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# WHO OWNS A CORPORATION AND WHO CARES?

RICHARD A. BOOTH\*

## INTRODUCTION

Some theories are so widely accepted that we forget they are theories. One such theory is the theory that a corporation is owned by its stockholders. This theory has proved useful as a way of organizing our thoughts about corporation law. It has helped us define the duty owed by directors and officers to the corporation and to the stockholders.

Most commentators would likely agree that a corporation is owned by its stockholders and that management has a duty to maximize stockholder wealth.<sup>1</sup> But the courts have generally resisted the temptation to go quite so far, except in limited circumstances such as review of takeover defenses or tactics in connection with a change of control.<sup>2</sup> The theory of stockholder ownership has also served to limit the duties owed by management to other constituencies.<sup>3</sup> But here too the theory has been limited by statute in most states.<sup>4</sup> So the question is, just how good a theory is it?

But first a word on theory generally. It is not entirely clear that a legal theory is a theory in the same sense that the efficient market theory or portfolio theory or option pricing theory or the capital asset pricing model are theories. One key difference is that a legal theory is usually viewed as normative rather than descriptive. On the other

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1. See generally MICHAEL P. DOOLEY, *FUNDAMENTALS OF CORPORATION LAW* 97 (1995); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 248-65 (1999); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 277-78 (1998). For a notable example of an argument based on the shareholder wealth maximization norm, see Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

2. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

3. See Comm. on Corp. Laws, Am. Bar Ass'n, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253 (1990).

4. See *id.*

hand there is certainly a school of thought—the contractual theory of the corporation—that the primary function of corporation law is to replicate the arrangements that people would make for themselves.<sup>5</sup> And in any given case, it may be quite difficult to tell whether the court is telling us how the law should be or telling us why the parties did not live up to the law as it is. For example, *Smith v. Van Gorkom*<sup>6</sup> may be seen either as holding that the board of directors failed to do its *existing* duty in connection with approving a merger transaction or as setting a new standard requiring that all boards of directors must seek to maximize stockholder value, as was made explicit months later in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*<sup>7</sup>

To the extent that corporation law is in fact descriptive, it seems quite clear that theories of organization such as the theory of the firm are relevant to corporation law. The theory of the firm seeks to tell us why firms form and thus may tell us why corporation law is how it is and how it should be different.<sup>8</sup> And even if corporation law is descriptive, there is no reason to think that it should be static. To borrow a phrase from the Army, corporation law should be all it can be. Thus, the distinction between the descriptive and the normative ultimately breaks down. In any case, if nature can have laws, the law can have theories.

While we are on the subject, why do we need a theory anyway? As in the sciences, a legal theory should be tested by its predictive value. A good theory should predict what the law will be in any given case; that is, a good legal theory predicts how a case will—or should—turn out. Thus, legal theories help us discover what the law is (depending, of course, on what “is” means).<sup>9</sup> Moreover, unlike theories that deal with the laws of nature, with legal theories we can

5. For the best discussion (and criticism) of this view, see Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997). On the one hand, the contractarian view of the corporation seems trivial. See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990). What possible justification could there be for corporation law to do something other than replicate the arrangements parties would make for themselves? No one today would seriously argue that a corporation should serve some public or social purpose determined by someone other than its constituents. On the other hand, the contractarian view makes some sense in the context of the debate over whether the rules of corporation law should be at all mandatory. For example, mandatory rules may be necessary where shareholders are numerous and scattered and thus suffer from collective action problems. For a broad ranging discussion of this issue, see Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).

6. 488 A.2d 858, 876 (Del. 1985).

7. 506 A.2d 173 (Del. 1986).

8. Blair & Stout, *supra* note 1, at 247.

9. Thank you Bill Clinton.

sometimes reach the conclusion that a particular case turned out incorrectly, in which case it may be reversed or may just sit there as bad law. A scientist cannot simply dismiss errant observations (cold fusion notwithstanding). Newton is lucky he did not see an apple rise back into the tree.

Theory is not just for academics anymore (if it ever was). Although a lawyer would prefer to find a case that is on “all fours” with the problem at hand, one is seldom so lucky. (How it is that so many new legal problems pop up with such regularity—like gophers in an arcade game—is a question for another day.) And if it were common to find such easy answers, there would not be much money in doing it. In short, a lawyer would be lost without a theory, even if it is just a little one to bridge the gap between that lawyer’s own case and a three-legged stool. Moreover, a lawyer needs to know the difference between a good theory and a not-so-good theory. Aside from prevailing in the courtroom when there is “no controlling legal authority,”<sup>10</sup> a lawyer who does deals will often need to decide how strong an opinion to give. Is it merely *more likely than not* that a court would rule in favor of the client, or can one say that a court *should* so rule, or even *will* so rule?

This also suggests a role for academics. To paraphrase Barry Manilow, we write the theories.<sup>11</sup> Few lawyers have the time or can take the risk to develop their own theories. Indeed, when it comes to legal theories, a newly discovered one tends to be less worthy than a well-worn one—at least in the courtroom. Other things being equal, a lawyer would probably rather use an argument that has been used before and for which there is a citation. Thus, we academics serve as a source of theories (and sometimes testimony to back them up), though we may be even fonder of citations and footnotes than our practicing siblings. What is really peculiar is that the theoreticians are left in charge of the students, though it may be that only before such an audience are we willing to try out some of our more radical ideas.

Theories are the scope through which we find facts. That is, they tell us what facts to look for. The danger is that we may miss facts that we are not looking for or disregard them as noise. But when the noise drowns out the music, it may be time for a new theory.

10. Thank you Al Gore.

11. This should not be taken as an admission that I like or ever intentionally listen to Barry Manilow. Rather, when the bailiff asked, “Do you swear . . . ?”, I would answer, as did Curly of the Three Stooges, “No. But I know all the words.”

## I. THE STOCKHOLDER OWNERSHIP THEORY

So how good is the stockholder ownership theory as a theory? Not very. It does not describe the law very well, nor does it do a very good job as a normative matter. Indeed, it does not even address many of the most important questions that arise these days.

The stockholder ownership theory has been under attack almost from its conception. Although the 1919 Michigan Supreme Court heartily endorsed the theory in *Dodge v. Ford Motor Co.*,<sup>12</sup> it was nonetheless controversial when Berle and Means reasserted it in *The Modern Corporation and Private Property*.<sup>13</sup> Up until the mid-1970s, the primary challenge came from those who argued for corporate social responsibility in various forms, and the debate was about for whom managers should be trustees (though it was never very clear that trust law bore much relation to corporation law).<sup>14</sup> Since then, scholars of the law and economics persuasion have argued that managerialism and empire building (sometimes under the guise of being a good corporate citizen) is the real danger.<sup>15</sup> In the last few years, the so-called progressive school has emerged to argue that a board of directors should consider the interests not just of its stockholders, but rather of a variety of constituencies.<sup>16</sup> Although the courts have largely rejected this view,<sup>17</sup> the courts have not unequivocally ruled that a board of directors has the obligation to maximize stockholder wealth either.

It is in this historical context that Margaret Blair and Lynn Stout have argued in a series of recent articles that the classical view of the corporation is flawed because it does not adequately explain the separation of ownership from control and—more important—why investors would submit to it.<sup>18</sup> Their answer is that the board of directors of a public corporation functions as a “mediating hierarchy” that allows various actors to entrust inputs to a corporation in

12. 170 N.W. 668 (Mich. 1919).

13. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

14. See *A.P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581 (N.J. 1953); see generally A.A. Sommer, Jr., *Whom Should the Corporation Serve?: The Berle-Dodd Debate Revisited Sixty Years Later*, 16 DEL. J. CORP. L. 33 (1991). Regarding the limitations of the trustee analogy, see Smith, *supra* note 1.

15. See Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REFORM 117 (1988).

16. See generally *PROGRESSIVE CORPORATE LAW* (Lawrence E. Mitchell ed., 1995).

17. See, e.g., *Munford, Inc. v. Valuation Research Corp.*, 98 F.3d 604 (11th Cir. 1996).

18. Blair & Stout, *supra* note 1, at 247.

situations in which the prospect of gain from collective action exceeds the return that one would expect from retaining control over one's own inputs.<sup>19</sup> In other words, because all of the contributors distrust each other to some extent, they all agree to give up control to a neutral third party. Specifically, the various actors are willing to give up control over their own inputs because the corporate form serves (1) to streamline information gathering and decision making, (2) to control shirking, and (3) to resolve disputes among various constituencies.<sup>20</sup> In this last connection, they suggest that the board of directors acts more like a judge or referee—sorting out the claims of various corporate constituencies—than it acts as a principal.<sup>21</sup> And they suggest that the arrangement is worth the cost of lost control even though reliance on a board of directors leads to the creation of additional agency costs.<sup>22</sup> From these premises, they argue that the progressive or communitarian view of the corporation is more accurate than either the traditional or the contractarian view of the corporation.<sup>23</sup>

Although the Blair-Stout Project affords important insights, it is flawed in at least two key respects. First, their argument is based on the notion that various actors contribute firm-specific inputs that cannot be withdrawn.<sup>24</sup> That simply is not true in the case of stockholders who contribute fungible cash and who can sell without notice.<sup>25</sup> Neither is it clearly true of bondholders or even lower-level employees. Indeed, it is only clearly true of management. Thus, it makes much more sense to think of the corporate form as designed to serve management and to think of stockholders and the market as the disinterested mediating hierarch.<sup>26</sup> And as it turns out, the evidence in support of this paradigm is quite substantial.

19. *Id.* at 265–76.

20. *Id.* at 276–78.

21. *Id.* This suggests that one will choose to form a corporation only if there is the prospect of economic rents (relative to other uses of the inputs, that is, opportunity costs), which may in turn explain the remarkable survival of the corporate income tax in the face of persistent academic criticism.

22. *Id.* at 283–87.

23. *Id.* at 253.

24. *Id.* at 265–76. This may also explain why the courts have traditionally been reluctant to order the involuntary dissolution of corporations even in fairly egregious cases.

25. Of course, a shareholder with a significant stake may find it more difficult to sell out as a practical matter and perhaps even as a legal matter.

26. I do not mean to suggest that the corporate form was somehow designed in the first place to perform this function, or even that it had come to do so as long ago as 1980. Rather, I only mean to suggest that since the mid-1980s the courts, legislators, regulators, commentators, and the markets have case-by-case and step-by-step intuited that corporations so function.

Second, one of the central mysteries that Blair and Stout seek to explain—the separation of management from control—seems to be evolving out of existence. Many companies now feature substantial management and employee ownership as a result of generous grants of stock options and the use of company stock to fund pension plans. As of 1999, among the two hundred largest US companies, there are fourteen in which more than 25 percent of the stock has been allocated to management and employees through options.<sup>27</sup> Among the two hundred largest companies, an average of 13.7 percent of shares is committed to options, and 2.07 percent of equity is granted annually, with fifteen companies granting more than 5 percent annually.<sup>28</sup> Moreover, the more a company relies on options as compensation, the more management may be induced to minimize the number of shares in public hands so as to keep the stock price higher. Thus, a company may repurchase shares on the open market (or may buy call options or sell put options), further enhancing management's relative stake in the company. Indeed, in 1997, it was reported that Microsoft (whose stock is 38 percent owned by or committed to its optionee employees) used cash equal to about two-thirds of its reported earnings to buy shares and options in order to control for dilution.<sup>29</sup> Alternatively, a company may opt to sell a relatively small percentage of shares to the public in the first place. In short, it would appear that there is much less separation of ownership from control than there was even as recently as 1980.

Quite aside from these quibbles, it appears that there is more than one kind of stockholder. There are passive investor stockholders. And there are active manager stockholders. The interests of these two groups of stockholders may diverge in significant ways. So, even if we assume that the stockholders do in fact own the company, which set of stockholders are we talking about? The stockholder ownership theory simply cannot answer the question.<sup>30</sup>

27. PEARL MEYER & PARTNERS, INC., 1999 EQUITY STAKE 3-7 (1999).

28. *Id.*

29. Roger Lowenstein, *Microsoft and Its Two Constituencies*, WALL ST. J., Dec. 4, 1997, at C1. It is thus not surprising that the SEC and the NYSE have focused recently on the need for stronger rules regarding dilution. It may be, however, that one of the reasons for the rise in relatively small offerings is that they allow for easier control of dilution or indeed allow for the possibility of going private more cheaply should the need arise.

30. *Cf. Smith, supra* note 1 (discussing the history of stockholder ownership theory in conflicts between groups of stockholders).

## II. A SHORT HISTORY OF CORPORATION LAW

To paraphrase *The Talking Heads*, how did we get here? To answer this question one needs to hark back to the heyday of the stockholder ownership theory. The theory reached its descriptive apogee in the great takeover wars of the 1980s when innumerable corporations were sold out from under incumbent management to bidders who appealed directly to the stockholders by means of the tender offer. All theorizing aside, stockholders demonstrated that they could and would sell out to the highest bidder.

There were three factors that drove tender offers. One factor was the growth of highly diversified mutual funds and other institutional investors who were essentially risk neutral.<sup>31</sup> A second factor was the development of the junk bond market, which allowed bidders to raise vast sums of cash.<sup>32</sup> The rise of junk bonds was itself fueled in part by the reluctance of corporations to pay dividends (and the concomitant misuse of available cash), as well as the recognition by investors that junk bonds were roughly equivalent to stock (with an enforceable promise to pay dividends). If the obligor defaulted there was always the alternative of a prepackaged bankruptcy in which the holders of junk bonds would at worst get stock—roughly what they had in the first place. The result of this confluence of factors was that corporations came under pressure to become more leveraged. Risk-neutral stockholders loved leverage. Any corporation that failed to borrow heavily and minimize its stock float saw its stock languish and likely became a target. The third factor was the formation during the 1960s and 1970s of numerous conglomerate corporations.<sup>33</sup> Diversified investors developed a distinct distaste for diversified companies. It was cheaper for investors to diversify than for companies to do so. Why would investors want prepackaged, off-the-rack diversification when they could form their own custom portfolio or choose from thousands of mutual funds? Perhaps even worse, management of a diversified company tended to be less focused than that of a company in a single line of business. Bidders soon discovered that they could often pay off takeover debt by

31. See Richard A. Booth, *Stockholders, Stakeholders, and Bagholders (or How Investor Diversification Affects Fiduciary Duty)*, 53 BUS. LAW. 429 (1998).

32. See ROBERT W. HAMILTON & RICHARD A. BOOTH, *BUSINESS BASICS FOR LAW STUDENTS* 375–76 (2d ed. 1998).

33. See Yakov Amihud & Baruch Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981).



breaking up target companies and selling the pieces for more than the cost of the whole.

One early reaction to the threat of a hostile takeover was the golden parachute, an attractive severance package designed to compensate ousted management for lost jobs. Many commentators saw golden parachutes as just another managerial abuse, but some noted that a properly tailored golden parachute would allow management to consider dispassionately the merits of a takeover bid from the point of view of the stockholders.<sup>34</sup> But if golden parachutes are such a good idea, why not further align management and stockholder interests by granting generous stock options, which (by the way) could reduce the need for cash compensation and the hit to earnings and even raise capital for the corporation upon execution.

Hostile takeovers may be less common than they were in the 1980s. The evidence is somewhat equivocal.<sup>35</sup> But the market for corporate control is even more active today than it was in the 1980s.<sup>36</sup> Of course, the reasons for mergers and acquisitions have changed somewhat. Nowadays, consolidation and going global are major motivations.<sup>37</sup> Nevertheless, the process of deconglomeration that began with the bust-up takeover of the 1980s is alive and well—witness the boom in spin-offs and tracking stock.<sup>38</sup> In short, the takeover is not dead. It has just gone in-house. Part of the reason may be that potential target managers hope to preempt a hostile takeover. But takeover defenses have become virtually impenetrable. So why does management so often *choose* to sell? The simple answer may be stock options and the increased equity stake that so many executives have in their companies.

But even if management could be compensated exclusively with stock, perfect alignment of interests is impossible. Management interest will always diverge from stockholder interest because

34. Richard A. Booth, *Is There Any Valid Reason Why Target Managers Oppose Tender Offers?*, 14 SEC. REG. L.J. 43, 59–60 (1986).

35. See generally John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000) [hereinafter Coates, *Takeover Defenses*]; John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837 (1999) [hereinafter Coates, *Mediating Hierarchy*].

36. See Coates, *Mediating Hierarchy*, *supra* note 35; Coates, *Takeover Defenses*, *supra* note 35.

37. See VICTOR BRUDNEY & WILLIAM W. BRATTON, *BRUDNEY & CHIRELSTEIN'S CASES AND MATERIALS ON CORPORATE FINANCE* 166–67 (4th ed. Supp. 2001).

38. Susan Pulliam, *More Parent Firms Are Setting Units Free*, WALL ST. J., Feb. 3, 2000, at C1.

stockholders are free to diversify. With diversification, an investor can eliminate the risk that some companies in a portfolio will underperform the market. For every company that underperforms, there will be another that exceeds expectations. You win some and you lose some. Only the average really matters.

A diversified stockholder cares little about risk at the company level. He or she will prefer that management assume extraordinary risk as long as the return is adequate. If ten companies each bet the farm on ventures that offer a 50 percent chance at a 100 percent return, half will succeed and half will fail. The diversified stockholder will get his expected 50 percent return, but half of the managers will get nothing (except possibly fired).

Management cannot diversify—at least not until options can be exercised. Even then, a manager's human capital is invested in a single venture. Management cannot hedge against the risk of failure. Thus, although a diversified stockholder may prefer that management be aggressive about taking on risky new ventures when the potential return is high, management may prefer a merely adequate return (and survival of the business) to a chance at a jackpot. The upshot is that management cares far more about how its company performs than stockholders do.<sup>39</sup>

Things were not always so. In the age of conglomerates before the 1980s, a share of stock in a diversified company was rather like a share in a mutual fund. Conglomerates do not, however, serve stockholder interests well. It is much cheaper for stockholders to diversify than it is for companies to diversify, and stockholders can easily adjust the mix of companies in which they invest. Moreover, the CEO of a conglomerate tends to be a jack-of-all-trades but a master of none. And thus they may lack the "vision thing."<sup>40</sup> Finally, market analysts have a tough time setting a value on a collection of companies in a wide variety of businesses. For all these reasons, the market did not like diversified companies. It bid down the price of such stocks, and most such companies are gone as a result of bust-up takeovers. But part of the cost of more focused companies is that managers must be compensated for higher risk. And if options are part of the compensation package, a CEO must take more risk for the

39. Options are not perfect, but (like democracy) they are better than the alternatives. To pay management on the basis of an artificial and manipulable number like earnings or assets invites invidious gaming. See *Kamin v. Am. Express Co.*, 383 N.Y.S.2d 807 (Sup. Ct. 1976); see also *Rogers v. Hill*, 289 U.S. 582 (1933).

40. Thank you George H. W. Bush.

same return as a diversified stockholder. It thus stands to reason that CEOs will negotiate for more options as compensation for added risk, and that public companies will come increasingly to be owned by management.<sup>41</sup>

Given the profound conflict between the interests of management and the interests of stockholders, one wonders why any company deigns to be publicly traded. Even the very largest companies can go private. It is not as if the capital available through the stock market is all that necessary.<sup>42</sup> So, to paraphrase George Bailey in *It's a Wonderful Life*, why do we have to have all these stockholders anyway? Ironically, one of the most important reasons for being publicly held is that it allows for the use of stock options as compensation for key employees.<sup>43</sup> And even more ironically, a public market also provides liquidity and allows manager-owners to achieve some degree of diversification. In other words, it allows them to bail out. One might even think of management as buying liquidity from public stockholders. Finally, stock options also have the distinct

41. Yet another way in which the interests of inside and outside stockholders diverge arises from the fact that companies are not necessarily in control of their own securities. Companies have no control over whether their stock will be the subject of options trading or will be stripped and sold in pieces as part of some exotic derivative. And to add insult to injury, many of these investments (and the strategies they allow) are off-limits to insiders. See, e.g., Securities Exchange Act § 16(A), 15 U.S.C. § 78p(c) (2001) (prohibiting short sales by officers, directors, and stockholders owning greater than 10 percent of any equity security). Moreover, the addition or subtraction of a stock in an index causes an increase or decrease in price having nothing to do with the fundamental value of the company. These "wag the dog" phenomena do not necessarily justify all of the efforts of management to manage the flow of information and stock price itself, but they do explain such behaviors to some extent. For a notable example of a case in which the court considered and rejected arguments by stockholders based on their peculiarly hedged position in a stock, see *H. B. Korenvaes Invs., L.P. v. Marriott Corp.*, 1993 WL 257422, at \*1 (Del. Ch. July 1, 1993). On the other hand, insiders are privileged to use inside information in deciding *not* to buy or sell. And indeed the SEC rules against insider trading have been somewhat softened for management stockholders. Compare Securities Exchange Act Rule 10b5-1, 17 C.F.R. § 240.10b5-1 (2000), and Securities Exchange Act Rule 10b5-2, 17 C.F.R. § 240.10b5-2 (2000), with *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998). It has also been suggested that one reason for the boom in options is that management is largely free to coordinate the grant and exercise of options with lows and highs in market price which themselves are somewhat controllable by management. This view of stock options is similar in many respects to the position advocated by Henry Manne that management should be free to engage in insider trading as a form of compensation. See generally HENRY MANNE, *INSIDER TRADING AND THE STOCK MARKET* (1966).

42. The massive leveraged buyouts of the 1980s demonstrated this beyond peradventure. And the concept is apparently alive and well at the turn of the century. See Scott McCartney et al., *Feeling Undervalued, Some Airlines Consider Bumping Stockholders*, WALL ST. J., Mar. 10, 2000, at A1; Suzanne McGee, *Control Issues: More Firms Turn to LBO Funding*, WALL ST. J., Feb. 14, 2000, at C1. Moreover, statistics demonstrate that in most years, corporations buy back more shares than they sell in the aggregate as measured in total dollar amount.

43. Joseph B. Treaster, *Going Public Amid Sharks: Insurers Look at Stocks as a Means of Survival*, N.Y. TIMES, Jan. 23, 2000, at 1.

advantage of providing an objective measure of performance that can be vital in a large company in which communication can be difficult and internal rivalries can lead to serious differences of opinion about how well the company is performing. In other words, beyond a certain size or level of complexity, a company *needs* to be publicly traded.<sup>44</sup> In a sense, public trading is a form of dispute resolution.<sup>45</sup>

Blair and Stout have argued that the board of directors acts as a mediator among various corporate constituencies.<sup>46</sup> In fact, it appears that the public stockholders and the market perform this function. The difference matters. By assuming that the board of directors acts as a mediator, Blair and Stout effectively assume the conclusion that the board should consider the interests of other constituencies as well as stockholders. If the stockholders are in fact the ultimate mediator, there is no reason to assume that they would or should consider the interests of other constituencies beyond the four corners of the contracts defining those interests. To be sure, it is somewhat unusual to think of a mediator as having an interest in the outcome of a dispute, which may well have led Blair and Stout to focus on the typically minimally compensated board of directors. But the idea of the board of directors as an advisory body that management may use as a glorified focus group to test out ideas and gauge potential stockholder reaction is equally believable—and probably more so given the profound conflict between the interests of management and stockholders.

In the end, one could think of the notion of stockholders as mediators as just another way of describing market discipline. The point is, however, that management submits to the discipline of the market for its own reasons, not because it necessarily must. The fact that stockholders may use their power in their own interest—perhaps to force the sale of the company through a tender offer—is a mere byproduct. Investors do not seem to care much about acting like owners, perhaps because they have become more confident that management will do the right thing. In short, stockholders tend to behave as if they are just along for the ride.

44. This is consistent with the approach implicit in I.R.C. § 7704 (1994), which mandates that if a company is publicly traded, it must be taxed as a corporation.

45. See Rebecca Smith, *Some See Dark Side in 'Phantom' Stock*, WALL ST. J., Nov. 15, 1999, at C1 (discussing constructive stock tied to division performance and used as incentive compensation).

46. Blair & Stout, *supra* note 1, at 276–78.

### III. THE EVIDENCE

It is ultimately impossible—in this context or any other for that matter—to say who is buying and who is selling. And it is unclear that it makes much difference. It is, however, apparent that management and the market are adversaries to some extent. At the very least, they are more akin to parties to an arm's-length bargain than they are to the traditional principal and agent model implicit in the stockholder ownership theory. And when one looks for it, additional evidence that managers and the market are engaged in a somewhat adversarial bargain is fairly easy to find.

#### A. Initial Public Offerings

It is a well-known anomaly of corporation finance that initial public offerings (“IPOs”) tend to be underpriced.<sup>47</sup> To be sure, much of the gain is often dissipated in the days and weeks that follow. Indeed, investors who buy newly offered shares in the aftermarket (rather than receiving an allocation from their broker at the offering price) often end up with a loss.<sup>48</sup> Nevertheless, on the average and over the long haul, IPOs tend to rise from their offering price by more than other shares of similar risk.<sup>49</sup>

One would think that the existing shareholders of companies going public would be outraged at the failure of their investment bankers to do a better job at setting prices for IPOs. But it appears that existing shareholders are quite happy when the stock soars following an IPO, despite the fact that a big pop in price would suggest that the company could have raised more capital for the same number of shares.<sup>50</sup> The explanation may be that although the company could have raised more money, the shareholders see the value of their own stock skyrocket. Nevertheless, the company (and

47. See Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 448 VAND. L. REV. 965, 965–66 (1995).

48. *Id.*; see also Terzah Ewing, *Burnt Offerings?: Street Debuts Are Fizzling After Pop*, WALL ST. J., Apr. 26, 2000, at C1.

49. See RICHARD W. JENNINGS ET AL., SECURITIES REGULATION 96–97 (8th ed. 1998) (collecting studies). Although IPOs carry above-market returns based on the offering price, it appears that they carry below-market returns when bought at the first-day closing price. *Id.* My own study of thirty-four IPOs during the month of October 1999 indicates that on average these offerings closed up 91.59 percent on the first day of trading.

50. See Robert McGough & Randall Smith, *IPO Issuers Don't Mind Money Left on the Table*, WALL ST. J., Nov. 3, 1999, at C1; Timothy J. Mullaney, *Is the Street Lowballing IPOs?*, BUS. WK., Apr. 3, 2000, at EB112.

presumably the existing stockholders' stock) would be worth that much more if it had sold its stock at a higher price.<sup>51</sup>

Arguably, competition should take care of the problem of underpricing. Underwriters should compete with one another to sell an issuer's stock at the highest possible price. Underwriters have every incentive to maximize offering price. With the standard flat-rate discount of 7 percent, the underwriter stands to make more money at a higher offering price.<sup>52</sup> Indeed, in recent years, several new firms have sought to develop ways to capture the benefit of underpricing for their issuer clients.<sup>53</sup> The results have been mixed at best.<sup>54</sup>

Numerous explanations have been offered for the apparently systematic under pricing of IPOs. But there has been relatively little investigation of whether the extent of under pricing can be correlated with the terms of the underwriting. The question is: Are there any identifiable factors that cause the market to bid up the price of some IPOs more than others?

A number of scholars have sought to show that there is a connection between anti-takeover provisions in the corporation charter and the success of an offering.<sup>55</sup> Consistent with their findings, my original hypothesis was that a company that sells a relatively large

51. Raymond Hennessey, *Start-Ups Still Fail to Benefit Fully as IPO Prices Soar*, WALL ST. J., Feb. 28, 2000, at C21. One might think that the corporation (or the selling shareholders) may have a claim against the underwriters who (after all) serve as agents for the issuer. Invariably, however, these claims are waived by both the corporation and the existing shareholders as part of the underwriting agreement. And given that no one has standing to sue for an injury to the corporation unless he or she was a shareholder at the time of the wrong, there is no one left who can sue the underwriter unless the waiver is found to be invalid for some reason.

52. Competition works slowly in the underwriting market. Issuers seldom switch underwriters. It is possible, however, that underwriters compete on the basis of reputation at a much earlier stage and that some underwriters get better prices for their offerings. See Mullaney, *supra* note 50, at EB112 (reporting that many firms switch underwriters for follow-on offerings possibly because of underpricing of IPO); Michael Siconolfi, *More Firms Switch Underwriters*, WALL ST. J., December 19, 1996, at C1; see also Randall Smith & Thomas T. Vogel Jr., *Time Warner Muscles Its Underwriters*, WALL ST. J., Jan. 28, 1993, at C1 (reporting that Time Warner was able to dictate terms of a series of deals because of competition among underwriters seeking the business).

53. Anthony B. Perkins, *IPOs Go Dutch, and Small Investors Gain*, WALL ST. J., Dec. 27, 1999, at A18. In addition, there are numerous alternatives to underwritten offerings ranging from do-it-yourself sales over the internet to outright stock giveaways. See generally Denis T. Rice, *Recent Developments in Offering Securities on the Internet*, in ANNUAL REVIEW OF DEVELOPMENTS IN BUSINESS FINANCING 1 (Am. Bar Ass'n Section of Bus. Law, Comm. on Devs. in Bus. Fin. ed., 2000).

54. For example, Wit Capital and W. R. Hambrecht & Co. have used the internet to conduct Dutch Auction offerings with some success. See Terzah Ewing, *Too Hot an IPO?: Andover.net's 252% Pop Raises Questions About Underwriter's 'Dutch Auction'*, WALL ST. J., Dec. 9, 1999, at C1; Randall Smith, *So Far, 'E-Underwriting' Gets a Slow Start*, WALL ST. J., Aug. 13, 1999, at C1.

55. See Coates, *Takeover Defenses*, *supra* note 35, at 276 n.8.

proportion of its shares in an IPO is likely to see a larger increase in its share price in the aftermarket because it exposes itself to the threat of takeover and thereby vouches (in effect) for the confidence that it has in its own prospects.

As it turns out, however, precisely the opposite appears to be true. My research, based on IPOs occurring during October 1999, indicates that there is an *inverse* correlation between offering size (as a percentage of shares retained by or for insiders) and the size of the first-day increase (pop) in stock price. In other words, smaller offerings increase more in the first day of trading than do larger offerings.

One possible explanation for why smaller percentage offerings show a bigger first day pop is simple supply and demand.<sup>56</sup> In other words, the fewer shares that are offered, the more intense the competition for them. Indeed, I have argued elsewhere that downward-sloping demand may explain underpricing of IPOs generally.<sup>57</sup> That is, given that IPOs are typically sold in a fixed-price offering, the price of the offering must be set low enough to induce the *n*th investor to buy. And given that the stock must be widely distributed (both legally and practically), it seems likely that many optimistic investors will get fewer shares than they would like to get. It is not clear, however, why supply and demand should work disproportionately in favor of smaller offerings. Moreover, one would think that the absolute number of shares available would be more important than the percentage of shares offered. Another possible explanation is that the small size of an offering signals to the market that management has a high level of confidence in the business and wants to retain more shares for itself or for a subsequent offering at a presumably higher price.<sup>58</sup> Neither of these theories explains why an underwriter would fail to adjust the price of a smaller offering proportionately upward so as to avoid *excessive* underpricing.

56. See Floyd Norris & Lawrence M. Fisher, *Offspring Outweighs Parent as Offering Hits the Market*, N.Y. TIMES, Mar. 3, 2000, at C1 (describing the offering by 3Com of shares in Palm, Inc., a 94 percent subsidiary after the offering, and stating that “[t]he soaring price for Palm partly reflected the fact that less than 5 percent of the outstanding shares in Palm were available for trading, far from enough to satisfy investor demand”); see also Terzah Ewing & Joshua Harris Prager, *Many Are Finding IPOs Still Out of Reach*, WALL ST. J., Feb. 28, 2000, at C21 (discussing the difficulty of small investors in getting access to IPO shares).

57. See Richard A. Booth, *The Efficient Market, Portfolio Theory, and the Downward Sloping Demand Hypothesis*, 68 N.Y.U. L. REV. 1187 (1993).

58. See Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987) (discussing the distinction between growth companies and cash cows).

One would think that underwriters would consider the quantity of stock to be sold in pricing the issue in the first place.<sup>59</sup>

In any event, if one assumes that an IPO will be underpriced, it clearly makes sense for a company to offer as few shares as it possibly can to establish a market price, and then sell more shares in a follow-on offering once the market price is established.<sup>60</sup> In other words, smaller offerings may themselves be a reaction to underpricing. Still, it is surprising that investors have been so eager to buy into such small offerings even though there is no guarantee that the company will sell more shares in a follow-on offering.

### B. Other Offerings

There are several other anomalous phenomena that may be related to the market's apparent taste for smaller offerings. First, follow-on secondary offerings (offerings by selling shareholders rather than by the issuing company) tend to perform better than offerings in which the money actually goes to the company.<sup>61</sup> This finding is somewhat counterintuitive in that one would think investors would be suspicious of offerings by which existing shareholders seek to bail out of their own investments rather than to raise money for the company. On the other hand, it may be that investors are suspicious of companies that *need* equity capital. Perhaps investors figure that a company with good prospects ought to be able to raise capital

59. It is possible that as of October 1999, underwriters had not figured out downward sloping demand and how to adjust for it in connection with relatively small offerings, but it seems unlikely. The Dutch Auction is founded on the notion that the quantity offered is inversely related to the market-clearing price. The Dutch Auction has been around for years and has been used extensively in connection with issuer repurchases since the early 1980s. Moreover, the Dutch Auction model has more recently been used by Wit Capital and Hambrecht & Company precisely in an effort to avoid underpricing in connection with IPOs. In short, it is inconceivable that underwriters are not aware that quantity is arguably a key factor in establishing the offering price. Indeed, some stock exchanges require that a minimum percentage of shares be offered to the public presumably for this very reason. There are two other possible explanations for excessive underpricing of smaller percentage offerings. First, it may be that investors assume more risk that the price will be incorrect if the offering is relatively small or that underwriters find it more difficult to price such offerings and that a bigger discount is therefore required to be built into the price. Second, the practice of portfolio weighting according to market capitalization may create disproportionate demand for smaller percentage offerings.

60. Suzanne McGee & Terzah Ewing, 'Piggyback' Deals: Keys to Unlock Insiders' IPO Stakes, WALL ST. J., Feb. 17, 2000, at C1.

61. See Lyn Perlmuth, *How to Predict a Stock's Decline*, INSTITUTIONAL INVESTOR, Sept. 1996, at 35 (reporting on a study by Inmoo Lee finding that among seasoned equity offerings ("SEOs"), companies offering additional stock by selling shareholders perform better than companies issuing new stock); see also Danielle Sessa & Terzah Ewing, *Some Insiders Sell Shares at Time of IPO*, WALL ST. J., Sept. 1, 1999, at C1.



privately or in the debt market, and therefore establishing a trading market for the company's shares is the most believable reason for going public.<sup>62</sup>

Second, several companies in recent years have sought to give away their stock for free or in exchange for minimal consideration, such as visiting an internet site or registering with it.<sup>63</sup> Stock giveaways seem to confirm that there is value in excess of the market beyond the capital one can raise in a public offering.<sup>64</sup> It may be that some entrepreneurs figure that they must pay to become publicly traded anyway (in the form of fees, expenses, discounts, and underpricing). Why not simply *give* away an amount of stock equal to these costs? It is always possible, after all, that one can establish a legitimate public market at a lower cost. Thus, another possible explanation for the excess price increase of smaller offerings is that the market charges a more or less fixed amount for liquidity. If so, one would expect this liquidity charge to be a larger proportion of smaller offerings.

Third, in many of the IPOs in the October 1999 sample, the offering consisted of lesser voting stock. Yet voting rights do not seem to affect the market reception for the stock, suggesting that investors do not particularly care about voting rights or the potential for a change in control.<sup>65</sup> Similarly, the market has been quite

62. It may also be the case that many secondary offerings are made by venture capital investors and that their earlier involvement with the company signals to the market that the company's prospects are better. Indeed, studies indicate that IPOs of companies backed by venture capital investors do better in the aftermarket over the long haul. That is, the IPOs of such companies are less underpriced at the time of offering but do better in the months that follow. See Christopher B. Barry et al., *The Role of Venture Capital in the Creation of Public Companies: Evidence from the Going Public Process*, 27 J. FIN. ECON. 447 (1990); Alon Brav & Paul A. Gompers, *Myth or Reality? The Long-Run Underperformance of Initial Public Offerings: Evidence from Venture and Non Venture Capital Backed Companies*, 52 J. FIN. 1791 (1997). It is far from clear what significance to attach to aftermarket performance. It may be that a significant immediate increase in price indicates that the market perceived more risk in the offering and thus required a bigger premium (or bribe) to buy the stock. In other words, one could argue that a bigger pop indicates a lesser quality stock. Nevertheless, the stockholders enjoy a better return in the short term.

63. See Denis T. Rice, *Free Stock on the Internet Is Not a Menace*, INSIGHTS, Oct. 1999, at 8; Scott Thurm, *SEC Questions Start-Ups' Cheap Stock Sales to Customers*, WALL ST. J., Sept. 26, 2000, at C1 (discussing the use of a supplier company's warrants of its stock to entice buyers to buy from the supplier company, the result of which is an overstatement of the supplier company's earnings); Gregory Zuckerman, *SEC Clears Web Firms' Stock Giveaway*, WALL ST. J., Nov. 16, 1999, at C1.

64. This is not necessarily an internet phenomenon. Rather, it has only been made practical by the internet. For an older example of a similar practice, see *SEC v. Datronics Engineers, Inc.*, 490 F.2d 250 (4th Cir. 1973).

65. Ronald Gilson has suggested that lesser voting stock may not matter in the context of a growth company because management interests are similar to shareholder interests. Gilson,

receptive to tracking stock even though it represents an interest in a line of business that is utterly captive to a larger corporation.<sup>66</sup>

In summary, it appears that smaller offerings and investor receptivity to them may be part of a larger trend away from the classical public corporation.<sup>67</sup> Nevertheless, although it is easy enough to see why management may be interested in minimizing the control power of public shareholders, it is not as easy to see why investors are willing to give up the power that they have traditionally had. The answer may lie in the rather remarkable evolution of the relationship between investors and managers over the last twenty years and, in particular, the phenomenal growth in the use of stock options and other forms of equity compensation.

### C. Poison Pills

In the end, the only reason that we say that a corporation is owned by its stockholders is that they may vote on a limited number of matters and, in theory, can sell the company out from under management. One might argue also that the shareholders own the company because they stand last in line financially and are entitled to all the leftovers when the company dissolves. The problem is that solvent companies rarely (if ever) dissolve. Of course, the stockholders may also benefit financially if the company pays dividends or repurchases its stock, but there is no legal requirement that the company undertake any such distributions.<sup>68</sup> And indeed fewer and fewer companies choose to pay dividends.<sup>69</sup>

*supra* note 58. See also Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 11 (1988). Ironically, lesser voting stock would not have been a possibility before the adoption of Securities Exchange Act Rule 19c-4, 17 C.F.R. § 240.19c-4 (2001), an SEC rule designed to protect shareholder democracy, which was subsequently struck down in *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990), as beyond the authority of the SEC. Before the adoption of the rule, a company with lesser voting stock could not be listed on the NYSE. Thus, practically speaking, a company that aspired to be listed on the NYSE at some later point would have needed to comply with NYSE rules or undergo a messy recapitalization before being listed on the NYSE. Under the rule, a listed company could not reduce the voting rights of outstanding shares and remain listed on a national securities exchange, but a company could issue lesser voting (or nonvoting) stock in the first place and still be listed.

66. See *Solomon v. Armstrong*, 747 A.2d 1098 (Del. Ch. 1999); *In re Gen. Motors Class H S'holders Litig.*, 734 A.2d 611 (Del. Ch. 1999) (discussing lack of control rights and built-in conflicts of interest in connection with tracking stock).

67. Michael C. Jensen, *Eclipse of the Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61.

68. But see *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919) (holding that a company must pay a dividend where it has declared that it has no other use for the funds). There are also many cases to the contrary involving closely held corporations, but for the most part these cases

Thus, the vote appears to be what counts. But many (if not most) of the largest companies have adopted poison pills. And those that do not have a pill probably can adopt one in short order.<sup>70</sup> Still other companies may be incorporated in states that have control share statutes that operate as the equivalent of a poison pill.<sup>71</sup> And in an increasing number of companies, management controls a working majority of the shares or the votes.<sup>72</sup> Studies seem to indicate that poison pills do not have much if any negative effect on stock price, which further suggests that stockholders do not much care about the vote.<sup>73</sup> To be sure, the evidence is equivocal because every company may potentially adopt a pill. Moreover, there do not seem to have been any fewer hostile takeovers in the 1990s after the advent of the pill than there were in the 1980s when the legality of the pill was somewhat in doubt.<sup>74</sup> But this may be because the courts have been willing to order pills withdrawn when there is no threat of stockholder coercion.<sup>75</sup> And given that the merger market in the 1990s far surpassed that of the 1980s in both numbers of deals and dollar value, it is unclear what we should make of a relatively flat rate of hostile takeovers.

Clearly, the poison pill has increased management rights relative to stockholder rights. We are very close to a requirement that a bidder deal with management or not at all. Does that mean that management owns the company? Not quite. But it does seem to suggest that stockholder rights were more extensive in (say) 1980 than it turns out they should have been. It hardly seems consistent with the stockholder ownership model that stockholder rights may be reduced by management without stockholder consent.

deal with attempts by controlling stockholders to pay themselves disguised dividends in the form of an enhanced salary or other perquisites while denying similar benefits to the minority.

69. See Kenneth N. Gilpin, *The Dividend Check Isn't in the Mail*, N.Y. TIMES, Feb. 4, 2001, § 3, at 10; Floyd Norris, *In 2000, Fewer Companies Paid Dividends to Investors and More of the Same Lies Ahead*, N.Y. TIMES, Jan. 3, 2001, at C9; Mark Hulbert, *Explaining Away the Dividend Yield*, N.Y. TIMES, Aug. 6, 2000, § 3, at 7; Floyd Norris, *Growing Number of Companies Choose Not to Offer Dividends*, N.Y. TIMES, Jan. 4, 2000, at A1.

70. See Coates, *Mediating Hierarchy*, *supra* note 35; Coates, *Takeover Defenses*, *supra* note 35, at 287–88.

71. See generally Richard A. Booth, *The Promise of State Takeover Statutes*, 86 MICH. L. REV. 1635 (1988).

72. See PEARL MEYER & PARTNERS, INC., *supra* note 27, at 3–7.

73. See Coates, *Mediating Hierarchy*, *supra* note 35; Coates, *Takeover Defenses*, *supra* note 35.

74. Coates, *Takeover Defenses*, *supra* note 35, at 276–77.

75. See *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

The real question is, are we better off than we were in 1980? Perhaps. To the extent that a pill allows management to focus more intensely on business rather than corporate warfare, it may be consistent with the interests of diversified stockholders in attracting and retaining management. Thus, it may be important for a company that relies heavily on stock options as compensation to protect itself from takeover. The question is whether a diversified stockholder is better served by stock options or the market for corporate control. The answer is far from clear.<sup>76</sup>

Although the stockholders can in theory force the sale of the company, in practice they really only have veto power. The stockholders can dispose, but they cannot propose. That is not nothing, but then again it is not exactly ownership either.

It is worth noting that the story of the poison pill clearly suggests that corporation law matters (and by implication, so does theory). Pills are legal and thus any company that does not have one can probably adopt one in short order (assuming it has enough authorized stock). Although we may sometimes be able to tell by event studies that a particular change in the laws of a single state or the terms of a single corporate charter is good or bad for stockholders, it is impossible to do so when the change affects the entire market as it does (practically speaking) when Delaware speaks. Thus, it is important that we get it right.

To be sure, the courts are ready to review the terms of a pill should it be triggered, but this too suggests an important role for law and theory. Indeed, the big worry about the pill has been that on its face it seems virtually bulletproof. Before the pill (and state takeover laws), the threat of takeover was there to keep management on its toes. And the beauty of that system was that it was self-executing. We still have takeovers, but now it is the courts rather than the market that say whether a takeover will proceed. In effect, the burden has shifted from target management to justify a takeover defense, to the bidder to argue why it should be lifted.

76. One might even argue that stock options have an intellectual property component and that there is an implicit requirement that the optionee be given a good faith opportunity to realize a profit. On the other hand, in practice many option plans provide for acceleration in the event of a takeover. It does not appear that any cases have arisen in which the threat to optionees has been credited as a reason not to withdraw a poison pill, but the argument has a good deal of merit, not because optionees are stockholders (they are not) but rather because undermining the compensation system may be bad for morale and thus bad for stockholders.

### D. *Sales of Control*

Yet another feature of US corporation law that casts doubt on the stockholder ownership model is the fact that a controlling stockholder is generally free to sell control at a premium and without sharing the premium with the remaining stockholders, provided that the premium does not come at the expense of the minority.<sup>77</sup> The rule is generally different elsewhere in the world. Indeed, in most countries the transfer of more than 20 or 30 percent of the stock of a company triggers a right in the remaining stockholders to sell their stock at the same price (although not necessarily for the same *kind* of consideration).<sup>78</sup>

Which rule makes more sense? The equal opportunity rule clearly prevents a form of looting (though there are many other ways to loot a corporation). But the price is that legitimate transfers of control by controlling stockholders are precluded unless the buyer is willing and able to buy all of the stock. On the other hand, one could argue—on a theory akin to conservation of matter and energy—that a control premium *must* somehow come out of the pocket of the minority. The US rule seems to presume that there are other sources of value. Clearly, there are other sources of value in that a controlling stockholder is free to manage the company within a wide range of possibilities. Indeed, the controlling stockholder may in theory dictate a strategy for purely personal reasons as long as the strategy is within the range of legitimate possibilities. Thus, in a country where money-losing sports franchises sell for hundreds of millions of dollars, it should not be surprising that someone is willing to pay for control. Still, one could argue, as have some courts, that control itself is somehow a corporate asset or is held in trust for all of the stockholders. And that leads back to a rule of equal treatment.<sup>79</sup>

The sale of control example arguably supports the notion that the stockholders own the company and suggests instead that the real myth is that of stockholder equality. Indeed, not even under the non-

77. See, e.g., *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996).

78. See Adam O. Emmerich & David E. Shapiro, *Poison Pill Approaches Its 15th Birthday: Responses of Other Jurisdictions Support Evidence of Beneficial Effects of Shareholder Rights Plans*, N.Y. L.J., Nov. 15, 1999, at S8.

79. In a classic and groundbreaking 1974 article, Brudney and Chirelstein argued that the idea of fairness is indeterminate in a world in which fair price is a range of values and that in the absence of a better rule, merger gains should be split equally. Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974). They were right about the premise, but not about the implication.

US rule do stockholders have true equality in that they can be paid in stock or notes when the seller of control receives all cash. But in some sense they are more equal than minority stockholders in US corporations. Similarly, US corporation law allows for differential compensation in a merger or other fundamental change.<sup>80</sup> Tracking stock also suggests that stockholders are happy with contractually defined rights that differ from those of other investors.<sup>81</sup>

In any event, the trusteeship theory is somewhat different from the stockholder ownership theory. Under trust law, a trustee owns the corpus of the trust but can have no beneficial interest in it.<sup>82</sup> Thus, the trusteeship theory proves too much. We have no rule *against* manager ownership. Quite to the contrary, we tend to bemoan the lack of manager ownership (even as it evolves away).<sup>83</sup> Although the notion that managers are trustees was once quite popular, it sounds almost corny now. No one thinks of managers as trustees (except perhaps some *managers* who always sound as if they are engaged in an elaborate rationalization when they talk about it). Indeed, it is doubtful that stockholders would be favorably impressed by such talk. On the other hand, the notion of trusteeship does speak to a distinct worry: How can we rationalize the idea that corporations control vast amounts of wealth if we do not tell ourselves that the corporation is somehow imbued with a public interest that extends beyond management and perhaps even the stockholders?

#### IV. FINDERS KEEPERS

The law of sales of control suggests that there is another possible model. Simply put, under this model controlling shareholders and management are largely free to appropriate value to themselves as long as to do so does not *decrease* the wealth of the remaining stockholders. As it turns out, this appears to be the rule in other

80. See MODEL BUS. CORP. ACT § 11.06(a)(6) & cmt. background (1985).

81. As Judge Frank Easterbrook has stated, markets work best when they span all the possibilities. *Chi. Mercantile Exch. v. SEC*, 883 F.2d 537 (7th Cir. 1989). In other words, investors prefer choice.

82. See RESTATEMENT (SECOND) OF TRUSTS § 16A (1957) ("Trustee Distinguished From Corporate Officer or Director"); *id.* at § 170 ("Duty of Loyalty").

83. On the other hand, in some arenas we also seem to think that a financial interest may adversely affect one's judgment. Thus, the big five accounting firms have been under pressure to limit or divest their consulting practices, which is not to mention the absolute rule against investing in audit clients. And some would argue that it is wrong for lawyers to invest in their clients or to accept equity as a fee notwithstanding that the role of lawyer as a zealous advocate is quite different from the role of the auditor as an independent monitor.

areas as well. It is the rule in Delaware for determining whether a controversy triggers duty of loyalty analysis.<sup>84</sup> Some such thinking may also explain the recent statutory repeal of the corporate opportunity doctrine in Delaware.<sup>85</sup> And it may be the ultimate explanation for the no-win exception to the business judgment rule.<sup>86</sup> It also describes the practice in connection with stock options. That is, stockholders seem to tolerate seemingly gigantic pay packages apparently without punishing companies that allow management in effect to appropriate large amounts of supposed stockholder wealth.<sup>87</sup> It may be that the stockholders reckon in effect that they are better off as stockholders because management is well paid even if management keeps more than its arguable share of the wealth. Indeed, as long as management agrees to accept stock as its primary form of compensation, it is hard to imagine that management would ever intentionally award itself so much in options that stock price would be adversely affected.<sup>88</sup>

In contrast, the trigger for the duty of loyalty under the Model Business Corporation Act ("MBCA") is merely that a director have a financial interest in the transaction that would reasonably be expected to exert an influence on the director's judgment.<sup>89</sup> The ALI Principles of Corporate Governance ("PCG") is somewhat closer to the Delaware rule in that the duty of fair dealing arises only if the transaction is one in which a financial interest would reasonably be expected to affect the judgment of an officer or director in a manner adverse to the corporation.<sup>90</sup>

The distinction between the approaches of Delaware and the MBCA is roughly parallel to the distinction in economics between Pareto optimality and Pareto superiority.<sup>91</sup> A Pareto superior move is one in which someone is made better off and no one is made worse

84. *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. 1971); *Fliegler v. Lawrence*, 361 A.2d 218 (Del. 1976); see generally Mary Siegel, *The Erosion of the Law of Controlling Shareholders*, 24 DEL. J. CORP. L. 27 (1999).

85. DEL. CODE ANN. tit. 8, § 122(17) (2000).

86. Booth, *supra* note 31, at 429.

87. See Lowenstein, *supra* note 29 (reporting that during the previous fiscal year Microsoft had used cash equal to two-thirds of its earnings to buy options and repurchase stock to offset dilution from compensatory stock options).

88. Richard A. Booth, *Seven Myths About Stock Options*, DIRECTORS & BOARDS, Summer 1999, at 35.

89. See MODEL BUS. CORP. ACT § 8.60 (1985).

90. PRINCIPLES OF CORP. GOVERNANCE § 1.23 (1994).

91. ROBIN PAUL MALLOY, LAW AND ECONOMICS 38-42 (1990); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 12-14 (3d ed. 1986).

off. A Pareto optimal move is one from which no further Pareto superior moves are possible. In other words, after a Pareto superior move, everyone is as well off as can be.<sup>92</sup>

To be sure, the notion that management and controlling stockholders may be motivated primarily by self-enrichment is contrary to much caselaw. But it is clearly tolerated in many circumstances as long as no damage is done to the remaining stockholders.<sup>93</sup> And, a fortiori, it is tolerated where the stockholders also gain from the transaction. In fairness, the rule seems to be that if the gain can be shared it should be shared.<sup>94</sup> In other words, what the stockholders own is a right to an equal share of the shareable returns from corporate level transactions subject to a wide variety of dilutive transactions.

Despite all the talk about how the stockholders own the company, there is really no statutory authority for the proposition. Indeed, aside from caselaw, only the PCG has ventured into the area and what it has to say is entirely consistent with the finders keepers norm: "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain."<sup>95</sup>

If the stockholders do not own the corporation, then how does one make sense of the *Revlon* doctrine (i.e., that once a corporation is for sale the board must maximize stockholder value)? One possible answer is that the real goal of the courts is not stockholder wealth maximization but rather preservation of market discipline.<sup>96</sup>

92. Professor Coates makes a similar point in the context of the appraisal remedy. See John C. Coates IV, "Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions, 147 U. PA. L. REV. 1251, 1321-25 (1999). Although some might say that a Pareto optimal move makes everyone better off, that is not absolutely necessary. On the other hand, John Rawls argued in *A Theory of Justice* that any decision that makes the better off still better off should be tolerated only if it also makes someone who is worse off somewhat better off. JOHN RAWLS, A THEORY OF JUSTICE, 52-65 (rev. ed. 1999). One might call this Rawlsian superiority and indeed it could be argued that much of corporation law reflects such an aspiration if not the imposition of such a rule in some notable cases.

93. See, e.g., *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964); *Grobow v. Perot*, 539 A.2d 180 (Del. 1988).

94. See Richard A. Booth, *The Business Purpose Doctrine and the Limits of Equal Treatment in Corporation Law*, 38 SW. L.J. 853 (1984).

95. PRINCIPLES OF CORP. GOVERNANCE § 2.01.

96. As I have argued elsewhere, this is consistent with the idea that management owes a duty to the corporation rather than the stockholders. Booth, *supra* note 31, at 429.



## V. SO WHAT?

The ultimate question is, what difference does it make whether or not we think of the corporation as being owned by the stockholders? Potentially plenty. Each of the above examples of situations in which stockholder ownership does not seem to hold is potentially a case in which it might matter whether the court subscribes to stockholder ownership theory or some more flexible view of corporate identity.

Aside from these examples, however, the question of who owns a corporation is clearly relevant in defining the limits of the duty to maximize stockholder wealth, the details of which are still being worked out in the courts. The question has arisen repeatedly in the last few years in the context of the appraisal remedy.

Most courts seem to agree that it is inappropriate to apply a minority discount in the context of an appraisal proceeding.<sup>97</sup> As the Delaware Supreme Court has stated, the goal of an appraisal proceeding should be to determine the value of the corporation as a whole, not the value of particular shares, and to award the found value per share to all dissenting stockholders.<sup>98</sup> Minority stockholders

97. The leading Delaware case is *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989), which involved appraisal proceedings following a short form merger. See also *Swope v. Siegel-Robert, Inc.*, 243 F.3d. 486 (8th Cir. 2001) (merger to form S Corporation under Missouri law); *Morrow v. Martschink*, 922 F. Supp. 1093 (D.S.C. 1995) (purchase in lieu of dissolution); *Brown v. Allied Corrugated Box Co.*, 154 Cal Rptr. (Cal. Ct. App. 1979) (purchase in lieu of dissolution); *Blitch v. Peoples Bank*, 540 S.E.2d 667 (Ga. Ct. App. 2000); *G&N Aircraft, Inc. v. Boehm*, 743 N.E.2d 227 (Ind. 2001) (dissolution; minority discount inappropriate because it would create majority premium); *Sieg Co. v. Kelly*, 568 N.W.2d 794 (Iowa 1997) (merger); *Arnaud v. Stockgrowers State Bank of Ashland*, 992 P.2d 216 (Kan. 1999) (reverse stock split); *In re Valuation of Common Stock of McLoon Oil Co.*, 565 A.2d 997 (Me. 1989) (merger); *MT Props., Inc. v. CMC Real Estate Corp.*, 481 N.W.2d 383 (Minn. Ct. App. 1992) (merger); *Hansen v. 75 Ranch Co.*, 957 P.2d 32 (Mont. 1998) (sale of assets); *Rigel Corp. v. Cutchall*, 511 N.W.2d 519 (Neb. 1994) (merger); *Friedman v. Beway Realty Corp.*, 661 N.E.2d 972 (N.Y. 1995) (sale of assets); *Woolf v. Universal Fid. Life Ins. Co.*, 849 P.2d 1093 (Okla. Ct. App. 1992) (appraisal in connection with amendments); *Charland v. Country View Golf Club, Inc.*, 588 A.2d 609 (R.I. 1991) (purchase in lieu of dissolution); *First W. Bank Wall v. Olsen*, 621 N.W.2d 611 (S.D. 2001) (merger to form S Corporation); *In re 75,629 Shares of Common Stock of Trapp Family Lodge, Inc.*, 725 A.2d 927 (Vt. 1999); *Waller v. Am. Int'l Distrib. Corp.*, 706 A.2d 460 (Vt. 1997) (oppression); *Prentiss v. WesSpur, Inc.*, No. 36321-2-1, 1997 Wash. App. LEXIS 637 (Wash. Ct. App. Apr. 28, 1997) (oppression); *HMO-W Inc. v. SSM Health Care Sys.*, 598 N.W.2d 577 (Wis. Ct. App. 1999) (merger).

98. *Cavalier Oil Corp. v. Harnett*, 564 A.2d 1137 (Del. 1989); accord *Paskill Corp. v. Alcoma Corp.*, 747 A.2d 549 (Del. 2000); see Philip Saunders, Jr., *Control Premiums and Minority Discounts*, in ROBERT B. DICKIE, *FINANCIAL STATEMENT ANALYSIS AND BUSINESS VALUATION FOR THE PRACTICAL LAWYER* 103 (1998); Coates, *supra* note 92; James Edward Harris, *Valuation of Closely Held Partnerships and Corporations: Recent Developments Concerning Minority Interest and Lack of Marketability Discounts*, 42 ARK. L. REV. 649 (1989); Mary Siegel, *Back to the Future: Appraisal Rights in the Twenty-First Century*, 32 HARV. J. ON LEGIS. 79 (1995); John D. Emory, Jr., Comment, *The Role of Discounts in Determining "Fair*

are still stockholders. The shares they own are legally equal to each and every other share of the same class. The fact that they cannot exercise control is no reason to assign minority shares a lesser value than other shares. Thus, a dissenting shareholder should ordinarily receive a pro rata share of the value of the corporation without any discount simply because the minority lacks control.<sup>99</sup>

But does this mean that a minority shareholder is also entitled to a share of the *control value* of the corporation? That is, should an appraisal court determine the per share price at which a controlling shareholder could sell control and then award that amount per share to dissenting stockholders? Surprisingly, several courts that have

*Value" Under Wisconsin's Dissenters' Rights Statutes: The Case for Discounts*, 1995 WIS. L. REV. 1155; Thomas D. Hall, Comment, *Valuing Closely Held Stock: Control Premiums and Minority Discounts*, 31 EMORY L.J. 139 (1982); Michael R. Schwenk, Note, *Valuation Problems in the Appraisal Remedy*, 16 CARDOZO L. REV. 649 (1994). On the other hand, there is a significant number of courts that have ruled that a discount may be appropriate usually as a reflection of the thin market for the shares in question. See *Hernando Bank v. Huff*, 609 F. Supp. 1124 (N.D. Miss. 1985) (merger; minority discount proper), *aff'd*, 796 F.2d 803 (5th Cir. 1986) (investment value based in part on market price was proper measure; use of comparables from merger cases improperly included control premium); *Perlman v. Permonite Mfg. Co.*, 568 F. Supp. 222 (N.D. Ind. 1983) (merger); *M Life Ins. Co. v. Sapers & Wallack Ins. Agency, Inc.*, No. 99CA0847, 2001 Colo. App. LEXIS 166 (Colo. Ct. App. Feb. 1, 2001) (merger; minority discount does not apply but marketability discount may apply); *Atlantic States Constr., Inc. v. Beavers*, 314 S.E.2d 245 (Ga. Ct. App. 1984) (merger); *Stanton v. Republic Bank of S. Chi.*, 581 N.E.2d 678 (Ill. 1991) (merger); *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky. Ct. App. 1982) (sale of assets); *Advanced Communication Design, Inc. v. Follett*, 615 N.W.2d 285 (Minn. 2000); *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232 (N.M. Ct. App. 1986) (purchase in lieu of dissolution); *Hall v. King*, 675 N.Y.S.2d 810 (Sup. Ct. 1998) (purchase in lieu of dissolution); *Gartman v. Picoma Indus., Inc.*, No. 88-CIV-061, 1993 WL 4175 (Ohio Ct. App. Jan. 5, 1993) (merger); *Columbia Mgmt. Co. v. Wyss*, 765 P.2d 207 (Or. Ct. App. 1988) (appraisal in connection with amendment); *Blasingame v. Am. Materials, Inc.*, 654 S.W.2d 659 (Tenn. 1983) (damages for breach of employment contract including agreement to issue stock). Compare *Lawson Mardon Wheaton, Inc. v. Smith*, 716 A.2d 550 (N.J. Super. Ct. App. Div. 1998) (dissenters exploited restructuring undertaken for tax advantages; marketability discount upheld), *rev'd*, 734 A.2d 738 (N.J. 1999) (no extraordinary circumstances present), with *Balsamides v. Protameen Chems., Inc.*, 734 A.2d 721 (N.J. 1999) (marketability discount appropriate in buyout ordered in dissolution proceeding because shares will remain illiquid); compare *Walter S. Cheeseman Realty Co. v. Moore*, 770 P.2d 1308 (Colo. Ct. App. 1988) (voluntary dissolution; no discount), with *WCM Indus., Inc. v. Trs. of the Harold G. Wilson 1985 Revocable Trust*, 948 P.2d 36 (Colo. Ct. App. 1997) (merger; discount discretionary); compare *Dreiseszun v. FLM Indus., Inc.*, 577 S.W.2d 902 (Mo. Ct. App. 1979) (sale of assets followed by tender offer for minority shares; no discount), with *King v. F.T.J., Inc.*, 765 S.W.2d 301 (Mo. Ct. App. 1989) (merger; discount permitted).

99. A minority discount may clearly be appropriate where the corporation is not a party to the transaction in question and the issue is what could the shares fetch on the open market (such as valuation for estate tax purposes). *HAMILTON & BOOTH*, *supra* note 32, at § 8.15 (2d ed. 1998); see Rev. Rul. 59-60, 1959-1 C.B. 237; *Righter v. United States*, 439 F.2d 1204 (Ct. Cl. 1971); *Rattee v. Rattee*, 767 A.2d 415 (N.H. 2001); Mary Louise Fellows & William H. Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895, 903-04 (1978); Annotation, *Valuation of Closely Held Stock for Federal Estate Tax Purposes Under Section 2031(b) of Internal Revenue Code of 1954 (26 USCA § 2031(b)) and Implementing Regulations*, 22 A.L.R. Fed. 31 (1975).

addressed the question have so ruled.<sup>100</sup> What is even more surprising is that many of the cases have involved transactions such as cashout mergers in which there is no sale of control. In such a case, the award of a control premium may require a controlling shareholder to pay twice for control.

In retrospect, it is fairly easy to see how the courts came effectively to presume that a control premium should routinely be added as an element of value. The problem can be traced back to 1983, when the Delaware Supreme Court handed down its landmark decision in *Weinberger v. UOP, Inc.*,<sup>101</sup> ruling, among other things, that appraisal should typically be the exclusive remedy in a dispute over fairness of merger price and that an appraisal court (consistent with the 1981 amendments to DGCL § 262) should consider all relevant factors in determining value. Thus, the court held that an appraisal court should consider any techniques or methods that are generally acceptable in the financial community. Specifically, the *Weinberger* court held that the appraisal court should consider

100. See *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513 (Del. 1999); *Nebel v. Southwest Bancorp, Inc.*, No. 13618, 1995 Del. Ch. LEXIS 80 (Del. Ch. July 5, 1995) (related case based on breach of fiduciary duty); *Rapid-Am. Corp. v. Harris*, 603 A.2d 796 (Del. 1992); *Borruso v. Communications Telesystems Int'l*, 753 A.2d 451 (Del. Ch. 1999) (adding 30 percent control premium because comparable company analysis reflects inherent minority discount); *Hintmann v. Fred Weber, Inc.*, No. 12839, 1998 Del. Ch. LEXIS 26 (Del. Ch. Feb. 17, 1998) (20 percent premium added to value of subsidiary shares). But see *M.P.M. Enters., Inc. v. Gilbert*, 731 A.2d 790, 797 (Del. 1999) (offers to purchase need not be given any weight in absence of evidence that they relate to going concern value of company, "fair merger price in the context of a breach of fiduciary duty claim will not always be a fair value in the context of determining going concern value"); *Kleinwort Benson Ltd. v. Silgan Corp.*, No. 11107, 1995 Del. Ch. LEXIS 75 (Del. Ch. June 15, 1995) (affirming addition of premium to market price to adjust for inherent minority discount but disallowing portion attributable to merger gain). See also *Cooper v. Pabst Brewing Co.*, No. 7244, 1993 Del. Ch. LEXIS 91 (Del. Ch. June 8, 1993) (rejecting addition of premium as incorporating post merger value); *Salomon Bros., Inc. v. Interstate Bakeries Corp.*, No. 10,054, 1992 Del. Ch. LEXIS 100 (Del. Ch. May 1, 1992) (also rejecting addition of premium as incorporating post merger value); *In re 75,629 Shares of Common Stock of Trapp Family Lodge, Inc.*, 725 A.2d 927 (Vt. 1999) (30 percent premium for control added to adjust for trading price of minority shares). But see *Ronald v. 4-C's Elec. Packaging, Inc.*, 214 Cal. Rptr. 225 (Cal. Ct. App. 1985) (apparently rejecting addition of control premium in buyout in lieu of dissolution where majority shareholder already possessed control); *Institutional Equip. & Interiors, Inc. v. Hughes*, 562 N.E.2d 662 (Ill. App. Ct. 1990) (rejecting addition of premium and discount as offsetting adjustments); *BNE Mass. Corp. v. Sims*, 588 N.E.2d 14 (Mass. App. Ct. 1992) (merger premium has no place in appraisal); *Foglesong v. Thurston Nat'l Life Ins. Co.*, 555 P.2d 606 (Okla. 1976) (minority shareholder has no expectation of control and premium should not be considered in determining appraisal price); *Walter v. The Nucleus, Inc.*, No. 181, 1990 Tenn. App. LEXIS 580, at \*12 (Tenn. Ct. App. Aug. 16, 1990) (rejecting addition of control premium as "simply a way to penalize the majority stockholders for their controlling interest, or, conversely, to reward the minority stockholders for the divestiture of their interests").

101. 457 A.2d 701 (Del. 1983).

evidence based on discounted cash flow and premiums in comparable transactions.<sup>102</sup>

Following *Weinberger*, the Delaware Supreme Court went on to hold in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>103</sup> that in a situation in which a company is up for sale, the board of directors has a duty to seek the highest price possible for the benefit of all the stockholders and cannot favor one bidder over another because of other considerations.<sup>104</sup> In *Cavalier Oil Corp. v. Harnett*,<sup>105</sup> the court held in the context of a short form merger that it is inappropriate to apply a discount to minority shares simply because they are minority shares, suggesting to some that minority shareholders should be entitled to all elements of value that may be attributable even to control shares. And in *Rapid-American Corp. v. Harris*,<sup>106</sup> the court held that in the appraisal of a parent company that owned 100 percent of the stock of three operating subsidiaries, the parent should be valued on the basis of the combined control value of the operating companies apparently on the theory that the parent was in a position to sell control if it chose to do so.<sup>107</sup>

102. *Id.* at 712–13. Although it could be argued that basing appraisal price in part on premiums in comparable transactions is equivalent to awarding some or all of the (percentage) gain from the transaction, it is also true (as the *Weinberger* court suggested) that part of the value of a company inheres in its potential as a takeover target (unless of course the company is utterly takeover proof). The use of discounted cash flow (“DCF”) (rather than GAAP earnings) was also revolutionary (even though standard practice in the financial community) because it is fundamentally inconsistent with notion that a noncontrolling shareholder cannot dictate distributions. To be sure, it is fair to presume that the shareholders will eventually receive distributions equal to the value of the company; DCF is based on the idea that the corporation will distribute available cash as soon as it becomes available.

103. 506 A.2d 173 (Del. 1986).

104. *Id.*; see also *Arnold v. Soc’y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1282 n.20 (Del. 1994) (shareholder is entitled to a premium where the transaction eliminates the potential for further premium); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42–43 (Del. 1994) (stating the same as *Arnold*, 650 A.2d at 1282 n.20).

105. 564 A.2d 1137 (Del. 1989).

106. 603 A.2d 796 (Del. 1992).

107. In most of the Delaware cases in which a control premium has been added, it has been added to the value of subsidiary shares. Arguably, there is a stronger case for adding a premium to subsidiary shares in the context of appraisal of parent company shares in that the subsidiary is an asset of the parent and is owned (and controlled) for the benefit of all parent stockholders. Where the subsidiary is the *primary* asset of the parent, however, as where the parent is a mere holding company, there is something more than a little artificial about bootstrapping a subsidiary premium into the valuation of the parent. *But see* *Agranoff v. Miller*, No. 16795, 2001 Del. Ch. LEXIS 71, at \*50 n.45 (Del. Ch. May 15, 2001). Moreover, one must be careful to allocate a control premium over all of the shares. In some cases, a controlling block may be salable at a higher premium than all of the shares. For example, it is at least conceivable that a buyer might be willing to pay a 100 percent premium for 51 percent of the shares, but only a 50 percent premium for 100 percent of the shares. On the other hand, one could also argue here that in such a case the control premium is at the expense of the minority and signals the likelihood of looting by the buyer.

On the other hand, the decisions that seem to support minority entitlement to some share of a control premium cannot be read in isolation. There are just as many decisions that cut the other way. For example, immediately following *Weinberger*, the court held in *Rosenblatt v. Getty Oil Co.*<sup>108</sup> that a majority shareholder in a cashout merger need not reveal the highest price it would be willing to pay simply because it controls the subsidiary and owes a fiduciary duty to the minority. Then, in *Paramount Communications, Inc. v. Time Inc.*,<sup>109</sup> the court held that a *Revlon* duty to maximize<sup>110</sup> does not arise in a so-called *strategic merger*, in which two widely held companies become one, and no one individual or discrete group buys or sells control. And in *Thorpe v. CERBCO, Inc.*,<sup>111</sup> the court held that a controlling stockholder has the right to sell its shares at a premium as long as the premium is not diverted from the corporation.<sup>112</sup>

In *McMullin v. Beran*,<sup>113</sup> the Court of Chancery held that no *Revlon* duty to maximize arises when a parent company decides to sell a controlled subsidiary for cash even though it could possibly have obtained a higher price in a differently structured transaction. In so holding, the court noted that a change in control arises when the shareholders lose a further opportunity to participate in a change of control premium,<sup>114</sup> and that *Revlon* does not apply to situations in which control of the company rests with a single controlling shareholder instead of the public.<sup>115</sup> The Delaware Supreme Court reversed, holding that even in the absence of a change of control (narrowly defined), there is still a duty to determine whether the deal maximizes shareholder value so that minority shareholders may

108. 493 A.2d 929 (Del. 1985).

109. 571 A.2d 1140 (Del. 1990).

110. I use the phrase "duty to maximize" to distinguish this aspect of *Revlon* from numerous other aspects such as the intermediate level of scrutiny. See *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1289 n.40 (Del. 1994) (citing Lawrence A. Cunningham & Charles M. Yablon, *Delaware Fiduciary Duty Law After QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)*, 49 Bus. Law. 1593, 1593-94 (1994), as "noting inappropriateness of such colloquialisms as "Revlon duties" and "Revlon-land" in arguments before [the Delaware courts]").

111. 676 A.2d 436 (Del. 1996).

112. It should be noted that none of these were appraisal cases and that it could be argued that the standard of valuation to be applied in an appraisal proceeding has been developed to reflect special considerations in the context of transactions that give rise to appraisal. These special considerations have never been articulated by the courts, however.

113. No. 16493, 1999 Del. Ch. LEXIS 227 (Del. Ch. Dec. 1, 1999).

114. See *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040 (Del. Ch. 1997); see also *McMullin v. Beran*, 765 A.2d 910, 918 (Del. 2000) (referring to a "final stage" transaction).

115. See *Mendell v. Carroll*, 651 A.2d 297 (Del. Ch. 1994).

decide whether to seek appraisal.<sup>116</sup> To be sure, the court characterized the cause of action primarily as one involving the board's failure to inform itself and the minority.<sup>117</sup> But the court also characterized the subject of the required inquiry as the determination "whether the merger consideration equaled or exceeded [the] appraisal value of the company as a going concern."<sup>118</sup> Thus, although *McMullin* is not itself an appraisal case, it is quite clear that the board must consider the appraisal standard of value and that the courts will certainly do so in reviewing whether the board has done its job.<sup>119</sup> Even if there were some doubt about whether appraisal value includes a control premium, there is no doubt that maximizing value implies obtaining the highest possible premium. Moreover, there is no reason for a shareholder to seek appraisal unless the appraisal price is likely to be higher than the merger price. And if the merger price involves any premium at all, which it almost invariably does, presumably the reason for seeking appraisal is to obtain a still bigger premium.<sup>120</sup>

Whatever doubt was left after *McMullin* that the standard of value in a Delaware appraisal proceeding includes a control premium was put to rest in *Agranoff v. Miller*.<sup>121</sup> *Agranoff* involved the valuation of shares purchased in violation of a stockholder agreement in order to determine the price at which the defendant would be required to sell them to the plaintiff. *Agranoff* was not an appraisal case, but because of doubts about the standard of value to be applied, the court determined the value of the shares two different ways: (1) based on fair market value principles that would be used in a context other than an appraisal proceeding and (2) based on the appraisal-unique fair value standard.<sup>122</sup> As the court stated, comparable companies analysis builds in a minority discount (in that it is based on

116. *McMullin v. Beran*, 765 A.2d 910 (Del. 2000).

117. The court expressly declined, however, to establish a new disclosure standard where appraisal is an option, citing *Skeen v. Jo-Ann Stores, Inc.*, 750 A.2d 1170 (Del. 2000). *McMullin*, 765 A.2d at 925.

118. *McMullin*, 765 A.2d at 922.

119. Indeed, the *McMullin* court mentions appraisal eleven times in the opinion and refers to maximizing value fourteen times. *McMullin v. Beran*, 765 A.2d 910 (Del. 2000).

120. In all fairness, the *McMullin* court's focus on appraisal may have been necessitated by a concern about materiality in that unless the minority stockholders could do something with the information disclosed to them, it would be futile to require the board even to review the deal. *Id.* at 922. The court does note, however, the possibility that the stockholders could have sought an injunction. *Id.* at 917. Compare *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977), with *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991).

121. *Agranoff v. Miller*, No. 16795, 2001 Del. Ch. LEXIS 71 (Del. Ch. May 15, 2001).

122. *Id.* at \*20-\*29.

prices at which minority stockholders trade small quantities of shares) that must be corrected by adding back a premium for control in an appraisal proceeding.<sup>123</sup> And indeed, the court found that while the fair market value of the shares was \$41.02 (without any discount or premium), the appraisal value was \$51.13 (reflecting a 30 percent control premium according to the court).<sup>124</sup> Thus, there is simply no doubt that the *Agranoff* court understood that the appraisal remedy reflects unique policy values.<sup>125</sup> The *Agranoff* court struggled somewhat with the question whether premiums in comparable transactions arose because of what might be thought of as the inherent value of control (which may or may not be an appropriate element of appraisal value) as opposed to planned changes in business strategy for the target (which clearly are not an appropriate element of appraisal value under the language of the statute). In the end, the court reasoned that even though the averaging of comparable company data would likely eliminate merger gains, a reduction of the average premium from 40 percent to 30 percent would help assure that only inherent control value was included.<sup>126</sup>

The ultimate point for present purposes is that the idea that the stockholders own the company has proven so powerful that the courts of Delaware have arguably conferred a windfall on minority stockholders in the form of a share of control value even when they have no reasonable expectation of participation in control. Presumably, this will translate into a higher cost of doing deals and fewer deals getting done than should be done even if only at the margin.

This cursory review of Delaware caselaw reveals that there are two distinct questions to be addressed in connection with premiums in appraisal proceedings. First, is it appropriate to add a premium at all in the context of an appraisal proceeding even if there is a change of control? Although this issue appears to be well settled in the affirmative, the fact remains that the plaintiffs in an appraisal proceeding are by definition dissenters who seek the value of their shares prior to any gain or loss from the transaction. To be sure, as the Delaware court suggested in *Weinberger*, every company is potentially for sale and thus part of the value of every company is a generic premium for control, as opposed to a specific premium for

123. *Id.* at \*48–\*54.

124. *Id.* at \*57–\*59.

125. *Id.* at \*23.

126. *Id.* at \*54 n.49.

control that may be offered by a bidder with specific plans for the target.<sup>127</sup> The latter sort of deal-specific premium presumably should not be part of an appraisal award.<sup>128</sup> But even if one can get cozy with the idea of awarding a premium in a change-of-control transaction, it does not follow that it makes sense to award a premium in (say) a going private merger in which the controlling shareholder remains in control and where there was never any prospect of a sale of control.<sup>129</sup> In other words, should a premium for control be added even if it is clear that the dissenters could not reasonably have expected a premium under any other circumstances?<sup>130</sup> This is but one of the questions that could hinge on whether we continue to view stockholders as owners.

### CONCLUSION

Clearly theory matters to business. It led managers into the conglomerate mergers of the 1960s. And arguably it led to the rise of institutional investors, increasing leverage, the bust-up takeovers of the 1980s, the boom in stock options as compensation, and the spin-off mania of the 1990s. Theory also matters in the law, not only because it guides the evolution of legal rules, but also because it allows us to make sense of the rules we have. Moreover, theory matters more in states where these cases arise less. A state supreme court judge in a hotly contested case involving (say) a sale of control in a state in which the court issues one or two corporation law opinions a year arguably needs a good theory more than does a Delaware chancellor who sees dozens of such cases. The theory that a corporation is owned by its stockholders is fine for many purposes but it is too simple for others. The danger is that too much deference to stockholder interest may get in the way of transactions that otherwise make sense and should go forward. Thus, it would seem that theory may serve yet another purpose. When it leads to absurd conclusions, it may signal to us that our understanding has reached a

127. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

128. The courts have done little to distinguish these two types of premiums, though it could be said that averaging premiums paid for comparable companies may have the same effect.

129. To be sure, *Weinberger* itself was such a case, but the majority therein was held liable for a breach of fiduciary duty in having failed to deal fairly with the minority.

130. Interestingly, the federal courts have recognized a parallel distinction in connection with materiality determinations under the federal securities laws. Although it is well settled that a fact need not be so important as to change the outcome of a vote or transaction in order to be material, the courts recognize that when a fact *cannot* make a difference it is not material. See *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083 (1991).



limit and that a new theory is needed. As Einstein said, a theory should be simple but not too simple. Elegance is for tailors.