shareholders of the slack poor corporation would benefit at the expense of the shareholders of the slack rich corporation for any cash offer greater than $S+a+b$. Indeed, it may be assumed that the more aggressive the managers of the slack poor corporation are in seeking a merger the less the true value, $S+a+b$, is. Because no meaningful or useful signal is given by slack poor corporation managers' actions in seeking a merger, without inside information slack rich corporation managers should never offer more than $S+\bar{A}+\bar{B}$ cash in a merger; nonetheless, $S+\bar{A}+\bar{B}$ may be an overbid if the value of the stock is overpriced as in the case $S+a+b < S+\bar{A}+\bar{B}$. Given the tendency of acquirors to overbid, a stock exchange benefits their shareholders.

The minimum acceptable offer from the viewpoint of the slack poor corporation's shareholders is $S+a$. Rational slack poor corporation shareholders should reject any offer less than $S+a$. A merger offer is only acceptable to the slack rich corporation if the offer price is between the market price of the slack poor corporation's stock and

(1987); N. Travlos, Corporate Takeover Bids, Method of Payment, and Bidding Firms' Stock Returns, J. OF FINANCE 42, 943-964 (1987).

$S+\bar{A}+\bar{B}$ and if the stock is undervalued ($S+a+b > \text{market price}$).

A merger is acceptable to both parties only if

- (1) $S+a+b \geq S+\bar{A}+\bar{B} \geq \text{offer price} \geq S+a \geq \text{market price}$, or
- (2) $S+\bar{A}+\bar{B} \geq S+a+b \geq \text{offer price} \geq S+a \geq \text{market price}$, or
- (3) $S+a+b \geq S+\bar{A}+\bar{B} \geq \text{offer price} \geq \text{market price} \geq S+a$, or
- (4) $S+\bar{A}+\bar{B} \geq S+a+b \geq \text{offer price} \geq \text{market price} \geq S+a$.

The proposed merger will fail in all other cases. Since the updated estimates a and b are only known to the slack poor corporation managers, the only conclusion that the slack rich corporation managers can reach from the slack poor corporation's acceptance of the offer is that the offer price is greater than $S+a$. They know $S+\bar{A}+\bar{B}$ but not $S+a+b$. The relative position of the offer price vis a vis $S+a+b$ is unknown to the managers of the slack rich corporation. Certainly, the merger is unacceptable to them if the offer price exceeds $S+a+b$. A cautious management of a slack rich corporation would not enter into any particular merger with a slack poor corporation, although on average it would be beneficial.

Myers and Majluf (1984) show that in a merger situation where the slack rich corporation offers an amount less than or equal to $S+\bar{A}+\bar{B}$, the slack poor corporation is better off issuing equity and investing in the positive net present

value project itself.²⁸ However, it will not do so if the value of the corporation without investment is greater than the old shareholders' aliquot share of the corporation with investment. The slack poor corporation would only accept the merger terms if the offer price exceeded $S+\bar{A}+\bar{B}$, but without inside information, the slack rich corporation should never offer more than $S+\bar{A}+\bar{B}$. Under these conditions no merger would take place. Mergers do take place. Ironically, one of the key takeover indicators making a corporation particularly vulnerable to a takeover is the type of management-stockholder structure described by Myers and Majluf in their 1984 paper.²⁹ Either slack rich acquiring corporations obtain inside information from the slack poor corporation's managers and $S+a+b>S+\bar{A}+\bar{B}$, or they foolishly offer more than $S+\bar{A}+\bar{B}$ which is not acceptable if managers are rational, or slack poor corporation managers

²⁸ The proof is as follows: Define $a^*(N')$ as the breakeven value of a , the value at which the slack poor firm is just indifferent to being acquired at the equilibrium price Q' . Note that $Q'=a^*(N')+S$. Recall that the requirement for a corporation to issue stock is $(E/P)(S+a)\leq E+b$. If P were equal to Q' , the corporation would issue and invest in $a^*(N')$ for any $b>0$. That is, $P=Q'=S+a^*(N')$,

$$(E/P)(S+a)=[E/(S+a^*(N'))](S+a^*(N'))=E<E+b.$$

Thus $a^*(M')$, the breakeven value of a at which the firm is just willing to issue stock, exceeds $a^*(N')$ for any $b>0$. Thus,

$$\bar{A}(M')+\bar{B}(M')>\bar{A}(N')+\bar{B}(N') \text{ and } P>Q'.$$

²⁹ R. Trough, Characteristics of Target Companies, 32 BUS. LAW. 1301 (1977).

accept terms less than $S+\bar{A}+\bar{B}$, particularly if $S+a+b < S+\bar{A}+\bar{B}$, that is, managers are not necessarily acting exclusively in the best interest of their shareholders.

This problem may be circumvented by a cash tender offer to the slack poor corporation's shareholders. Typically, the value of the consideration offered to the target shareholders exceeds the market value of the stock as a premium to obtain control. In the model used here, the consideration is in an amount between the market price and $S+\bar{A}+\bar{B}$. This strategy may succeed because neither party has inside information. A cash tender offer for the slack poor corporation's stock would not convey any bad news to the market or to the slack poor corporation's shareholders since it would not be based on inside information concerning the updated estimated values of a and b which are only known to the slack poor target corporation's management.

Target shareholders wishing to tender their shares do so by forwarding their stock to the tender offeror's agent, usually a depository bank. The tender offer must be left open for at least twenty days which may be extended.³⁰ Commonly, the tender offer is conditional on the occurrence of certain events, such as tender of all or stated part or percentage of the target shares, a favorable antitrust ruling, or the tender offeror's ability to obtain financing.

The advantages of a tender offer are that it is

³⁰ 17 C.F.R. § 240.14e-1 (1991).

generally cheaper than a proxy fight as a non-negotiated takeover; if not successful, the tender offeror still has its investment in the acquired target stock and may be able to dispose of it at a profit;³¹ a tender offer is faster; and secrecy is easier to maintain. Tender offers often are followed by mergers unless prohibited by the state takeover statutes³² which impose post-acquisition restrictions on business combinations.

Tender offers may be used to circumvent target management in a hostile takeover situation. Hirshleifer and Titman³³ construct a model for hostile takeovers. In their model, unlike the model employed here, there is one potential acquiror who is a minority shareholder of the target corporation. All other shareholders are atomistic. The potential acquiror has only one opportunity to bid. If the offer is rejected, the potential acquiror loses the synergistic value. Hirshleifer and Titman show that the optimal bid is a strictly increasing function of the improvement in value resulting from the takeover which is

³¹ There is evidence that positive, cumulative abnormal returns persist for approximately two years after a failed takeover bid thus providing the basis for a gain. M. Bradley, A. Desai, and E. Kim, The Rationale Behind Interfirm Tender Offers: Information or Synergy? J. OF FINANCIAL ECONOMICS 11, 183-206 (1983).

³² See, text regarding state takeovers statutes in Part B.3, infra.

³³ D. Hirshleifer and S. Titman, Share Tendering Strategies and the Success of Hostile Takeover Bids, J. OF POLITICAL ECONOMY 98, 295-324 (1990).

rational since the greater the potential gain, the more the potential acquiror is willing to bid. This results in a separating outcome in that the bidders reveal the level of improvement through their bids. Low improvement value results in a low bid while a high improvement value results in a high bid. What the potential bidder does not know is the price at which the atomistic shareholders will tender due to personal costs and benefits of tendering not known to the bidder. The asymmetry of information is between the large shareholder and the atomistic shareholders of the same target corporation. Hirshleifer and Titman imply that a reduction in the degree of asymmetry of information between the large shareholder and the others increases the probability of success. Such is not the case in the model used in this dissertation since there is no difference in the degree of asymmetry of information. Each is ignorant of the true or updated estimated values of a and b . The Hirshleifer and Titman results only obtain if the potential acquiror, the large shareholder, has superior information.

The Hirshleifer and Titman model also shows that for a tender offer to be profitable, dilution of the minority holdings is not necessary as Grossman and Hart³⁴ modelled.

Rejection of a bid is costly to the bidder who loses both the improvement value and costs incurred in

³⁴ S. Grossman and O. Hart, Takeover Bids, the Free Rider Problem, and the Theory of the Corporation, BELL J. ECONOMICS 11, 42-64 (1980).

investigation and bidding. Rejection also allows target management time to react and organize to oppose the hostile takeover. Hirshleifer and Titman examine management defensive actions of "poison pill" and "sale of the crown jewels" and litigation. In such cases, the likelihood of failure increases.

A major problem for a potential acquiror who holds a minority of the shares and attempts a hostile takeover is a control-share statute such as the one enacted in Indiana.³⁵ Indiana's control-share statute withstood scrutiny by the United States Supreme Court in *CTS Corporation v. Dynamics Corporation of America*.³⁶ More than one-half of the states have enacted some form of control-share statute modelled after the Indiana statute. The purpose of a control-share statute is keep the acquiror from exercising the voting power of the acquired stock thereby rendering the acquiror powerless to make the changes necessary to reap improvement value. Whenever an entity acquires control as defined in the statute (any of three possible levels: 20 percent, 33-1/3 percent, or more than 50 percent) it is not necessarily entitled to vote those control shares. To be able to vote the control shares, a resolution must be passed by a majority of disinterested shares of each class entitled to vote on the resolution. Disinterested shareholders are

³⁵ Ind. Code §§ 23-1-42-1 et seq.

³⁶ 481 U.S. 69 (1987).

those other than the acquiror and officers and inside directors of the acquired corporation. The effect is to condition control of the corporation on the approval of a majority of the old, disinterested shareholders of the target corporation.

In the model used in this dissertation, the managers of the slack poor corporation may oppose the cash tender offer and advise their shareholders to reject the offer and holdout for a higher amount possibly greater than $S+\bar{A}+\bar{B}$. Without inside information concerning the updated estimated values of a and b , the slack rich firm should never offer more than $S+\bar{A}+\bar{B}$. Ex ante both the slack poor corporation's shareholders and the slack rich corporation would be better off if an offer between the market price and $S+\bar{A}+\bar{B}$ were accepted. However, the shareholders of the slack poor corporation may be misled by their managers as to the true value of the corporation and refuse to tender. Ultimately, the shareholders must make their own decision regarding the sufficiency of the offer. Management that breaches its duty by intentionally inflating the value of the slack poor corporation and misleading its shareholders may be guilty of violating Section 10b³⁷ and Rule 10b-5³⁸ of the Securities Exchange Act of 1934 and the Williams Act.

B. Legal Aspects

³⁷ 15 U.S.C. § 78j(b) (1988).

³⁸ 17 C.F.R. § 240.10b-5 (1991).

1. General Antifraud

a. Federal

The antifraud provisions of the federal securities laws apply to securities whether they are exempt from registration or not or whether they are transactionally exempt or not. Consequently, the antifraud provisions apply to the model under consideration under all circumstances. The primary antifraud provisions are section 17³⁹ of the Securities Act of 1933, section 10(b) of the Securities Exchange Act of 1934, and section 206⁴⁰ of the Investment Advisers Act of 1940.

Section 10 is the catchall provision of the Securities Exchange Act of 1934. Its purpose is to provide relief from abuses not otherwise addressed in the act. However, section 10 is not a self-executing provision. It is only effective through rules and regulations promulgated by the commission pursuant to the authority of section 10 to make such rules as are necessary or appropriate in the public interest or for the protection of investors. In 1942, rule 10b-5 was issued by the commission.⁴¹ Interestingly, rule 10b-5 is merely modified language of section 17(a) of the Securities Act of 1933; the principal modification is that section 17(a) only applies to sales of securities whereas section 10

³⁹ 15 U.S.C. § 77q (1988).

⁴⁰ 15 U.S.C. § 80b-6 (1988).

⁴¹ SEC Securities Exchange Act Release No. 3230 (May 21, 1942).

applies to a purchase or sale.

Rule 10b-5 provides that

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

(1) to employ any device, scheme, or artifice to defraud,

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

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

Section 10 and rule 10b-5 are stated as prohibitions and give rise to administrative proceedings,⁴² suits for injunction by the commission,⁴³ and criminal actions⁴⁴ referred to the Justice Department for prosecution. However, it was established as early as 1946 that there was an implied civil cause of action for damages in behalf of the defrauded victim.⁴⁵

The elements of a cause of action under rule 10b-5 are (1) use of the mails, an instrumentality of interstate

⁴² Sections 21 and 21A, Securities Exchange Act of 1934, 15 U.S.C. §§ 78u and 78u-1 (1988).

⁴³ Section 20(d), Securities Exchange Act of 1934, 15 U.S.C. § 78t(d) (1988).

⁴⁴ Section 32, Securities Exchange Act of 1934, 15 U.S.C. § 78ff (1988).

⁴⁵ Kardon v. National Gypsum Co., 69 F.Supp 512 (E.D.Pa. 1946). This holding was affirmed in Basic, Inc. v. Levinson, 485 U.S. 224 (1985).

commerce, or any facility of a national securities exchange; (2) a purchase or sale of a security; (3) fraud or deceit or a misstatement or omission of a material fact; (4) scienter; (5) causation; (6) reliance; and (7) damages in a civil action. A private cause of action must be brought by a purchaser or seller.⁴⁶ This requirement is strictly applied. A merger entails a purchase and sale of a security.⁴⁷

Two of the three clauses of rule 10b-5 deal with fraud or deceit. Fraud does not include overreaching by a controlling shareholder unless it is accompanied by actual deception.⁴⁸ A cause of action for fraud under rule 10b-5 is similar to common law fraud in that there must be a relationship between the parties which gives rise to a duty that is violated. In insider trading cases, the insider by virtue of his or her position gains access to information intended for corporate purposes and not personal benefit.⁴⁹ The corresponding duty is to abstain from the marketplace

⁴⁶ *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952).

⁴⁷ *SEC v. National Securities*, 393 U.S. 453 (1969).

⁴⁸ *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977).

⁴⁹ *Chiarella v. U.S.*, 445 U.S. 222 (1980); *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961).

until the information is made public.⁵⁰ The insider must not take unfair advantage of information unknown to persons with whom the insider is dealing. In many instances the courts are not clear as to which clause of rule 10b-5 the court is applying, particularly in insider trading cases.

Clause 2 of rule 10b-5 deals with misstatements and omissions of material facts. A fact is material if it is the kind of information that a reasonable investor would consider important in making his or her investment decision.⁵¹ In the context of an untrue statement of a material fact, the intentional misstatement is akin to common law fraud. In the case of an omission of a material fact where there is a duty to disclose, an element of conjecture is introduced. The test of materiality then becomes whether the reasonable investor would have acted differently had he or she known of the undisclosed fact.⁵²

Since the U. S. Supreme Court's decision in *Ernst & Ernst v. Hochfelder*,⁵³ scienter is a requirement of a cause of action under section 10b and rule 10b-5. Scienter requires an intent to deceive, manipulate, or defraud.

⁵⁰ *Investors Management Co., Inc.*, 44 S.E.C. 633 (1971); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228 (2d Cir. 1974).

⁵¹ *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

⁵² *Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128 (1972).

⁵³ 425 U.S. 185 (1976).

Negligence will not support a cause of action under section 10b and rule 10b-5. The Supreme Court reserved the issue of whether recklessness was equivalent to intentional conduct, but virtually all lower courts hold that it is. Breach of fiduciary duty without an allegation of deception, misrepresentation, or deception is not actionable under rule 10b-5.⁵⁴

Causation is a necessary element of a cause of action under section 10b and rule 10b-5.⁵⁵ The misrepresentation or fraud must be the proximate cause of plaintiff's loss. If the misrepresentation is of a material fact on which plaintiff relied but is not the reasonable direct cause of the pecuniary loss, no recovery is allowed.

In fraud cases and cases involving affirmative misstatements of material facts, plaintiffs must show actual reliance.⁵⁶ However, if the misleading statement constitutes a fraud on the market, plaintiff does not have to show reliance but only that he or she bought or sold a security at a price that was affected by the misleading statement.⁵⁷ The fraud on the market theory is based on the

⁵⁴ Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

⁵⁵ Affiliated Ute Citizens of Utah v. U.S., 406 U.S. 128 (1972).

⁵⁶ List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir. 1965), cert. denied, 382 U.S. 811 (1965), reh. denied, 382 U.S. 933 (1965).

⁵⁷ Basic, Inc. v. Levinson, 485 U.S. 224 (1988).

notion that the price of a security is based on all available material information concerning the business. Misleading statements, therefore, affect market price. Nondisclosure or complete omission cases present another problem. Plaintiff would have to show that he or she would have relied on the facts if they had been made known to him or her, which, in effect, means that the omitted facts were material facts.⁵⁸ In a nondisclosure case, if the plaintiff proves materiality, he or she has in fact proved reliance.⁵⁹

The measure of damages in most cases is the "out of pocket" rule.⁶⁰ The damages award is based on the difference between what the plaintiff gave up and the value of what was received in the transaction. In the model used in this dissertation, the penalty for lying is the difference between the misrepresented value and $S+a+b$. In addition to damages awarded to a private plaintiff, the Commission may assess a civil penalty up to three times the actual damage. No punitive damages are assessed in an antifraud case. The potential for liability is great especially in insider trading cases since liability extends to all persons who traded in the market during the time that

⁵⁸ *Affiliate Ute Citizens of Utah v. U.S.*, 406 U.S. 128 (1972).

⁵⁹ *Id.*

⁶⁰ Section 20A, Securities Exchange Act of 1934, 15 U.S.C. § 78t-1 (1988). See, e.g., *Green v. Occidental*, 541 F.2d 1335 (9th Cir. 1976) (*Sneed, J.*, concurring).

the inside information was undisclosed.⁶¹ However, some courts attempt to limit the defendant's liability. For example, the sixth circuit requires "trading causation" between plaintiff's losses and defendant's trading on the basis of the undisclosed information.⁶²

Knowing the amount of damages that can be assessed for violation of section 10(b) and rule 10b-5 and section 14(e), the cost of lying can be calculated. Court costs, attorneys' fees, and other costs are not considered. If the managers of the slack poor firm lie and inflate the value of the firm, the gain from lying is the difference between the inflated value, V_i , and the actual or true value, V_t . Based on the inside knowledge of the updated estimates of a and b , the actual or true value of the firm, V_t equals $S+a+b$. The cost of lying is the difference between the product of the probability of being caught, p , times the gain and the product of the probability of not being caught, $(1-p)$, times the gain.

$$\text{Cost of Lying} = p(V_i - V_t) - (1-p)(V_i - V_t).$$

Rearranged,

$$\text{Cost of Lying} = (2p-1)(V_i - V_t).$$

It pays to lie if the Cost of Lying is negative, i.e.,

$$(2p-1)(V_i - V_t) < 0.$$

⁶¹ Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90 (10th Cir. 1971).

⁶² Fridrich v. Bradford, 429 F.2d 307 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

Since $(V_1 - V_i) > 0$, otherwise, the lie is not beneficial, it pays to lie if $(2p - 1) < 0$ or $p < .5$.

If the possibility of civil penalties, CP, under section 2A(a)(2) of the Securities Exchange Act of 1934 is added,

$$\text{Cost of Lying} = p[(V_1 - V_i) + CP] - (1 - p)(V_1 - V_i).$$

Rearranged,

$$\text{Cost of Lying} = (2p - 1)(V_1 - V_i) + pCP < 0$$

which must be negative for lying to pay. Consequently,

$$[CP / (V_1 - V_i)] < [(1 - 2p) / p].$$

Assuming the maximum civil penalty equal to three times $(V_1 - V_i)$,

$$[(1 - 2p) / p] > 3.$$

For lying to pay, $p < .2$. Managers must determine their subjective assessment of the probability of being caught. If they believe that the probability of being caught is less than twenty percent, they will lie.

Knowing the cost of lying, the value of the firm, V , may be calculated. The value of the firm is equal to the false inflated value of the firm, V_1 , less the cost of lying.

$$V = V_1 - \text{cost of lying.}$$

$$V = V_1 - p[(V_1 - V_i) + CP] - (1 - p)(V_1 - V_i).$$

$$V = V_1 - pCP.$$

$$V = S + a + b - pCP.$$

The value of the firm is the actual or true value less the probability of being caught lying times the civil penalty imposed if caught.

Rule 10b-5 applies to preliminary merger negotiations when there is either non-disclosure of a material fact when a duty to disclose exists or a misleading material misstatement or omission.⁶³ Both sides of a negotiated merger would probably prefer not to disclose any information concerning the negotiations. Premature disclosure could drive up the price of the stock, making the merger more expensive or cause the negotiations to be abandoned. Disclosure, if made, could be misleading and subject the parties to liability. On the other hand, failure to disclose information where a duty to disclose exists is actionable. Silence is not misleading absent a duty to disclose. "No comment" is the equivalent of silence.⁶⁴

In *Basic, Inc. v. Levinson*⁶⁵, the United States Supreme Court adopted the *TSC Industries, Inc. v. Northway, Inc.*⁶⁶ standard for materiality in preliminary negotiation cases. The court went on to say that materiality may vary on a case by case basis balancing the probability that the transaction will be consummated and its magnitude or significance to the issuer. The court in *Basic* rejected the Third Circuit's standard set out in *Greenfield v. Heublein, Inc.*⁶⁷ that

⁶³ *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

⁶⁴ *In re Carnation Co.*, [1984-85 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,801, 87,595-96 (July 8, 1985).

⁶⁵ 485 U.S. 224 (1988).

⁶⁶ 426 U.S. 438 (1976).

⁶⁷ 742 F.2d 751 (3d Cir. 1984).

merger discussions were not material until agreements with respect to price and structure of the transaction had been determined.

Section 10(b) and rule 10b-5 apply in a negotiated merger situation. Using the slack rich-slack poor model, if either the slack rich corporation seeks to negotiate a merger or the slack poor corporation managers actively seek out a slack rich corporation, the preliminary negotiations may contain material facts that have to be disclosed to the target corporation shareholders. Information concerning price would be of the utmost importance to the slack poor, target corporation shareholders and, therefore, material. If the slack poor corporation managers distort or lie about the updated estimates of a and b in the negotiations such action could constitute a misstatement of a material fact which would subject the managers of the target, slack poor corporation to liability for violation of section 10(b) and rule 10b-5. If the managers distort or lie about the value of the slack poor corporation to their own shareholders in disclosing the negotiations or in recommending approval of the merger if a shareholder vote is required, they violate section 10(b) and rule 10b-5. Interestingly enough, if the directors of the slack poor corporation and all the old shareholders are involved in the fraud on the slack rich corporation with respect to the true value of the slack poor corporation, the slack poor corporation could recover on the

basis of a plan to defraud future shareholders."⁶⁴ Section 10(b) and rule 10b-5 potential liability provides an incentive for managers of the corporations to tell the truth about the value of the corporation, if it must be disclosed. How effective that incentive is depends on the managers' perception of the possibility of being subjected to such liability.

Criminal sanctions under the Securities Exchange Act of 1934 provide an even greater incentive to tell the truth than the criminal sanctions under the Securities Act of 1933. In 1984, Congress passed the Insider Trading Sanctions Act (ITSA). The ITSA increased the maximum jail term from five to ten years and increased the criminal fine for individuals from \$100,000 to \$1,000,000. For non-natural persons the fine was increased from \$500,000 to \$2,500,000.

b. State

Each of the four major pieces of federal securities regulation carefully preserves the rights of the states to regulate securities within their respective jurisdictions.⁶⁵ As a result, all states and the District of Columbia have

⁶⁴ *Bailes v. Colonial Press, Inc.*, 444 F.2d 1241 (5th Cir. 1971).

⁶⁵ See, e.g., Section 28, Securities Exchange Act of 1934, 15 U.S.C. § 78bb (1988) and Section 18, Securities Act of 1933, 15 U.S.C. § 77r (1988).

enacted their own "blue sky" laws.⁷⁰

The commissioners on Uniform State Laws drafted a Uniform Securities Act⁷¹ for adoption by the states in 1956 and amended it in 1958. Since 1956 more than thirty states have adopted, in whole or in part, the Uniform Securities Act; however, national uniformity even among the adopting states is still lacking. Most states that adopted the act did so with substantial changes. Over time, different state courts have interpreted the language of the uniform act differently. The large commercial states such as New York, California, Texas, and Illinois have not adopted any part of the uniform act.

As is the case with the antifraud provisions of the federal securities law, antifraud provisions of the state securities law represent a relaxation of the more stringent requirements of common law fraud. The manifestation of this proposition is contained in section 401(d) of the Uniform Securities Act, which provides that "'Fraud,' 'deceit,' and 'defraud,' are not limited to common law deceit."

The antifraud provision of the Uniform Securities Act bears a striking resemblance to sections 12 and 17(a) of the Securities Act of 1933 and rule 10b-5 under the Securities Exchange Act of 1934. Section 101 of the Uniform Securities Act provides that:

⁷⁰ So called because of the reference to "blue sky" in *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).

⁷¹ 7B U.L.A. 509 (1958).

It is unlawful for any person, in connection with the offer, sale or purchase of any security, directly or indirectly

(1) to employ any device, scheme, or artifice to defraud,

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

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

All of the states except New Hampshire authorize the state authority to bring suit for injunction against fraudulent conduct in the sale of a security, and most states extend that power to the purchase of a security.

The Uniform Securities Act provides only for a cause of action by a defrauded purchaser against his or her seller and makes no provision for a cause of action by a defrauded seller against his purchaser. This rule is adopted by a majority of the states. In a merger, the cause of action would be by the purchaser (slack rich corporation) against the seller (slack poor corporation). New York and Rhode Island make no provision for a private cause of action; however, in New York a private civil cause of action may be implied.

The elements of a cause of action for fraud under state securities law are essentially the same as under federal securities law; however, there are some important differences. The scienter requirement, which has played an important role in the development of federal rule 10b-5, is treated quite differently under state law. The scienter

requirement exists as an element of a civil action, but the burden of proof is shifted from the defrauded purchaser to the seller to prove that the seller was unaware of any misrepresentation or omission of material facts and in the exercise of reasonable care could not have known of any. The reasonable care standard means that negligence is sufficient scienter.

Common law reliance is not required as an element of a civil fraud case under state law; however, the buyer must show that he or she did not know of the untruths or an omission to recover. Purchaser's reliance generally must be reasonable, but some states allow a purchaser to accept the statements made at face value and rely on them.

Generally, materiality is the same under both federal and state securities law, utilizing the reasonable person test that the representation be one which the reasonable person would take into consideration or attach importance to in determining his or her course of action.

The express civil cause of action in most states is granted to the purchaser as against his or her seller. Remedies granted to a successful plaintiff are rescission of the sale or suit for damages if he or she no longer owns the securities. The Uniform Securities Act and state securities laws require privity of contract between the purchaser and seller. The antifraud provisions of state securities law are more in the nature of the express civil liability provision of section 12 of the Securities Act of 1933 rather

than section 17(a) of that act or section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, which support a civil cause of action by any person whether in privity of contract or not. Since section 410(h) of the Uniform Securities Act provides that no cause of action not specified therein may be created, a parallel development of implied civil causes of action for damages to rule 10b-5 is foreclosed.

State securities regulation adds an extra incentive to tell the truth although not as powerful as the federal securities laws.

2. Tender Offers and the Williams Act⁷²

Mergers and sales of all the assets require action by the board of directors of the target corporation. A hostile board of directors generally means instant doom to the merger or sale. A direct confrontation with a hostile board of directors may be avoided by dealing directly with the shareholders of the target corporation by offering to buy their stock for cash, property, or other stock in a tender offer.

At first blush, the definition of a tender offer seems straight forward. The problem is whether the "tender offer" is subject to the Williams Act. The term "tender offer" is not defined in the statutes, and the Securities and Exchange Commission has refused to define the term for fear that the

⁷² 15 U.S.C. §§ 78m(d), 78m(e), 78n(d), 78n(e), and 78n(f) (1988).

definition would be too restrictive and provide lawyers with a weapon to avoid regulation. The SEC has promulgated a list of eight factors to aid in the analysis, but some courts have expressed concern as to whether the factors were "either a permissible or a desirable interpretation of the statute."⁷³ The SEC position, although not adopted, is set out in Exchange Act Release No. 16,385 as Proposed Rule 14d-1(b)(1)⁷⁴.

The term "tender offer" includes a "request or invitation for tenders" and means one or more offers to purchase or solicitations of offers to sell securities of a single class, whether or not all or any portion of the securities sought are purchased, which (A) During any 45-day period, are directed to more than 10 persons and seek the acquisition of more than 5% of the class of securities, except that offers by a broker (and its customer) or by a dealer made on a national securities exchange at the then current market or made in the over-the-counter market at the then current market shall be excluded if, in connection with such offers, neither the person making the offers nor such broker or dealer solicits, or arranges for the solicitation of any order to sell such securities, and such broker or dealer performs only the customary functions of a broker or dealer and receives no more than the broker's usual and customary commission or the dealer's usual and customary mark-up; or (B) Are not otherwise a tender offer under paragraph (b)(1)(i) of this section, but which (1) are disseminated in a widespread manner, (2) provide for a price which represents a premium in excess of the greater of 5% of or \$2 above the current market price, and (3) do not provide for a meaningful opportunity to negotiate the price and terms.

Although the subject of many court cases, the courts

⁷³ *Brascan, Ltd. v. Edper Equities, Ltd.*, 477 F.Supp. 773 (S.D.N.Y. 1979).

⁷⁴ 44 Fed. Reg. 70,349 (1979).

have yet to produce a clear, comprehensive definition of "tender offer." Congress understood the term to mean an offer to buy or sell securities, or a solicitation of an offer to sell a security through some sort of exchange of the securities for other consideration.⁷⁵ A conventional tender offer has been defined by the courts as having three elements, a bid, a premium price, and a conditional obligation to purchase all or a specified amount of the tendered shares.⁷⁶ However, courts recognize an unconventional tender offer as an apparent attempt to gain control of a corporation by purchasing shares without a formal tender offer such as open market or block purchases. The United States Supreme Court test was articulated in *Securities & Exchange Commission v. Ralston Purina Co.*⁷⁷ The test is whether or not the particular class of persons affected needs the protection of the Securities Exchange Act of 1934, taking the totality of circumstances into consideration. Certain transactions have been held not to be tender offers, including a stock repurchase from a director who was deemed incompatible by the other

⁷⁵ Hearings on S. 510 Before the Subcomm. on Sec. of the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. (1967).

⁷⁶ *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195, 1206 (2d Cir. 1978).

⁷⁷ 346 U.S. 119 (1953).

directors,⁷⁸ a stock repurchase of a 9.9 percent voting block as greenmail,⁷⁹ open market transactions at or below the market price without active solicitations,⁸⁰ the purchase of 42 percent of a class of securities from only seven security holders,⁸¹ and privately negotiated purchases from large or substantial shareholders.⁸²

A tender offer for the stock of a publicly held corporation is subject to the Williams Act (sections 13(d) and (e) and 14(d), (e), and (f) of the Securities Exchange Act of 1934). Under section 13(d), any person or group of persons who becomes the owner of more than five percent of any class of securities registered under section 12 of the Securities Exchange Act of 1934 must file with the issuer of the securities and a Schedule 13D with the Securities and Exchange Commission a statement setting forth (1) the background of the person or persons, (2) the source of the funds to be used in the acquisition, (3) the purpose of the acquisition, (4) the number of shares actually owned, and (5) any relevant contracts, arrangements, or understandings

⁷⁸ In re General Motors Class E Stock Buyout Securities Litig., 694 F.Supp. 1119 (D.Del. 1988).

⁷⁹ Pin v. Texaco, Inc., 793 F.2d 1448 (5th Cir. 1986).

⁸⁰ Ludlow Corp. v. Tyco Laboratories, 529 F.Supp. 62 (D.Mass 1981).

⁸¹ Stromfield v. Great Atl. & Pac. Tea Co., 484 F.Supp 1264 (S.D.N.Y.) aff'd, 646 F.2d 563 (2d Cir. 1980).

⁸² University Bank & Trust Co. v. Gladstone, 574 F.Supp. 1006 (D.Mass 1983).

concerning the ownership of the stock or its acquisition. The statement must be filed within ten days of acquisition of the required percentage of stock.

An accurate statement of the purpose of the acquisition is important since managers' fiduciary duties shift from the corporation to the shareholders under Revlon if the acquiring corporation intends to sell the assets rather than continue the target corporation's operations. Managers of the target corporation may delay the tender offer by alleging that the tender offeror has filed a false or misleading Schedule 13D. A private right of action for injunctive relief under Section 13d is recognized in many circuits,⁸³ although no private civil cause of action for damages is permitted.⁸⁴ A tender offeror's failure to disclose its intent such as to gain control or sell the assets may result in injunctive relief granted to the target corporation's management.⁸⁵ The tender offeror's past activities in takeovers may or may not be used as evidence

⁸³ See, e.g., *Portsmouth Square, Inc. v. Shareholders Protective Comm.*, 770 F.2d 866 (9th Cir. 1985); *Gearhart Industries v. Smith Int'l Inc.*, 741 F.2d 707 (5th Cir. 1984); *Indiana Nat'l Corp. v. Rich*, 712 F.2d 1180 (7th Cir. 1983).

⁸⁴ See, e.g., *Rubin v. Posner*, 701 F.Supp 1041 (D.Del 1988); *Sanders v. Thrall Car Mfg. Co.*, 582 F.Supp 945 (S.D.N.Y.), aff'd per curiam, 730 F.2d 910 (2d Cir. 1984); *Schnell v. Schnell*, [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,927 (S.D.N.Y. Mar. 30, 1981).

⁸⁵ See *Chromalloy American Corp. v. Sun Chem. Corp.*, 611 F.2d 240 (8th Cir. 1979) and *General Aircraft Corp. v. Lampert*, 556 F.2d 90 (1st Cir. 1977).

of intent depending on the circuit.⁸⁶

Under section 14(d), no person may make a tender offer that would result in his or her owning more than five percent of a class of securities required to be registered under section 12 of the Securities Exchange Act of 1934 unless a Schedule 14D-1 has been filed with the commission and a copy of which is furnished to each offeree. The information to be contained in the statement is essentially the same information that is required to be filed under section 13(d).

When managers of a target corporation solicit or recommend to their shareholders that they accept or reject a tender offer bid they must file a Schedule 14D-9 with the Securities and Exchange Commission.⁸⁷ The rationale for these disclosure requirements was aptly stated by the Second Circuit in *Chris-Craft Industries v. Piper Aircraft Corp.*⁸⁸

By reason of the special relationship between them, shareholders are likely to rely heavily upon the representations of corporate insiders when the shareholders find themselves in the midst of a battle for control. Corporate insiders therefore have a special responsibility to be meticulous and precise in their representations to shareholders.

⁸⁶ See *Dan River, Inc. v. Icahn*, 701 F.2d 278 (4th Cir. 1983) (past performance not indicative of future performance). *Contra*, *Trane Co. v. O'Connor Sec.*, 561 F.Supp. 301 (S.D.N.Y.), appeal dismissed, 718 F.2d 26 (2d Cir. 1983) (past history persuasive).

⁸⁷ 17 C.F.R. § 240.14d-9(a)(a) (1991).

⁸⁸ 480 F.2d 341, 364-65 (2d Cir.), cert. denied, 414 U.S. 910 (1973).

Management's position statement required by rule 14e-2 constitutes a solicitation or recommendation for purposes of rule 14d-9. Item 4 requires disclosure of management's position regarding the offer. If the price is stated to be inadequate, reasons must be given to support that position. The information in the Schedule 14D-9 is received by the shareholders of the target corporation since in practice the Schedule 14D-9 without attachments is used as part of the initial communication to shareholders following the tender offer bid.

Section 14(e) makes it unlawful for any person to misstate or omit a material fact, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with a tender offer. While there is no specific cause of action granted to shareholders of the target corporation under section 14(e), the United States Supreme Court has implied one in *Piper v. Chris-Craft Industries*.⁸⁹ Violation of section 14(e) is the most common claim asserted by target corporation managers and shareholders. As a result, judges are becoming skeptical and reluctant to entertain them.⁹⁰

Standing is granted to the target corporation to bring

⁸⁹ 430 U.S. 1 (1977).

⁹⁰ See, e.g., *MacFadden Holdings, Inc. v. JB Acquisition Corp.*, 802 F.2d 62 (2d Cir. 1986); *Data Probe Acquisition Corp. v. Datatab, Inc.*, 722 F.2d 1 (2d Cir. 1983), cert. denied, 465 U.S. 1052 (1984); *Diamond v. Arend*, 649 F.Supp 408 (S.D.N.Y. 1986).

suit for injunctive relief to prohibit the tender offer but not for damages;⁹¹ likewise, the tender offeror does not have standing to sue the target corporation management for damages.⁹² A tender offeror has standing to sue a competing tender offeror for injunctive relief⁹³ but not for damages.⁹⁴ Under section 14(e), a non-tendering target corporation shareholder has standing to sue since the statutory element is "in connection with a tender offer" rather than the "purchase or sale" of a security as under section 10(b) and rule 10b-5.⁹⁵

The elements of a cause of action under 14(e) are similar to those required under section 10(b) and rule 10b-

⁹¹ See, e.g., *Florida Commercial Banks, Inc. v. Culverhouse*, 772 F.2d 1513 (11th Cir. 1985); *E.H.I. of Florida, Inc. v. Insurance Co. of North America*, 499 F.Supp. 1053 (E.D. Pa. 1980), *aff'd*, 652 F.2d 310 (3d Cir. 1981); *Wellman v. Dickinson*, 475 F.Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983).

⁹² *Piper v. Chris-Craft Industries.*, 430 U.S. 1 (1977).

⁹³ See, e.g., *Humana, Inc. v. American Medicorp, Inc.*, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,286 (S.D.N.Y. Jan. 5, 1978); *Weeks Dredging & Contracting, Inc. v. American Dredging Co.*, 451 F.Supp 468 (E.D.Pa. 1978); *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981), *cert.denied*, 455 U.S. 982 (1982).

⁹⁴ *Kalmanovitz v. G. Heileman Brewing Co.*, 769 F.2d 152 (3d Cir. 1985).

⁹⁵ *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); *Hundahl v. United Benefit Life Ins. Co.*, 465 F.Supp. 1349 (N.D.Tex. 1979); *Wellman v. Dickinson*, 475 F.Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983); *In re Commonwealth Oil/Tesoro Petroleum Corp. Securities Litig.*, 467 F.Supp 227 (W.D.Tex. 1979).

5. The test for materiality in tender offer cases⁶ was actually set out in a proxy case under section 14(a). A fact is material if

there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote...[T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.⁷

The courts have taken a rather pragmatic approach to materiality rather than engage in a "nit-picking" exercise.⁸ This relaxation of the standard in takeovers occurs because both sides of the issues are represented by opposing forces making it more likely that all material information will be disclosed by one or the other sides.⁹ Moreover, in contested control situations the failure of one of the contestants to take remedial action with respect to an alleged misstatement or omission is considered by some

⁶ Piper Aircraft Corp. v. Chris-Craft Indus., 430 U.S. 1, 50 (1977).

⁷ TSC Indus., Inc. v. Northway, Inc., 426 U.S. 443, 449 (1976).

⁸ Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., 600 F.2d 355, 363 (2d Cir. 1979); Kohn v. American Metal Climax, Inc., 458 F.2d 255 (3d Cir.), cert. denied, 409 U.S. 874 (1972).

⁹ SEC v. Falstaff Brewing Corp., [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,583 (D.D.C. Oct. 28, 1978); Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., 600 F.2d 355 (2d Cir. 1979); Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195 (2d Cir. 1978); Ash v. LFE Corp., 525 F.2d 215 (3d Cir. 1975); Gerstle v. Gamble-Skogmo, 478 F.2d 1281 (2d Cir. 1973).

courts to be evidence that the alleged misstatement or omission is not material.¹⁰⁰ Any significant relationship between the tender offeror and target managers is material to an evaluation of the target managers' recommendations to their shareholders.¹⁰¹

Scienter which is required in a section 10(b) and rule 10b-5 case may or may not be required in a section 14(e) case. The language of section 14(e) that makes it unlawful to make an untrue statement or omit a material fact may be read as not requiring scienter. Whereas, the language concerning fraudulent, deceptive, or manipulative acts or practices could be read as requiring scienter. To date, the United States Supreme Court has not ruled on this question; however, several lower courts have required scienter.¹⁰²

Causation and reliance in a section 14(e) case are essential elements of a private civil cause of action.¹⁰³ Section 14(e) causation is often analyzed in the context of section 10(b) and rule 10b-5 materiality and reliance;

¹⁰⁰ *Kennecott Copper Corp. v. Curtiss-Wright Corp.*, 584 F.2d 1195, 1200 n.4 (2d Cir. 1978); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

¹⁰¹ *Bell v. Cameron Meadows Land Co.*, 669 F.2d 1278 (9th Cir. 1982).

¹⁰² *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1299 n.17 (2d Cir. 1973); *A. & K. Railroad Materials, Inc. v. Green Bay & W.R. Co.*, 437 F.Supp. 636, 642 (E.D.Wis. 1977).

¹⁰³ *Berman v. Gerber Products Co.*, 454 F.Supp 1310 (W.D. Mich. 1978); *Halle & Stieglitz, Filor, Bullard, Inc. v. Empress Int'l, Ltd*, 442 F.Supp. 217 (D.Del. 1977).

causation and reliance are presumed in an omission case if materiality is proved.¹⁰⁴

As in the case of an allegation of a section 13(d) violation, a tender offeror's failure to disclose its plans and purposes such as intent to obtain control or to liquidate is actionable under section 14(e).¹⁰⁵ An accurate statement of the purpose of the acquisition is important since managers' fiduciary duties shift from the corporation to the shareholders under *Revlon* if the acquiring corporation intends to sell the assets rather than continue the target corporation's operations.

In general, the tender offeror may keep secret its own evaluations or appraisals of the target corporation made with publicly available information.¹⁰⁶ The tender offeror, however, must disclose confidential information used in making the evaluation.¹⁰⁷ In *Envirodyne* the target corporation had considered the possible sale of the

¹⁰⁴ *Kramas v. Security Gas & Oil, Inc.*, 672 F.2d 766 (9th Cir.), cert. denied, 459 U.S. 1035 (1982); *Lewis v. McGraw*, 619 F.2d 192 (2d Cir.), cert. denied, 449 U.S. 951 (1980).

¹⁰⁵ *Georgia-Pacific Corp. v. Great Northern Nekoosa Corp.*, No. 89-0254P (D.Me. Feb. 15, 1990); *Koppers Co. v. American Express Co.*, 689 F.Supp. 1371 (W.D.Pa. 1988); *Marshall Field & Co. v. Icahn*, 537 F.Supp. 413 (S.D.N.Y. 1982); *Pargas, Inc. v. Empire Gas Corp.*, 423 F.Supp. 199 (D.Mo.), aff'd per curiam, 546 F.2d 25 (4th Cir. 1976).

¹⁰⁶ *El Paso Co. v. Burlington Northern, Inc.*, No. EP-82-CA-397 (W.D.Tex. Jan. 5, 1983); *Camelot Industries Corp. v. Vista Resources, Inc.*, 535 F.Supp. 1174 (S.D.N.Y. 1982).

¹⁰⁷ *In re Envirodyne Industries Shareholders Litig.*, No. 10702 (Del. Ch. Apr. 20, 1989).

corporation. Its largest shareholder, ARTRA, had agreed to participate in the sale and, consequently, acquired confidential inside information. No offers were received so the corporation abandoned attempts to sell. ARTRA's financial advisor, Salomon Brothers, was made privy to the inside information. Salomon Brothers subsequently pursued a takeover bid for Envirodyne using the inside information to formulate the offer price. The court held that the inside information was material and must be disclosed to the target corporation shareholders. Likewise, other misuse of confidential inside information constitutes a violation of section 14(e). When confidential inside information is received by the tender offeror under a confidentiality agreement, or derived from a former officer or director of the target corporation, the tender offeror cannot properly use such information without disclosing it to the target corporation's shareholders;¹⁰⁸ however, disclosure may violate the agreement which may be actionable. The tender offeror is in an untenable position. In such cases the tender offer typically is not allowed to proceed.¹⁰⁹

¹⁰⁸ LFC No. 31 Corp. v. Ransburg Corp., No. IP 88-1277-C (N.D.Ind. Jan. 9, 1989); A. Copeland Enters., Inc. v. Guste, 1989-2 Trade Cas. (CCH) ¶ 68,713 (E.D.La. Nov. 28, 1988), aff'd, 865 F.2d 1264 (5th Cir. 1989); Murrar Ohio Mfg. Co. v. AB Electrolux, No.01:88-0387 (E.D.Tenn. May 23, 1988).

¹⁰⁹ General Portland, Inc. v. La Farge Coppee S.A., [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,148 (N.D.Tex. Aug. 28, 1981); Burlington Indus. v. Edelman, 666 F.Supp. 799 (M.D.N.C.), aff'd, [1987 Transfer Binder] Fed. Sec. L. Rep. ¶ 93,339 (4th Cir. June 22, 1987).

A tender offer may be initiated in two different ways, by "bear hug" or by a surprise announcement of the tender offer to the shareholders directly bypassing the target corporation's board.

In the "bear hug" approach the acquiring corporation makes an offer to acquire the target corporation at a fixed price directly to the managers or board of directors of the target corporation. This approach does several things. The offer can be in preliminary form and be negotiable as a friendly takeover. Target directors are forced to disclose the offer to their shareholders creating pressure on the directors to accept.¹¹⁰ The preliminary negotiations may contain material facts that have to be disclosed to the target corporation shareholders. Information concerning price would be of the utmost importance to the slack poor, target corporation shareholders and, therefore, material. Rule 14e-2¹¹¹ requires the target corporation's managers within ten business days following an offer to publish or send to their shareholders a statement that it either recommends acceptance or rejection of the offer, expresses no opinion and is neutral towards the offer, or is unable to take a position on the offer. This statement must disclose the reasons why management either took the position or refuses to take a position. In the ten day interim, the

¹¹⁰ Rule 14d-9 and *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

¹¹¹ 17 C.F.R. § 240.14e-2 (1991).

target corporation may evaluate the offer and communicate with its shareholders provided that the communication does no more than identify the bidder, state that the offer is being considered, state that the corporation will issue its opinion regarding the offer within the ten day period, and request shareholders to wait until they are informed of the corporation's position. All communications must be fair and in accordance with rule 10b-5 and section 14(e).

Management's statements to shareholders are scrutinized by the courts particularly regarding statements about the inadequacy of the price. A statement that the price is inadequate is misleading if the target managers are aware of non-public information that would dispute their conclusion.¹¹² Therefore, if the slack poor corporation's managers lie about the updated estimates of a and b to their own shareholders in determining the adequacy of the tender offer, they may be liable under section 10(b) and rule 10b-5 and section 14(e). The incentive to tell the truth may solve the asymmetric information problem in "bear hug" type tender offers. The offeror only has inside information if it is acquired from the target managers. If it is received from the target managers, that must be disclosed to the target shareholders.¹¹³ The inside information concerning

¹¹² *Emhart Corp. v. USM Corp.*, 403 F.Supp. 660 (D.Mass. 1975); *SEC v. Texas Int'l Co.*, 498 F.Supp. 1231 (N.D.Ill. 1980).

¹¹³ *Crane Co. v. Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970).

the updated estimates of a and b also will have to be disclosed if target managers make any representation concerning the adequacy of the tender offer.

A troublesome situation after the 1989 Management's Discussion and Analysis of Financial Conditions and Results of Operations (MD&A) releases¹¹⁴ is the difference in the test of *Basic, Inc. v. Levinson* and Item 303 of Regulation S-K.¹¹⁵ If the MD&A test for mandatory disclosure is applied to preliminary merger negotiations, the MD&A requirements would force disclosure in some cases that the *Basic* test would not. Under Item 303, forward-looking data is to be disclosed: (1) if management cannot determine that the event is unlikely to occur and (2) if it is otherwise of a material amount. The Item 303 test requires the probability of occurrence to be treated as if it were either 100 percent or zero percent. The test in *Basic* allows for a continuous spectrum from zero to one hundred percent. It is an unanswered question as to whether or not information could be withheld under the business purpose exemption in rule 10b-5 cases.¹¹⁶ Disclosure under Item 303 may be more

¹¹⁴ SEC Releases Nos. 33-6835, 34-26831 (May 18, 1989).

¹¹⁵ See Chapter III for a discussion of MD&A.

¹¹⁶ See, e.g., *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 394 U.S. 976 (1969).

extensive than under the antifraud provisions,¹¹⁷ although the MD&A interpretive releases do provide that information need not be disclosed if it would jeopardize the negotiations.

If the slack poor corporation managers distort or lie about the updated estimates of a and b in the negotiations such action could constitute a misstatement of a material fact which could subject the managers of the target, slack poor corporation to liability for violation of section 10(b) and rule 10b-5 and sections 14(d) and (e). Section 10(b) and rule 10b-5 and sections 14(d) and (e) potential liability provides an incentive for managers of the corporations to tell the truth about the value of the corporation.

A hostile board of directors of the target corporation may engage in defensive maneuvers and frustrate the takeover attempt by stopping it or making it too expensive. A wide array of defensive maneuvers, such as a friendly merger with a more desirable corporation (white knight), a counteroffer to buy by a friendly party, or a repurchase of its own stock by the target corporation, are available to thwart the takeover. *Unocal*, *Revlon*, and *Time* impose restrictions on

¹¹⁷ "No rule of law condones fraud simply so that other corporate goals might thereby be served." Brief for the Securities and Exchange Commission as Amicus Curiae, *Basic Inc. v. Levenson*. "The securities laws do not operate under the assumption that material information need not be disclosed if management has reason to suppress it." *Roeder v. Alpha Industries, Inc.*, 814 F.2d 22, 25 (1st Cir. 1987).

the target corporation's board of directors' use of defensive measures. The modified or enhanced business judgment rule is in effect in takeover situations. The purpose of the enhanced rule is to insure that defensive measures are motivated by a good faith concern for the welfare of the corporation and its shareholders rather than to perpetuate management. Under *Unocal* the board of directors must make a reasonable investigation before adopting a takeover defensive measure. The board investigation must provide material information and expert advice to the directors on such matters as inadequacy of consideration, nature and timing of the offer, legality, impact on stakeholders other than shareholders, and the risk of nonconsummation, to be able to make an informed, dispassionate decision. Unless it was approved by a majority of independent, outside directors, the board of directors would have the burden of showing the entire or intrinsic fairness of the transaction. Further, the defensive response must be reasonable in relation to the threat posed by the hostile bid.

The Delaware Supreme Court in *Time* overruled the Chancery Court holdings in *Interco* and *Pillsbury* which indicated that the board of directors of a target corporation could only oppose a hostile bid if it were a coercive two tier bid or constituted an all cash bid at less than a fair price. The Delaware court held that the board of directors of a target corporation may refuse to consider

an all-cash, all-share offer made at an adequate price. This is the "just say no" defense. This holding is in the factual context of deciding between long-range and short-range plans.

The fair price defensive tactic is used to defend against two-tier, front-end loaded attacks to protect shareholders who may tender because they fear being squeezed out at a lower price. To protect shareholders, the consideration paid must be cash or the same type of consideration paid for the largest block of the stock acquired and must equal the greatest of: (1) the highest price paid by the offeror for any shares of the target acquired during the tender offer period, (2) an amount which bears the same or a greater percentage relationship to the then market price of the target corporation's stock as the highest price paid by the tender offeror bears to the market price of the stock immediately preceding the commencement of the tender offer, or (3) an amount equal to the earnings per share of the corporation for the four full consecutive fiscal quarters immediately preceding the proposed business combination multiplied by the then price-earnings ratio of the offeror. This provision insures equal treatment of all shareholders during all stages of the tender offer.

An alternate defensive tactic with the same effect is the right of redemption privilege. Minority shareholders are granted the right in the articles of incorporation or bylaws to put their stock to the tender offeror at specified

redemption prices. The target corporation could adopt a right of redemption privilege that reflects the updated estimates of a and b. Such a signal could overcome the asymmetric information problem. Right of redemption privileges are not permitted in all states.¹¹⁸

3. State Regulation of Takeovers

More than forty states have enacted laws regulating takeovers of companies incorporated or doing business in their respective states. These statutes tend to be more extensive than the federal statute which is perceived by the states as having shortcomings and tend to favor the incumbent management of the target corporation. Between 1968 and 1982, thirty-seven states adopted "first generation" takeover statutes. These statutes required a bidder to disclose certain information concerning the offer. One of the more debilitating parts of these state statutes generally imposed a waiting period from 10 to 60 days from the announcement and the commencement of the tender offer. It is this waiting period that allowed hostile incumbent management of the target corporation to marshal its forces to ward off the tender offer and frustrate the attempt of the acquiring corporation's management to take over the target company. Most of these statutes empowered a state

¹¹⁸ The Delaware Court of Chancery upheld a fair value rights plan in *MacAndrews & Forbes Holding, Inc. v. Revlon*, 501 A.2d 1239 (Del. Ch.), *aff'd*, 505 A.2d 454 (Del. 1985). *Contra*, *Minstar Acquiring Corp. v. AMF, Inc.*, 621 F.Supp. 1252 (S.D.N.Y. 1985) and *Buckhorn, Inc. v. Ropak Corp.*, 656 F.Supp. 209 (S.D. Ohio 1987).

official to determine whether or not the disclosure was adequate and the whether or not the offer was "fair." The designated state official was empowered to conduct hearings to make these determinations. There have been inconsistent decisions in the federal courts as to whether or not these more extensive state statutes infringe upon the federal prerogative of regulating securities.¹¹⁹ The United States Supreme Court's first decision regarding state takeover statutes resulted in six separate opinions in which a bare majority voted to overturn the Illinois statute on narrow Commerce Clause grounds.¹²⁰ Following the Supreme Court decision, state takeover statutes in Michigan,¹²¹ Missouri,¹²² Kentucky,¹²³ Virginia,¹²⁴ Maryland,¹²⁵

¹¹⁹ MITE Corp. v. Dixon, No. 79-C-200 (N.D.Ill. Feb. 9, 1979), aff'd, 633 F.2d 486 (7th Cir. 1980), aff'd sub nom. Edgar v. MITE Corp., 457 U.S. 624 (1982); Brascan Ltd. v. Lassiter, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,247 (E.D.La. Apr. 30, 1979); Dart Industries v. Conrad, 462 F.Supp. 1 (S.D.Ind. 1978) (enjoining state laws). Contra, AMCA Int'l Corp. v. Krouse, 482 F.Supp. 929 (S.D. Ohio 1979); City Investing Co. v. Simcox, 476 F.Supp. 112 (S.D.Ind. 1979), aff'd, 633 F.2d 56 (7th Cir. 1980); UV Industries v. Posner, 466 F.Supp. 1251 (D.Me. 1979) (upholding state statutes).

¹²⁰ Edgar v. MITE Corp., 457 U.S. 624 (1982).

¹²¹ Martin-Marietta Corp. v. Bendix Corp., 690 F.2d 558 (6th Cir. 1982).

¹²² National City Lines, Inc. v. LLC Corp., 524 F.Supp. 906 (W.D.Mo. 1981), aff'd, 687 F.2d 1122 (8th Cir. 1982).

¹²³ Esmark, Inc. v. Strode, 639 S.W.2d 768 (Ky. 1982).

¹²⁴ Telvest, Inc. v. Bradshaw, 547 F.Supp. 791 (E.D.Va 1982), aff'd, 697 F.2d 576 (4th Cir. 1983).

Oklahoma,¹²⁶ and Minnesota¹²⁷ were invalidated. The Massachusetts statute was upheld.¹²⁸ Five years after its decision in *MITE*, the United States Supreme Court upheld Indiana's takeover statute by a 6 to 3 vote.¹²⁹

As a result of these setbacks, states adopted "second generation" takeover statutes. This second generation of takeover statutes uses several different approaches. One of the more common forms is the fair price takeover statute. Under a fair price takeover statute, certain business combinations must be approved by a super-majority (usually 80 percent), unless a statutorily determined fair price is paid. The fair price formulas are complicated and extensive as evidenced by the Maryland statute on which most of the fair price statutes are modeled. See Appendix B.1 for text of the Maryland Statute.

Other states have adopted control share acquisition statutes which require shareholder approval before an acquisition of a specified percentage of stock. The

¹²⁵ *Bendix Corp. v. Martin-Marietta Corp.*, 547 F.Supp. 522 (D.Md. 1982).

¹²⁶ *Mesa Petroleum Co. v. Cities Serv. Co.*, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,064 (W.D.Okla. Dec. 21, 1982), aff'd, 715 F.2d 1425 (10th Cir. 1983).

¹²⁷ *APL Ltd. P'ship v. Van Dusen Air, Inc.*, 622 F.Supp. 1216 (D.Minn. 1985).

¹²⁸ *Agency Rent-A-Car, Inc. v. Connolly*, 686 F.2d 1029 (1st Cir. 1982).

¹²⁹ *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

acquiror may vote its control shares only to the extent approved by a majority of disinterested shareholders of that class of stock. Business combination statutes are also common. These statutes prohibit for a specified period of time business combinations with any person acquiring a certain percentage of stock. Cash-out statutes and shareholder rights plan validation statutes have also been enacted. The cash-out statutes require an offeror who acquires a specified percentage of stock to buy out any shareholder who desires to tender at a price determined by the statute. A shareholders rights plan allows the target corporation to issue shareholders rights or options to purchase a class of securities on conditions fixed by the board of directors.

A "third generation" of takeover statutes is beginning to appear. Pennsylvania, Indiana, and New Jersey have adopted far reaching statutes in reaction to the enhanced business judgment rule applied by the Delaware court in *Unocal* and *Revlon*. Indiana rejects the *Unocal* rule and establishes a presumption that the board action in taking defensive measures is "valid unless it can be demonstrated that the determination was not made in good faith after reasonable investigation."¹³⁰ This third generation of takeover statutes is broadening the corporate constituency statutes discussed in Appendix A.

¹³⁰ Ind. Code § 23-1-35-1(g) (1989).

C. Conclusion

In this part, proposed solutions of negotiated (friendly) and hostile mergers and direct and "bear hug" tender offers are examined. Only in a direct tender offer where target corporation managers remain neutral and silent does the asymmetric information problem disappear. In the direct tender offer, neither the offeror nor the target shareholders are in possession of inside information. Both sides would benefit if the offered price is within the acceptable range between $S+a$ and $S+\bar{A}+\bar{B}$. In all other cases asymmetric information is problematic. Moreover, target corporation managers have an incentive to lie about the updated estimates of a and b .

Federal and state securities antifraud provisions provide an incentive to tell the truth. In a negotiated merger or bear hug tender offer, the offeror may obtain inside information from the target corporation's managers. If so, disclosure may have to be made. Making a misstatement of a material fact or omitting a material fact may result in liability. If the target corporation's managers mislead or fail to disclose material information to their own shareholders, they become liable. Defensive tactics may also be a source of liability under federal securities law.

Under federal securities law

$$\text{Cost of Lying} = (2p-1)(V_i - V_o) + pCP.$$

It pays to lie if the probability of getting caught is less

than twenty percent. If managers perceive the probability of getting caught at less than twenty percent they will lie about the true value of the corporation. The value of the corporation becomes

$$V=V_1-pCP \text{ or } V=S+a+b-pCP.$$

From the shareholders' viewpoint, they will have no confidence in the information received from their managers or the offeror if they perceive that the probability that the offending management will not be caught lying is greater than or equal to eighty percent.

The asymmetric information problem also may be addressed through use of the fair price provisions of state takeover statutes. The articles of incorporation or bylaws may be amended to provide that target corporation shareholders be able to put their stock to the corporation at a price that represents the updated estimates of a and b . The fair price provision signals the updated estimates.

The implications of this hypothesis are that (1) target corporations should be undervalued and have unfinanced growth opportunities, (2) the target corporation should have a lower rate of return on equity than other firms as a result of not maximizing its value, (3) acquiring corporations should not have internal growth opportunities available either as a result of being in a slow growth industry sector or an older corporation in the growth cycle with few remaining opportunities, (4) acquiring corporations should have free cash flows or excess debt capacity, (5)

there should be more mergers in periods of strong economic growth because acquiring corporations are looking for growth opportunities, (6) merger announcements should produce abnormal positive stock returns.

APPENDIX B.1

Fair Price Statute

(1) The aggregate amount of the cash and the market value as of the valuation date of consideration other than cash to be received per share by holders of common stock in such business combination is at least equal to the highest of the following:

(i) The highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by the interested stockholder for any shares of common stock of the same class or series acquired by it within the 5-year period immediately prior to the announcement date of the proposal of the business combination, plus an amount equal to interest compounded annually from the earliest date on which the highest per share acquisition price was paid through the valuation date at the rate for 1-year United States Treasury obligations from time to time in effect, less the aggregate amount of any cash dividends paid and the market value of any dividends paid in other than cash, per share of common stock from the earliest date through the valuation date, up to the amount of the interest; or

(ii) The highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by the interested stockholder for any shares of common stock of the same class or series acquired by it on, or within the 5-year period immediately before, the determination date, plus an amount equal to interest compounded annually from the earliest date on which the highest per share acquisition price was paid through the valuation date at the rate for 1-year United States Treasury obligations from time to time in effect, less the aggregate amount of any cash dividends paid and the market value of any dividends paid in other than cash, per share of common stock from the earliest date through the valuation date, up to the amount of the interest; or

(iii) The market value per share of common stock of the same class or series on the announcement date, plus an amount equal to interest compounded annually from that date through the valuation date at the rate for 1-year United States Treasury obligations from time to time in effect, less the aggregate amount of any cash dividends paid and the market value of any dividends paid in other than cash, per share of common stock from that date through the valuation

date, up to the amount of the interest; or

(iv) The market value per share of common stock of the same class or series on the determination date, plus an amount equal to interest compounded annually from that date through the valuation date at the rate for 1-year United States Treasury obligations from time to time in effect, less the aggregate amount of any cash dividends paid and the market value of any dividends paid in other than cash, per share of common stock from that date through the valuation date, up to the amount of the interest; or

(v) The price per share equal to the market value per share of common stock of the same class or series on the announcement date or on the determination date, whichever is higher, multiplied by the fraction of:

1. The highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by the interested stockholder for any shares of common stock of the same class or series acquired by it within the 5-year period immediately prior to the announcement date, over

2. The market value per share of common stock of the same class or series on the first day in such 5-year period on which the

interested stockholder acquired any shares of common stock.

(2) The aggregate amount of the cash and the market value as of the valuation date of consideration other than cash to be received per share by holders of shares of any class or series of outstanding stock other than common stock in the business combination is at least equal to the highest of the following (whether or not the interested stockholder has previously acquired any shares of the particular class or series of stock):

(i) The highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by the interested stockholder for any shares of such class or series of stock acquired by it within the 5-year period immediately prior to the announcement date of the proposal of the business combination, plus an amount equal to interest compounded annually from the earliest date on which the highest per share acquisition price was paid through the valuation date at the rate for 1-year United States Treasury obligations from time to time in effect, less the aggregate amount of any cash dividends paid and the market value of any dividends paid in other than cash, per share

of the class or series of stock from the earliest date through the valuation date, up to the amount of the interest; or

(ii) The highest per share price (including any brokerage commissions, transfer taxes and soliciting dealers' fees) paid by the interested stockholder for any shares of such class or series of stock acquired by it on, or within the 5-year period immediately prior to, the determination date, plus an amount equal to interest compounded annually from the earliest date on which the highest per share acquisition price was paid through the valuation date at the rate for 1-year United States Treasury obligations from time to time in effect, less the aggregate amount of any cash dividends paid and the market value of any dividends paid in other than cash, per share of the class or series of stock from the earliest date through the valuation date, up to the amount of the interest; or

(iii) The highest preferential amount per share to which the holders of shares of such class or series of stock are entitled in the event of any voluntary or involuntary liquidation, dissolution or winding up of the corporation; or

(iv) The market value per share of such class or series of stock on the announcement date,

plus an amount equal to interest compounded annually from that date through the valuation date at the rate for 1-year United States Treasury obligations from time to time in effect, less the aggregate amount of any cash dividends paid and the market value of any dividends paid in other than cash, per share of the class or series of stock from that date through the valuation date, up to the amount of the interest; or

(v) The market value per share of such class or series of stock on the determination date, plus an amount equal to interest compounded annually from that date through the valuation date at the rate for 1-year United States Treasury obligations from time to time in effect, less the aggregate amount of any cash dividends paid and the market value of any dividends paid in other than cash, per share of the class or series of stock from that date through the valuation date, up to the amount of the interest; or

(vi) The price per share equal to the market value per share of such class or series of stock on the announcement date or on the determination date, whichever is higher, multiplied by the fraction of:

1. The highest per share price
(including any brokerage commissions, transfer

taxes and soliciting dealers' fees) paid by the interested stockholder for any shares of any class of voting stock acquired by it within the 5-year period immediately prior to the announcement date, over

2. The market value per share of the same class of voting stock on the first day in such 5-year period on which the interested stockholder acquired any shares of the same class of voting stock.

(3) The consideration to be received by holders of any class or series of outstanding stock is to be in cash or in the same form as the interested stockholder has previously paid for shares of the same class or series of stock. If the interested stockholder has paid for shares of any class or series of stock with varying forms of consideration, the form of consideration for such class or series of stock shall be either cash or the form used to acquire the largest number of shares of such class or series of stock previously acquired by it.

(4) (i) After the determination date and prior to the consummation of such business combination:

1. There shall have been no failure to declare and pay at the regular date therefor

any full periodic dividends (whether or not cumulative) on any outstanding preferred stock of the corporation;

2. There shall have been:

A. No reduction in the annual rate of dividends paid on any class or series of stock of the corporation that is not preferred stock (except as necessary to reflect any subdivision of the stock); and

B. An increase in such annual rate of dividends as necessary to reflect any reclassification (including any reverse stock split), recapitalization, reorganization or any similar transaction which has the effect of reducing the number of outstanding shares of the stock; and

3. The interested stockholder did not become the beneficial owner of any additional shares of stock of the corporation except as part of the transaction which resulted in such interested stockholder becoming an interested stockholder or by virtue of proportionate stock splits or stock dividends.¹

¹ Md. Corps. & Ass'ns Code Ann. § 3-603 (1985).

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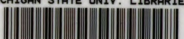
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