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F. HODGE O'NEAL SYMPOSIUM ON CORPORATE LAW AND FINANCE

FOREWORD—EVOLVING BUSINESS ASSOCIATIONS: UNDERSTANDING THE ROLE OF LAW

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Corporations law, at least from the time of Berle and Means, has been based on a stylized model of a large enterprise with many passive shareholders, each owning a small portion of the total ownership interest. Doubt about the continued applicability of this model in an era of institutional investors' holding large blocks of stock has provoked a flurry of scholarly critique[1] and may yet lead to change in our legal structure regarding corporations.[2] This recent scholarship broadens an ongoing debate elsewhere in corporations law. The effort to modify law for business

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1. *See, e.g.*, Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) (stylized facts, never wholly true, are today simply false); Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117 (1988) (examining the potential power of investment institutions); Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991) (discussing laws and regulations that have limited the role of institutional shareholders).

2. In June 1991, the Securities and Exchange Commission (SEC) proposed changes to several proxy rules that would have facilitated a greater institutional role in the proxy process. The SEC presented the proposal as the first of a series of possible rulemaking initiatives relating to the proxy solicitation process. *See* Exchange Act Release No. 29,315, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,811 (June 17, 1991). The proposal sparked an unanticipated number of comments

forms that do not fit the stylized model has long been a defining feature of close corporations law. More recently, the deluge of management buyouts and other going-private transactions has produced a whole new set of enterprises that do not fit the stylized model and that therefore require further adaptations of the traditional law.

This Symposium presents an array of provocative articles and commentary addressing law as applied to close corporations and going-private enterprises. These articles define anew how we think about the business firm and also offer guidance for defining the role of law and private ordering for all business enterprises. The Symposium contains written versions of presentations made at a conference held in St. Louis on November 8 and 9, 1991. The conference was jointly sponsored by the School of Law and the Center for Business Law and Economics of the John M. Olin School of Business of Washington University. This Symposium is a fitting tribute to F. Hodge O'Neal, whose innovative work highlighted the need to recognize that not all enterprises fit within assumed statutory norms. As Professor O'Neal pointed out, variations from these statutory norms require increased private ordering to plan around undesired statutory rules and greater attention to problems created in the absence of planning when these statutory laws are applied to business enterprises for which they were not designed.[3]

I. CLOSE CORPORATIONS

Statutory law traditionally did not address the different needs of enterprises with a small number of investors intimately involved in the operation of the business and lacking a public market for their shares. All investors were presumed to desire the normal corporate attributes of separation of function between owners and managers, centralized power in the board of directors, and decisions by majority rule. Indeed, those shareholders who sought to modify these rules (for example, to limit by

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and the SEC backed off this initiative in November, saying it would repropose the rules at some future date. *See* Sec. Reg. & L. Rep. (BNA) No. 46, at 1669-70 (Nov. 22, 1991).

3. Professor O'Neal's treatise, *Close Corporations: Law and Practice*, first published in 1958, has a strong planning perspective, guiding lawyers for close corporations in the steps necessary to permit the closely held enterprise to modify the assumed corporate form. *See* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS: LAW AND PRACTICE (3d ed. 1988) [hereinafter CLOSE CORPORATIONS]. His treatise, *Oppression of Minority Shareholders*, first published in 1975, addresses a variety of shareholder disputes including going-private transactions. *See* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS (2d ed. 1985).

contract the majority shareholder's power to discharge a minority investor) met with judicial insistence on traditional norms.[4] In the past forty years, however, legislatures and courts have come to appreciate attributes unique to the closely held business and have both permitted and encouraged a distinctive body of law fitted to the needs of these enterprises.[5]

As close corporations law has evolved, it has often been somewhat distinct from the main body of corporations law. In contrast, the first two principal articles in this Symposium illustrate the interconnection of close corporations law to the larger inquiry using close corporations to discuss game theory and the relative roles for courts and legislatures.

Ian Ayres uses a familiar line of close corporations cases to tell a broader story about the relative efficiency of courts and legislatures in dealing with close corporations issues. This story becomes a means to explore whether there is tension between two frequent assertions of law and economics scholars: (1) corporations statutory law is efficient, (a race to the top theory); and (2) common law is efficient. By examining judicial decisions nullifying statutory intent and statutes overriding judicial decisions, Ayres probes the relative efficiencies of the two laws. His assertion of the relative inefficiency of legislatures in crafting rules for close corporation governance draws the attention of two noted commentators in this area, Roberta Romano and Geoffrey Miller. Miller asserts that both statutory and common law are efficient for close corporations. Romano suggests that the two are at least complimentary and tend toward efficiency.

That debate is informative, but there may be more value to Ayres' points that do not directly address that question. Romano restates the inquiry as whether corporate grievances are more likely to be brought to courts or to legislatures. As Ayres' article suggests, the answer is courts. After a falling out among participants, the weaker party, typically the minority shareholder, often ends up with little or no return on an illiquid investment, a result contrary to that for which the parties bargained. The parties' bounded rationality thus has created a gap best filled by courts after the fact.

Ayres' suggestion that the legislature is more likely to reflect the interest of majority parties stirs calls from the commentators for additional

4. *See, e.g.*, McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934).

5. *See* O'NEAL & THOMPSON, CLOSE CORPORATIONS, *supra* note 3 (chapter 1 details the distinctive needs of close corporations).

empirical research; his conclusion, however, is not surprising. His point that close corporation law may be distorted to protect public corporation law deserves broader recognition. It is sometimes difficult to distinguish the intentional lumping of close corporations with public corporations from an uninformed application of public corporation law to close corporations. Either case distorts close corporations law. An example is a recent Arizona case involving a fight for control of a close corporation between two factions of the same family, each owning about half of the company's shares.[6] The state appellate court cited a host of public corporation takeover decisions, all strongly protective of the board's prerogative to direct this enterprise, to resolve the dispute with no recognition that the enterprise was nothing like the publicly held corporations seen in the cases cited by the court.

Jason Scott Johnston addresses the role for courts and markets in balancing the possibility that the majority shareholders in a close corporation will misuse corporate powers against the possibility that the minority will file bad faith, opportunistic lawsuits asserting oppression or breach of fiduciary duty. Johnston approaches this central problem in corporate law from a game theory perspective, not heretofore used in the close corporation context. He challenges the simple conclusion (of what he terms the "perfect market" analysis) that ex ante private bargaining is better than judicial resolution imposed ex post. He asserts that this analysis fails to examine seriously the strategic limitations on the terms parties can agree to ex ante, and he offers a contract proposal game as an alternative.

Johnston's analysis suggests less need for an expansive fiduciary duty in symmetrical partnerships if the parties bargain with sophisticated legal representatives and a sophisticated awareness of the possibility for opportunistic behavior. He finds a judicially applied "reasonable expectations" standard is appropriate for closely held corporations, however, because of the strategic problems of contracting for an expansion of fiduciary obligations in that setting. Charles O'Kelley's commentary suggests that Johnston might broaden the focus of the game by including the initial selection of business form, which is inextricably linked to whatever bargaining later occurs about fiduciary duty. From this perspective, O'Kelley finds Johnston's analysis more useful as a gapfilling theory for

6. Schoen v. Schoen, 804 P.2d 787 (Ariz. Ct. App. 1990).

discrete transactions between strangers than for long-term relational contracts.

John Hetherington questions whether business participants will have the knowledge of their own (and their co-venturers') predatory proclivities to divide good from bad entrepreneurs for Johnston's model. Hetherington would focus on who should bear the costs of mutual antagonism after the loss of mutual confidence as the motives and behaviors change in an ongoing relationship. He suggests that the hostility of the Perfect-Markets analysis to providing legal relief preserves the vulnerability of the disadvantaged within the closely held business relationship. Protection of minority shareholders' expectations after a falling out between the parties, in Hetherington's view, supports both greater productivity and an economically more just society.

The growth in state statutes authorizing limited liability companies illustrates legislative encouragement of participants' desire to expand the choices of business forms. This budding means of organization lets firms adopt limited liability without the tax costs found in the corporate form.[7] The growing adoption of statutes permitting this form may test Ian Ayres' assertion that states do not compete for close corporation charters and may expand the contract proposal game Jason Johnston advances. Larry Ribstein takes a different approach, staking out a broad claim that the partnership form is attractive for many firms on the margin only because the regulatory costs of limited liability, including double corporate taxation and limitations on organizational form, make incorporation too expensive. His prediction of the possible death of partnership is provocative in itself; his thesis also illustrates a broader theme in business associations law in its suggestion of a more limited role for regulation generally, and in particular for regulation as to unlimited liability. The move to limited liability companies with reduced liability for business participants thus parallels some of the recent proposals to revise the Uniform Partnership Act and changes in state corporations statutes to permit corporations to limit their directors' liabilities for breaches of the duty of care.[8]

Ribstein argues that a firm's possible use of limited liability to externalize tort costs does not justify restricting the availability of limited lia-

7. *See generally* Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. (forthcoming 1992).

8. *See generally* Committee on Corporate Laws, *Changes in the Revised Model Business Corporation Act—Amendment Pertaining to the Liability of Directors*, 45 BUS. LAW. 695 (1990).

bility. This argument carries him into the current debate over efforts to remove limited liability for corporate participants, at least for torts.[9] Robert Hillman takes direct issue with Ribstein's point, asserting that the potential for externalities justifies restrictions on limited liability and arguing against a unitary analysis of limited liability that does not distinguish public from closely held firms. Saul Levmore's recognition that enormous numbers of actors have gravitated toward tax-disfavored classifications makes him less inclined than Ribstein to assume that regulation, taxation, or tort liability are always suspect, and more inclined to look at competition between states and competition between interest groups within states. As Levmore poses the question, we will have to look further to see if limited liability companies are a frontier-expanding innovation or the unfortunate product of interest-group politics.

II. Going Private and Management Buyouts

The seemingly mass movement in the 1980s by which management and investment groups purchased the equity interests of public shareholders did not create a new form of doing business. It did provoke a lively debate as to how law should respond to the frequent changes in the form by which individual firms do business. This conference brought together two economists whose empirical work suggests skepticism about regulating these transactions, and two lawyers skeptical of the transactions without regulation. Steve Kaplan, whose studies are printed elsewhere, has produced significant empirical work illustrating that many firms in going-private transactions return to public ownership in a fairly short time.[10] The empirical work of Jeffrey Davis and Ken Lehn (presented by Lehn at this conference) questions the value of required disclosure in going-private transactions. The conference presented an engaging interchange between the economists and the two legal scholars on the panel: Al Sommer, who as an SEC Commissioner in 1974 propelled the going-private debate into the public spotlight,[11] and Victor Brudney, who has previously suggested that some management initiated transac-

9. *See, e.g.*, David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565 (1991); Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991).

10. *See* Steven N. Kaplan, *The Staying Power of Leveraged Buyouts*, 29 J. FIN. ECON. 287 (1991) (many firms taken private go public again within a few years); Steven N. Kaplan & Jeremy C. Stein, *The Evolution of Buyout Pricing and Financial Structure* (National Bureau of Economic Research Working Paper No. 3695, May 1991).

11. A.A. Sommer, Jr., *"Going Private:" A Lesson in Corporate Responsibility*, Law Advisory

tions ought to be banned.[12]

The discussion that followed the panelists' presentations highlighted the different perspectives brought to this problem. The excerpt that follows begins with a comment from Philip Dybvig, John M. Simon Professor of Finance at Washington University, as to the relative value of each empirical work. Dybvig's observation on differences between valuation as seen by shareholders and as seen by managers brings the lawyers on the panel into the discussion:

> *Phil Dybvig*: I put a lot more faith in numbers like Steve's previous study rather than just looking at the premium because you are trying to measure the difference between the price that the managers are paying and the true value. And what Ken is measuring in his studies is the difference between the price before the buyout compared to what the manager paid. . . .
>
> I think what Steve does is closer. I do think that there is a separate issue which is that the intrinsic value as perceived by the inside manager is much different from the intrinsic value as perceived by the market. And it would be nice to know how the increase is split up between that difference. That is something that we just can't measure. That's very important to these values.
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> *Al Sommer*: I think that's an important point. Take your John Kluge case. Now, I don't know if the value changed in the two years between the time that he took the company private and the time he sold off all the assets, but my guess would be that . . . the company could have sold off those assets at the time of the going-private transaction at significant premiums over what they were carried on the books at or reflected in the value in the market. So there was a value there. The market didn't recognize it. So I, . . . as a shareholder of Metromedia, look at that value and see it in terms of the stock market because I don't really expect that anybody is going to take measures such as he took to realize the values. I didn't expect the company to sell off their assets. I don't invest with the expectation of that and I don't hold the stock with the expectation of that. So there is a value in there that is only going to be realized if somebody takes the initiative to sell off those assets. So he does it; but he does it after going private so that he gets the benefit of it. . . . You have this value that is imbedded in there and the measure that the shareholder uses as to how much benefit he's getting and whether it's enough is in terms of what he sees as the market price—what he can sell it for. Now, there is where the whole thing leaves me con-

Council Lecture, Notre Dame Law School (Nov. 1974), *in* [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,010 (Nov. 20, 1974).

12. Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1365-70 (1978).

fused. . . . [M]uch of the value could be realized in the context of a publicly held company. And why doesn't management do it?

Steve Kaplan: Why did Dick Munro do the *Time-Warner* deal when two years later the stock price is at ninety dollars, and he could have had two hundred dollars? Why did Ross Johnson have an air force?

Victor Brudney: If you ask me why does he do it, he isn't doing it for me. I happen to be a Time stockholder. He certainly isn't doing it for my benefit.

Steve Kaplan: The point there is that there are some managements who will do it. And there are other managements who won't. How do you get changes? Let's say Ross Johnson decides I'm going to change RJR Nabisco without an LBO. . . . And people kind of scratch their heads and go: "Why are you doing this? We are a profitable company." I am not saying this is true in all cases. And there are clearly bad LBOs. . . . But, there are situations where . . . you do this and it sends a really strong signal to the whole organization that things are going to change. And you can do things that would be harder to do without that big shock. . . .

Phil Dybvig: There is hardly a management signal that would be more costly to the shareholders. This is incredibly costly . . . This is saying in order to do what's good for the shareholders I have to take away forty percent of the value. . . . There ought to be some way to send a signal to the employees without saying, "well the only way I can signal the employees that we're serious about this is for me to take two-thirds of the firm value and put it in my pocket."

Steve Kaplan: You're taking a chunk of it and you are also giving a chunk to the public shareholders.

Victor Brudney: If shareholders understand this should they charge more for their capital? In a perfect market we'll equilibrate won't we? . . . If investors know that it is not the economic increment in the value of the enterprise that is all theirs, but that at a certain point an indeterminate amount of it can be appropriated by managers for themselves . . . they'll charge more for capital, isn't that right?

Steve Kaplan: They know that.

Victor Brudney: Do they? . . . Let me put it another way: if the market knows it then there is surely no harm in stating it explicitly ex ante; but I don't see anybody rushing to do that.

Steve Kaplan: No. But this is why. This is the rationale behind the SEC or the Exchange that has allowed you to do a dual class—to have two classes of stock—if you are doing an IPO [Initial Public Offering] rather than doing two classes of stock (midstream).

Victor Brudney: I am not sure you are proving your point with that.

Steve Kaplan: If you are doing it ex ante people will understand that one

class of stock has no voting rights. So management can do whatever they want to you and those shares are typically priced.
Victor Brudney: Why are you reluctant to have it stated explicitly? You say it's understood. You say, well here's another mechanism that shows it.
Steve Kaplan: It's explicit. You don't have voting rights. What's more explicit than that?
Victor Brudney: That doesn't say that you can expropriate. . . . We ought to know why there can't be an explicit statement about the exposure to a risk of division at the end of the hunt.
Deborah DeMott: Or to use the rollup example. . . . Why doesn't the SEC require that each prospectus for a new publicly offered limited partnership say up front "an additional thing you should know is we can roll you up?" Why resist that?
Al Sommer: Having once been a guardian of "The Holy Grail" of disclosure, I don't really have much faith in it. I don't think it would change people's investment decisions at all if they saw that emblazoned on the front page of the prospectus, because the salesman would overcome the effects of that very quickly.

Just as limited liability companies provide the format to discuss some of the current close corporations issues, partnership rollups provide a timely vehicle to discuss many of the problems involved in management buyouts. Deborah DeMott provides the first detailed scholarly look at these transactions. As she described it in the panel discussion that followed the presentations:

> These are really "small fry." These are funny little types of investment. It's a small kind of change-of-control transaction overall. There was an enormous amount of initial disclosure—ex ante disclosure as well as disclosure at the point of the rollup. It's nonetheless intriguing to me that this alone among the phenomena that we talked about this afternoon looks like it's going to lead to Congressional legislation. A committee staff member on the House Subcommittee told me that the Subcommittee had received more investor complaints with regard to rollups than anything else they had worked on in the institutional memory of the committee staff, including penny stocks, leveraged buyouts, IPOs, . . . I . . . would have predicted if this were an appropriately competitive capital market in the way that it functioned, it surely should be possible for a limited partnership sponsor to bond itself to investors in such a way as to preclude the possibility of this kind of transaction.

Though these transactions currently may seem on the edge of regulatory discussions, they may provide the vehicle for working out larger issues, including the familiar debate over federal preemption of state regulation of business associations. Legislation proposed, but not passed, in the last Congress would have provided appraisal rights for investors in a rollup,[13] an issue previously left to state corporations law. The relative importance of state and federal law for resolving corporations issues has continually fluctuated during the last sixty years. We are now at a point at which state law occupies a larger role than it did a generation ago, and federal courts seem increasingly inclined to limit federal law to disclosure.[14] Congressional action to establish federal appraisal rights for investors in rollups would clearly indicate that the move to limit federal rights for business entities has reached its apogee.

Many going-private or management buyout transactions present difficult issues as to the role of investment bankers and their fairness opinions. As Dale Oesterle notes in his commentary, the worst abuses associated with fairness opinions have occurred in LBOs of publicly traded firms: this topic thus in some ways extends the previous discussion. Courts have occasionally questioned the role of investment bankers and their fees, but efforts to impose liability on investment bankers have not progressed very far. Ted Fiflis provides a theory by which these investment bankers might be held responsible to shareholders as gatekeepers. William Carney challenges Fiflis' plan, stating that contracts, markets, independent directors, and courts willing to set aside unfair transactions will provide protection for shareholders without the need for the liability Fiflis suggests. Oesterle's position is between these two, providing a useful exchange of views on this topic. Murray Weidenbaum's address links this discussion of investment bankers to the debate over going-private transactions. Weidenbaum's experience as an academic, a government official, and a director in various corporations gives him a distinct perspective on the takeovers of the last ten years, and he uses that experience to speak frankly about some of these transactions.

Justice Andrew G.T. Moore II of the Delaware Supreme Court, the author of many of that court's recent takeover opinions, provides an overview for the entire legal discussion of these issues with his retrospective of the 1980s and the key Delaware corporate decisions of that decade. Moore suggests that the 1980s might be viewed as only a gold-plated age of corporate law rather than a golden age of corporate law and

13. *See, e.g., Stark Bill Would Encourage Dissenters' Rights In Rollups,* Sec. Reg. & L. Rep. (BNA) No. 17, at 599 (Apr. 26, 1991).

14. *See, e.g.*, The Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990) (finding SEC Rule 19c-4 to be beyond the powers delegated to the Commission).

he notes that the luster is wearing off. His review of *Smith v. Van Gorkom*, *Unocal*, *Revlon* and *Paramount* identifies the role of the court in the takeover process and focuses on how the court's decisions have changed the role of directors.