A Positive Analysis of the Common Law of Corporate Fiduciary Duties

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BY RUTHEFORD B CAMPBELL, JR.*

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  University. The author thanks his research assistant, Lynda Bannister, for her
  outstanding work on this Article.
The purpose of this Article is to offer a positive analysis of the common law of corporate managers' fiduciary duties. The

1 Some of the most noteworthy positive analyses done in recent years have been a result of the law and economics movements, where commentators, such as Judge Richard Posner, have written extensively attempting to demonstrate, for example, that the common law is compatible with a pursuit of economic efficiency, as that term is defined by them. See, e.g., RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (4th ed. 1992). Posner defines economic efficiency as a pattern of resource allocation in which resources are distributed according to one's willingness and ability to pay the most for the particular resource. Id. at 11-15. For a discussion of other definitions of economic efficiency, see Jules L. Coleman, Efficiency, Utility, and Wealth Maximization, 8 Hofstra L. Rev. 509, 512 (1980).

2 In this Article, the term “managers” includes corporate officers and directors but excludes corporate owners. The author realizes that some cases make distinctions between the fiduciary duties of officers and directors. For example, in the classic old case of Bates v. Dresser, 251 U.S. 524 (1920), bank directors, but not the president, escaped liability for the actions of an employee who literally stole all the assets of the bank. Nonetheless, the basic principles applied to actions by officers and directors are the same, and thus the two groups are treated as one.

Also, owners (i.e., stockholders) are involved in certain corporate “management” decisions, such as voting to approve a merger, and, accordingly, they have been subjected to scrutiny under fiduciary principles. See, e.g., Swinney v. Keebler Co., 329 F. Supp. 216 (D.S.C. 1971), rev’d, 480 F.2d 573 (4th Cir. 1973) (imposing fiduciary duty on majority stockholder selling majority block of voting stock); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (imposing fiduciary duty on majority stockholder voting on affiliated merger). Out of practical necessity, however, the discussion in this Article is limited to fiduciary duties as applied to “managers,” although much of what is proposed in this piece seems applicable to stockholders’ management decisions, especially when the decisions are undertaken by a majority or controlling stockholder.
Article attempts to explain the present shape of these corporate fiduciary duties by reference to Pareto criteria.

A particular state of affairs ("state B") is considered to be Pareto superior to another state of affairs ("state A") if at least one person in state B is better off than he or she is in state A and no one in state B is worse off than he or she is in state A. Since in a move from state A to state B, no one loses and at least one person gains, state B is considered superior to state A. Any state is Pareto efficient if no further move to a Pareto superior state is possible.

This Article proposes that corporate managers' fiduciary duties as developed through the common law are best understood as mandates from courts for corporate managers to take all actions that move corporate shareholders to Pareto superior states. This Article suggests that such an analysis enables one to discover a general consistency in the spate of seemingly confusing cases interpreting managers' fiduciary duties in such diverse matters as lock-ups, managers' freedom (or perhaps obligation)

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3 Since this piece is intended as a positive article, it does not treat in any detail the moral justification for the underlying principles utilized in explaining the common law of corporate fiduciary duties. In another recent piece, the author deals extensively with such normative matters in regard to corporate fiduciary duties. See Rutheford B Campbell, Jr., Corporate Fiduciary Principles for the Post-Contractarian Era, 23 Fla. St. U. L. Rev. (forthcoming 1996) [hereinafter Campbell, Corporate Fiduciary Principles].


5 Over the years, courts have faced questions involving various provisions that are designed in greatly varying degrees to "lock up" an acquisition on behalf of a favored suitor. The lock-up techniques vary from the exceedingly mild versions, such as provisions merely obligating the board of the target to recommend a merger to the target's stockholders, see, e.g., Jewel Cos. v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555 (9th Cir. 1984); Belden Corp. v. InterNorth, Inc., 413 N.E.2d 98 (Ill. App. Ct. 1980); ConAgra, Inc. v. Cargill, Inc., 382 N.W.2d 576 (Neb. 1986), through the perhaps somewhat stronger versions, such as agreements that the target's board will use its best efforts to complete the acquisition by the favored suitor, see, e.g., Jewel Cos. v. Pay Less Drug Stores Northwest, Inc., 741 F.2d 1555 (9th Cir. 1984); Great Western Producers Co-Operative v. Great Western United Corp., 613 P.2d 873 (Colo.
to promote the interests of constituencies other than stockholders,\textsuperscript{6}

freeze-outs, and the meaning and applicability of the so called *Revlon* duties.\(^7\)

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\(^7\) The following is representative of the more significant articles written on freezeouts and other similar transactions in which stockholders have been subjected to varying degrees of economic and strategic pressure to give up their equity interests in a company in exchange for cash: Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354 (1978) [hereinafter Brudney & Chirelstein, *A Restatement*]; Edward F. Greene, *Corporate Freeze-out Mergers: A Proposed Analysis*, 28 STAN. L. REV. 487 (1976); Thomas L. Hazen, *Management Buyouts and Governance Paradigms*, 25 WAKE FOREST L. REV. 1 (1990); Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624 (1981). The most significant cases in the area deal with the subject of whether or not a valid business purpose is required in a freezeout. This issue is discussed infra notes 67-88 and accompanying text, and is displayed in its most intriguing form by tracing the Delaware cases on the matter beginning with Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) and ending with Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

\(^8\) As is described more fully infra notes 89-95 and accompanying text, the Delaware Supreme Court held in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), that when it became apparent in a takeover battle that the target would be broken up, the duty of the target's board "changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.* at 182. Not surprisingly, this holding generated subsequent litigation dealing with such matters as when these so called "*Revlon* duties" attach. *See, e.g.*, Paramount Communications Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989). For the meaning of the obligation to auction, see, *e.g.*, Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994); *see also* Ronald J. Gilson & Reinier Kraakman, *What Triggers Revlon?*, 25 WAKE FOREST L. REV. 37 (1990); Janet E. Kerr, *Delaware Goes Shopping for a "New" Interpretation of the Revlon Standard: The Effect of the QVC Decision on Strategic Mergers*, 58 ALB. L. REV. 609 (1995); Stephen P. Lamb & Andrew J. Turezyn, Revlon and Hanson Trust: Unlocking the Lock-ups, 12 DEL. J. CORP. L. 497 (1987); Kenneth J. Nechbar, Revlon, Inc. v. MacAndrew & Forbes Holdings, Inc. — The Requirements of a Level Playing Field in Contested Mergers and Its Effect on Lock-ups and Other Bidding Deterrents, 12 DEL. J. CORP. L. 473 (1987); Paul L. Regan, *The Unimportance of Being Earnest: Paramount Rewrites the Rules for Enhanced Scrutiny in Corporate Takeovers*, 46 HASTINGS L.J. 125 (1994); E. Ashton Johnston, Note, *Defenders of the Corporate Bastion in the Revlon Zone*: Paramount Communications Inc. v. Time Inc., 40 CATH. U. L. REV. 155 (1990);
The Article offers not only explanations of the major cases in the area of corporate fiduciary duties but also examples of cases in which courts have varied from the requirement that managers pursue Pareto superior states. Such deviations have wrought confusion and problematic outcomes. Accordingly, in connection with the positive analysis, this Article at times offers prescriptions for rules of law that are inconsistent with managers' obligations to pursue Pareto superiority on behalf of corporate stockholders.

While all of this admittedly sounds esoteric, in fact the analysis is intended to be intensely practical by providing courts and corporate planners with clear principles that can be applied in a fashion that promotes consistency and reduces the deadweight costs of uncertainty. To assist in this practical side of the Article, references to Pareto criteria, which seem more suited to the lexicons of moral theorists and economists, are translated in Part I of the Article into the most usual and traditional corporate law language.

I. MANAGERS' GOALS IN RELATION TO WEALTH MAXIMIZATION AND WEALTH TRANSFERS

Actions of corporate managers can affect the wealth of stockholders only in two ways. First, managers' actions can affect the value of the corporation as a whole. Second, managers' actions can reallocate value to or away from stockholders.

A simple example of a decision by corporate managers that affects the overall corporate value is a decision by a CEO or a board of directors of the corporation to acquire a new machine. If the machine is a profitable investment for the corporation, the acquisition increases total corporate value and should, unless other corporate claimants are able to appropriate all the increased value for themselves, increase the wealth of the stockholders. Similar increases in corporate value result from decisions by corporate managers to refinance at a cheaper interest rate an existing loan to the corporation, to switch to a lower cost supplier of raw products, or to reduce labor costs by reducing its labor force or lowering wages. In each of these examples, total stockholder wealth is likely increased because the corporation, against which stockholders have claims, increases in value as a result of the action of managers.

The acquisition of the profitable machine
(or other managers' decisions that increase
overall corporate value) can be understood by
reference to Figure A and Figure B. In the
figures, total corporate value, or at least one
version of total corporate value,\(^9\) is represent-
ed by the areas within the circles. Preferred
stockholders' claims against this corporate
value ("preferred stockholders' wealth") are
represented by the areas (designated as "Pre-
ferred" in the Figures) within the circles that
are above the lines a-b, and common stock-
holders' claims to this corporate value ("com-
mon stockholders' wealth") are represented
by the areas (designated as "Common" in the
Figures) within the circles that are below the
lines a-b. A simplifying (but inaccurate)
assumption in Figures A and B, which is later
eliminated, is that only stockholders have
claims against the corporate wealth.

Figure A represents the situation prior to the acquisition of the
profitable machine. Figure B represents the total and relative\(^10\) wealth
of stockholders after the acquisition of the machine. The profitable
acquisition increases total corporate value from the area within the circle
\(V^1\) (represented by the solid circle in Figure A and the broken circle in
Figure B) to the area within the circle \(V^2\) in Figure B.\(^11\)

\(^9\) For now, total corporate value is limited to the corporate value against
which stockholders have claims. Clearly, other value exists which one rightfully
may consider to be "corporate" value. Most obviously, to refer to normal
accounting practices, assets of the corporation represent corporate value, and
under accounting rules those assets are balanced against the claims of creditors
(liabilities) and the claims of stockholders (equity). One may also consider that
employees have either legally enforceable or morally compelling claims against
corporate value. These matters are treated subsequently in this Article, and the
limiting assumption that only stockholders have claims against corporate value
is removed. For now, it may be helpful to consider Figures A and B as
representing a corporation that has no liabilities.

\(^10\) An assumption in this graphic display that usually is inaccurate is that the
common stockholder and the preferred stockholder share equally in corporate
gains. This assumption is later removed.

\(^11\) Of course, stockholders' wealth can also be decreased by decisions of
Examples of managers' actions that reallocate wealth to or away from stockholders are also easy to find and describe. These actions may involve a reallocation within a single class of stockholders, between or among classes of stockholders or between stockholders and other corporate constituencies, such as creditors or employees.

Examples of management decisions that reallocate corporate wealth between two classes of stockholders are the old single company recapitalization cases in which managers facilitated changes in the financial rights of preferred stockholders. In one recurring fact pattern, managers in corporations with preferred stock in arrears on dividends facilitated the elimination of the preferred stockholders' dividend arrearages. To the extent that the preferred stockholders were not paid a fair managers that decrease the total value of the corporation. If the machine is not profitable, if the interest rate is higher, or if labor or raw materials become more expensive, the decision by managers to make the change will decrease stockholder wealth.

Figure C represents state C, the situation following a corporate wealth-decreasing move by managers. Total corporate value decreased from the area within the broken circle $V^1$ to the area within the circle $V^3$; the assumption is that common stockholders' wealth and preferred stockholders' wealth decreased by an amount represented by the shaded areas below and above the line a-b respectively.

12 Most of these cases arose in a period beginning during the Great Depression and ending sometime shortly after World War II. See, e.g., Alfred F. Conrad, Manipulation of Share Priorities — the Record of 79 Listed Securities, 8 VAND. L. REV. 55 (1954) (surveying cases between 1932 to 1951). Of course, such cases occur thereafter. See, e.g., Gruss v. Curtis Publishing Co., 534 F.2d 1396 (2d Cir.), cert. denied, 429 U.S. 887 (1976); Bove v. Community Hotel Corp., 249 A.2d 89 (R.I. 1969).

13 A “single company recapitalization” means a transaction in which the contractual rights of stockholders, normally preferred stockholders, are changed without any significant amalgamation of assets (i.e., without, for example, a merger occurring).

14 Examples of such cases include Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del. 1943), aff’d, 146 F.2d 701 (3d Cir. 1944); Western Foundry Co. v. Wicker, 85 N.E.2d 722 (III. 1949); Iowa ex rel. Weede v. Bechtel, 31 N.W.2d 853 (Iowa 1948), cert. denied, 337 U.S. 918 (1949); Dratz v. Occidental Hotel Co., 39 N.W.2d 341 (Mich. 1949); Wessel v. Guantanamo Sugar Co., 35 A.2d 215 (N.J. Ch.), aff’d, 39 A.2d 431 (N.J. 1944); Buckley v. Cuban American
value for their lost arrearages, the transaction transferred value from the preferred stockholders to the common stockholders.\textsuperscript{15}

Figure D shows the Corporation following such a move by managers. The factual assumptions of the figure are as follows: the managers facilitate a single company recapitalization that eliminates preferred stockholders' arrearages; the preferred stockholders are paid less than fair value for their lost arrearages,\textsuperscript{16} and the total value of the corporation

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\textsuperscript{16} Preferred stockholders subjected to such actions typically enjoy protective provisions that diminish the risk of unfair treatment. Thus, for example, depending on the law of the particular state, preferred stockholders may enjoy voting rights, see REVISED MODEL BUSINESS CORP. ACT § 10.04(a)(9) (1991), and fiduciary protection. For cases applying fiduciary constraints to such transactions, see Hottenstein v. York Ice Mach. Corp., 136 F.2d 944 (3d Cir. 1943), \textit{cert. denied}, 345 U.S. 886 (1945); Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del. 1943), \textit{aff'd}, 146 F.2d 701 (3d Cir. 1944); Goldman v. Postal Tel., Inc., 52 F. Supp. 763 (D. Del. 1943); Porges v. Vadsco Sales Corp., 32 A.2d 148 (Del. Ch. 1943); Iowa \textit{ex rel. Weede v. Bechtel}, 31 N.W.2d 853 (Iowa 1948), \textit{cert. denied}, 337 U.S. 918 (1949); Wessel v. Guantanamo Sugar Co., 35 A.2d 215 (N.J. Ch.), \textit{aff'd}, 39 A.2d 431 (N.J. 1944); Kamena v. Janssen Dairy Corp., 31 A.2d 200 (N.J. Ch. 1943); Zobel v. American Locomotive Co., 44 N.Y.S.2d 33 (N.Y. Sup. Ct. 1943); Bove v. Community Hotel Corp., 249 A.2d 89 (R.I. 1969); Matteson v. Ziebarth, 242 P.2d 1025 (Wash. 1952). One should observe, however, that preferred shareholders, at least historically, have not fared well in these transactions and often have been subjected to significant
is otherwise unaffected by the transaction. The broken line a-b represents the division of wealth between the common and preferred stockholders before the recapitalization, and the solid line a'-b' represents the division after the recapitalization. Preferred stockholders lost and common stockholders gained an amount represented by the shaded area between the line a-b and line a'-b'.

An example of a managers' decision that reallocates wealth within a single class of stockholders is an affiliated merger. Assume that Parent Corp. owns seventy percent of Sub Co. and that the balance of Sub Co. is publicly owned. If the managers of Sub Co. facilitate a merger of Sub Co. into Parent at an unfairly low exchange price, the managers of Sub Co. facilitate a wealth transfer from the minority stockholders of Sub Co. to the majority stockholder of Sub Co., which is Parent Corp.

The graphic illustration of that transaction is seen in Figure E, which again indulges a simplifying, but probably inaccurate, assumption that the affiliated merger does not increase total corporate value (this assumption is removed later). Figure E, for simplification purposes, assumes that only common stockholders have claims against the corporate wealth, and thus the division of value between majority stockholders and minority stockholders prior to the merger is represented by the broken line a-b. As a result of the unfair acquisition, the assumption is that the minority receives value only equal to the area above the solid line a'-b' while the majority winds up with value equal to the area below line a'-b'. Thus, the majority gains and the minority loses an amount represented by the shaded area between the lines a-b and a'-b'.

Admittedly, life is more complicated than is apparent from the foregoing figures with their sterilizing assumptions. For example, it is highly unlikely that Figure B accurately represents the situation following the purchase of the profitable machine, since, most obviously, the normal losses of value.

This is a correct assumption, provided the transaction is tax neutral. The elimination of arrearages affects only the division of value among stockholders. If in fact the market values the total of common and preferred claims following the recapitalization higher (or lower) than before the recapitalization, the result is irrational.
contractual cap on the dividends of the preferred stockholders means that the wealth of the common stockholders and the preferred stockholders would most likely be affected disproportionately. Thus, the post-investment wealth and gains by the respective stockholders might be more appropriately represented by Figure F. In that figure, the gains by the preferred stockholders from the purchase of the profitable machine are represented by the lightly shaded area between circle $V^1$ and $V^2$, and the gains of the common stockholders are represented by the darkly shaded area between circle $V^1$ and $V^2$.\(^1\)

All this is complicated even further if one removes the unrealistic assumption that total corporate value is shared only by corporate stockholders. In fact, of course, other constituencies have claims against corporate wealth. The most obvious of these constituencies are creditors and employees of corporations, both of whom have expectations, principally contractual in nature, of sharing in the value generated by corporate operations.

Figure A as a starting point, therefore, is misleadingly simple. The more (but still, perhaps, not totally) complete representation of the corporation may be Figure G,\(^1\) in which the area within $V^1$ represents not only the total value of the expectations of stockholders, but also includes the value of the expectations of the corporation’s creditors and employees.\(^2\)

\(^{19}\) The economic reason for the preferred stock’s increase in value following the profitable investment, even though, we are assuming, the preferred stock is non-participatory preferred (i.e., enjoys only fixed dividends), is that the stream of earnings anticipated by the preferred stockholders, though fixed in amount, becomes less risky, at least to some degree, following the profitable investment.

\(^{19}\) The ordering of the claims in the figure (i.e., preferred claims, being on the bottom and employee claims, being on the top) is intended to have no significance. The claims are placed in that order only as a way to make illustrations clearer and more compact. Also, no significance is intended by the claimants’ relative portion of the area of circle $V^1$ in Figure G. Obviously the relative and absolute claims of such constituencies vary in each corporation.

\(^{19}\) If Figures A and G represent the same corporation, then definitionally the
Starting with Figure G, therefore, and then moving to Figure H, one can graphically represent the result of the corporation's purchase of a new profitable machine. In Figure H, which represents the situation following the purchase of the machine, the area between $V^1$ and $V^2$ represents the gain from the new machine, and in light of the previously expressed assumption that preferred stockholders, creditors and employees have essentially fixed claims or expectations, one may assume that the common stockholders will garner the largest part of the gain represented in Figure H.

Again starting with Figure G, one is able to provide an example of a wealth transfer between stockholders and a non-stockholder constituency by reference to a highly leveraged acquisition. Often in these transactions, creditors of the target suffer a significant dilution in the value of their investment as a result of the additional leverage generated in the acquisition. The claim of the creditors, which no one seems seriously to dispute, is that the lost value of the debt instruments is appropriated in these transactions by stockholders. Assuming the correctness of this claim, and further assuming (although this second assumption in most instances may be incorrect) that the highly leveraged transaction does not increase the overall value of the target, Figure I represents the situation after news of the highly leveraged acquisition is absorbed by the market.

Area under $V^1$ in Figure G is greater than the area under $V^1$ in Figure A, since Figure G represents the expectations of more claimants.

21 See infra notes 104 and 119-22 and accompanying text.

22 See infra note 104.

23 The appropriation could have been by either the old stockholders or the new stockholder (the acquiror). For the purposes of the graphic representations, I assume the value was acquired by the old stockholders, although a contrary assumption in no way changes the results of my analysis.

24 The gains are measured by reference to the time at which the information of the acquisition is absorbed in the market in order to avoid the graphic difficulty of dealing with any allocation of gains to the acquirer. Allocation of the total stockholder gains between the old target stockholders and the acquiror, however, does not change the outcome of this analysis.
In Figure I, therefore, $V^1$ is unchanged from Figure G, since the assumption is that the value of the corporation is not increased by the change in control, but line a-b becomes line a'-b', reflecting the expropriation by common stockholders of part of the value of the creditors. The extent of the expropriation is represented by the shaded area in Figure I between lines a-b and a'-b'.

A management decision can, of course, affect both the overall value of the corporation and reallocate wealth among constituencies. An example of this can be constructed again by reference to a highly leveraged acquisition, but now one must remove the assumption of no increase in value of the target as a result of the change in control. In fact, the economic data indicates that removing the assumption is realistic, since the premiums paid stockholders in such transactions appear to be generated both by wealth transfers from creditors and by the effect of transferring control of the corporations to new owners/managers, who, presumably, think they can manage the company more efficiently and thus are willing to pay a premium over market value for the company. 

Figures G and J portray such a highly leveraged transaction in which the total value of the corporation increases by transferring control to more.

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25 An interesting inversion of this example is found in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), where the board of directors of Revlon, in the face of a hostile bid for Revlon, accepted a competing bid from a white knight and attempted to justify the move as a way to protect the value of certain of Revlon’s outstanding notes. Id. at 184. Stockholders, however, successfully claimed that the protection of the creditors through accepting the bid of the white knight came at the expense of the value of the stockholders’ investments and that, accordingly, the action of Revlon’s board in accepting the bid was not consistent with the board’s fiduciary duty to common stockholders. Id. In essence, the common stockholders claimed that the decision of the managers to protect Revlon’s notes through the acceptance of the white knight’s bid transferred wealth from common stockholders to creditors.

efficient managers and at the same time wealth is transferred from creditors to stockholders. Figure G represents the state of affairs before any information about the leveraged buyout is absorbed by the market. Figure J represents the state of affairs after news of the leveraged buyout is absorbed by the market for the corporation's equity and debt securities. The gain in total corporate value resulting from the transaction is represented by the area between $V^1$ and $V^2$, and the assumption is that the gain is appropriated by common stockholders. In addition, stockholders gain as a result of expropriation of creditors' value (due to the highly leveraged nature of the transaction). That additional gain by the stockholders is represented by the area between line a-b and $a^1$-$b^1$.

To complete this diagrammatic display, it may be helpful to hypothesize a situation in which one group of investors, common stockholders in this case, is able to increase its wealth even though the total wealth of the corporation is decreased by the move. An example of this occurs when corporate managers facilitate a sale of all of the common stock of the corporation to a corporate looter. Because the new owner (the looter) intends to mismanage the corporation by, for example, diverting necessary operating funds to itself through inflated salaries or perhaps even through theft, the total value of the corporation decreases. The selling stockholder, however, is able to increase its total wealth by selling to the looter the opportunity to loot the corporation (i.e., the opportunity to expropriate part of the wealth of the other constituencies).

This transaction is represented by reference to Figure G, which represents the situation before information of the sale to the looter is absorbed in the market value of the various claims against corporate value, and Figure K, which represents the situation after information concerning the sale to the looter is fully absorbed into the respective values. Although the total value of the corporation is reduced by the area between $V^1$ and $V^3$, the total wealth of the common stockholder is increased from Figure G to Figure J, because

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27 See supra notes 23 and 24.
the common stockholder expropriated a large part of the wealth of the preferred stockholders, creditors and employees.

Admittedly, the foregoing explanations may be overly long and tedious, but important, if somewhat simple, points are to be made here. Specifically, actions by corporate managers can affect the wealth of stockholders and other corporate constituencies only by changing total corporate wealth or by reallocating wealth among or within corporate constituencies. Alternatively, managers' actions can affect both total wealth and the distribution of wealth, and as shown above, the effects may, with respect to stockholders or any corporate constituency, go in opposite directions at the same time. The dynamics of all this are important as one considers the obligation of corporate managers to pursue Pareto superior states on behalf of corporate stockholders.

II. Managers' Goals in Relation to Pareto Superiority

The common law of corporate fiduciary duties is best understood in terms of an obligation on corporate managers to take any step that moves corporate stockholders to a Pareto superior state. Thus, corporate managers are obligated under the common law to make all moves in which, as a result of the move, at least one stockholder is better off and no stockholder is worse off. Some cases, certainly, stray from these principles, but those cases are aberrational, and when clearly confronted with a choice, courts nearly always require managers to pursue Pareto superiority on behalf of corporate stockholders.

Restating these Pareto obligations of corporate managers in the terms of the narrative descriptions and graphic representations in Part I of this Article, managers, first of all, are obligated to pursue maximization of total stockholder wealth. This obligation of corporate managers follows from the Pareto criteria, since if a move by managers makes at least one stockholder better off and no stockholder worse off, then definitionally total stockholder wealth increases. Thus, relating this to the prior examples and graphic displays, managers are required to purchase the profitable machine that moves the corporation from the state represented by Figure A to the state represented by Figure B.

Continuing to restate managers' Pareto obligations in the terms of Part I, and qualifying somewhat the obligation expressed immediately above, corporate managers are prohibited from making any move that
transfers wealth away from any stockholder or group of stockholders.\(^{(28)}\) This rule is merely a restatement of the Pareto requirement that the move make no stockholder worse off. Managers, accordingly, are prohibited by their fiduciary duties from facilitating the unfair elimination of preferred stockholder arrearages, represented in Figure D, or the unfair affiliated merger, represented by Figure E, since both transactions violate the obligation of managers to avoid wealth transfers detrimental to stockholders.

As is apparent from the foregoing formulation, courts, when measuring whether a move by corporate managers makes anyone better off or worse off, consider only the interests of corporate stockholders. Stated otherwise, in measuring the impact of moves by corporate managers, courts limit the relevant universe for the application of the

\(^{(28)}\) A necessary corollary of these two Pareto-based rules is that managers must, to the extent possible, make any move that is Kaldor-Hicks efficient and turn that move into a Pareto superior move. This important point, however, requires some definition and explanation.

A move is Kaldor-Hicks efficient if the winners from the move could compensate the losers from the move, whether or not such compensation in fact occurs. See Murphy & Coleman, supra note 4, at 186.

Assume, for example, that prior to an affiliated merger the value of a minority interest in a company is $10, while the company as a whole (including the minority interest) is valued at $100. In the affiliated merger, however, the minority stockholder is paid only $5 for his or her interest, even though as a result of the efficiencies from the merger the total value of the company increases to $110. This affiliated merger is Kaldor-Hicks efficient, because the winner, the majority stockholder who gains $15 from the transaction, could compensate the loser, the minority stockholder, even though, let us assume, the majority stockholder does not in fact compensate the minority stockholder for its $5 loss. The merger, however, is not a Pareto superior move, since without some compensation to the minority, the minority is a loser as a result of the transaction.

The obligation of corporate managers to pursue Pareto superior transactions on behalf of stockholders should logically include the obligation to pursue this affiliated merger, since it is wealth-maximizing, but to restructure the transaction in such a way that the loss to the minority stockholder is eliminated. One distinguished commentator has observed that restructuring deals in ways that turn Kaldor-Hicks efficient transactions into Pareto superior transactions normally can be easily done. Morey W. McDaniel, Stockholders and Stakeholders, 21 Stetson L. Rev. 121, 134 n.43 (1991) [hereinafter McDaniel, Stockholders and Stakeholders] ("[M]anagers, acting as agents for all participants, can arrange cheaply, if not costlessly, for the necessary side payments.").
Pareto concepts to stockholders only. Again referring to the graphic representations of Part I of this Article, Figure A, which includes only stockholders, and not Figure G, which includes other constituencies, is the correct representation of the starting point (i.e., the universe) for evaluating managers’ moves and decisions.

Important, this means that a move instituted by corporate managers can be Pareto superior within the stockholder-only universe even though the move creates numerous and significant financial losers, so long as those losers are not corporate stockholders. Return to the example of the highly leveraged acquisition. In Figures G and J in Part I of this Article, the highly leveraged acquisition is portrayed in relation to the broader universe that includes constituencies other than stockholders. The assumptions in those Figures are that the move, the highly leveraged acquisition, increases total stockholder wealth both as a result of the increase in total corporate wealth, which is derived from the efficiencies of the transaction, and as a result of the wealth transfers from creditors to stockholders. Viewed in relation to this more expansive universe, the transaction generates losses for creditors. Within the more limited stockholder-only universe, however, the assumptions are that total stockholder wealth is increased and no stockholder loses as a result of the transaction. Thus, the highly leveraged acquisition moves the stockholder-only universe to a Pareto superior state and must be pursued by managers, even though losers are created in other groups.

Although so limiting the relevant universe to stockholders creates certain moral issues,29 the limitation ameliorates a significant, practical obstacle to the use of Pareto superiority as a guide for decisionmaking. Critics of Pareto criteria correctly point out that the criteria of a Pareto superior move are nearly impossible to meet in the real world,30 since in the unlimited universe of the real world, nearly all moves create losers. As Professor Dworkin observes, “there are few Pareto-inefficient states.”31

This extremely broad limitation on the use of Pareto criteria would seemingly always be present if Pareto criteria are used to evaluate

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29 In two separate articles the author articulates reasons for expanding the protection of fiduciary duties beyond the stockholder-only universe. Campbell, Limited Liability, supra note 6, at 55-71; Campbell, Corporate Fiduciary Principles, supra note 3.

30 See Murphy & Coleman, supra note 4, at 186; Posner, supra note 1, at 14.

managers' decisions in an unlimited universe. For example, in an unlimited universe, a simple decision by corporate managers to shift to a more economical supplier of electrical cable would create waves of losers, including not only the owners of the former, less efficient supplier itself, but also the old supplier's employees, creditors, managers, suppliers, and merchants in the town where the supplier maintains its business, and the list goes on.

No need exists to belabor the obvious point, which is that virtually any management decision, even one that most consider to be in the best interests of the corporation and society, creates layers of losers. By limiting the application of Pareto concepts to a universe that encompasses only stockholders, however, courts are faced with a much more manageable task in applying Pareto criteria.

In addition to applying Pareto criteria to the stockholder-only universe, courts utilize financial costs as opposed to economic costs in determining whether a move by managers makes stockholders better or worse off. This compromise also is essential as a practical matter if Pareto criteria are to provide a workable paradigm for courts. The matter requires some further explanation, however.

Economists typically define costs to include more than just financial costs. Assume, for example, that Alpha Corporation builds a financially profitable building that is considered by everyone but one of the corporation's stockholders, Mr. Adams, to be the most beautiful building ever built. Mr. Adams, who lives across the street from the building and owns only one share of Alpha, however, considers the building horribly ugly. If we assume that Mr. Adams would be willing to pay up to $10 for the removal of the building, and that his proportionate share of the increase in the value of Alpha because of the construction of the profitable building is $1, Mr. Adams has suffered an economic loss of $9 as a result of the construction of the building, even though he actually gained as a financial matter.

Courts, in demanding that managers pursue Pareto superiority on behalf of stockholders, measure gains and losses in financial terms and not in economic terms. Thus, referring to the above example, managers

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32 Judge Posner gives an excellent example of this in his textbook:

If I refuse to sell for less than $250,000 a house that no one else would pay more than $100,000 for, it does not follow that I am irrational, even if no "objective" factors . . . justify my insisting on such a premium. It follows only that I value the house more than other people. This extra value has the same status in economic analysis as any other value.

POSNER, supra note 1, at 56.
are obligated to build the financially profitable building, even though it created an economic (but not financial) loss for Mr. Adams and, accordingly, if measured in such economic terms was not a Pareto superior move. However appealing it is to demand that managers pursue Pareto superiority as measured by economic values, such a requirement suffers from the same difficulties discussed earlier regarding an unlimited universe. Managers simply cannot calculate when a decision will cause some non-financial, economic loss to a stockholder, and courts do not demand such a criterion be applied.

The common law fiduciary duties of corporate managers, therefore, are best understood as an obligation that managers pursue Pareto superior states, but only within the stockholder-only universe and only measured by financial, as opposed to economic, values.

III. THE CASES

A. The Application of General Principles

The obligation to pursue Pareto superior states on behalf of a stockholder-only universe requires corporate managers to make wealth-increasing moves on behalf of stockholders and to make no move that creates a loser among the stockholders.33

The first of these obligations, to make moves that increase the total wealth of the stockholder-only universe, explains the outcomes of many of the classic corporate fiduciary duty cases that may appear unrelated. For example, in Dodge v. Ford Motor Co.34 the court concluded that Henry Ford was improperly pursuing a course that was not in the interests of maximizing the profits of Ford’s stockholders, but, instead, was attempting to improve the life of Ford’s workers and improve consumer welfare by providing even more and cheaper cars for the public. In the course of the opinion the court stated: “A business corporation is organized and carried on primarily for the profit of the stockholders.”35

Smith v. Van Gorkom36 is also explained by reference to the obligation of corporate managers to pursue wealth-maximizing and thus

33 See supra note 28, for the obligation of managers in the event these two rules conflict.
34 170 N.W. 668 (Mich. 1919).
35 Id. at 684.
36 488 A.2d 858 (Del. 1985).
Pareto superior states on behalf of stockholders, since underlying the board's breach of its fiduciary duty in that case was its failure to take steps necessary to facilitate a wealth-maximizing sale of the corporation.\textsuperscript{37}

A third and also quite different type of case, but one that is equally interesting and equally demonstrative of the obligation of managers to pursue Pareto superiority through wealth-maximizing moves on behalf of stockholders, is *McMahan & Co. v. Wherehouse Entertainment, Inc.*\textsuperscript{38} In that case, Wherehouse in a prospectus circulated in connection with a public sale of its debentures stated that the contractual protection accorded the debenture holders under a poison put provision could be waived by a majority of Wherehouse's "Independent Directors."\textsuperscript{39} The Second Circuit, however, concluded that such a statement may have misled the debenture holders regarding the protection of the provision, since the directors "would never protect the interest of debenture holders except by coincidence because, as ordinary directors, they were required by law to protect the interest of the shareholders."\textsuperscript{40}

The second component of managers' Pareto superior obligation, to create no losers within the stockholder-only universe, also explains many apparently theoretically distinct corporate fiduciary duty cases. The lexicon of these cases expresses this part of the Pareto superior obligations not in terms of the "creation of losers" or even in terms of "wealth transfers" but, instead, as the obligation to avoid transactions that are "unfair,"\textsuperscript{41} "grossly unfair," or amount to "constructive fraud."\textsuperscript{42}

\textsuperscript{37} Id. at 872.

\textsuperscript{38} 900 F.2d 576 (2d Cir. 1990).

\textsuperscript{39} Id. at 577-78.

\textsuperscript{40} Id. at 580. The Second Circuit held that a jury issue was present regarding the question of whether the disclosures were misleading. Id. at 580-82.

Cases are, of course, replete with statements regarding the obligation of corporate managers to maximize the value of the stockholder-only universe. See, e.g., *Dynamics Corp. v. CTS Corp.*, 794 F.2d 250, 256 (7th Cir.), rev'd, 481 U.S. 69 (1986) (holding that managers' obligation is "stockholder wealth maximization"). Consolidating works, such as the American Law Institute's *Principles of Corporate Governance*, discuss the "economic objective" of a corporation, which is the objective of "enhancing corporate profit and shareholder gain." *PRINCIPLES OF CORPORATE GOVERNANCE* § 2.01 (American Law Institute 1994).


\textsuperscript{42} *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418, 422 (D. Del. 1944)
Two situations considered earlier, single company recapitalizations and affiliated acquisitions, are, perhaps, the most apparent examples of courts' unwillingness to permit managers' decisions that create financial losers in the stockholder-only universe. Corporate recapitalizations are typically initiated by common stockholders through their surrogates, the corporate managers, and are designed to change part or all of the preferred stockholders' bundle of rights. The catalyst for the recapitalizations is normally some change in economic circumstances that convinces the common stockholders and the corporate managers that a "rebargaining" of the preferreds' rights is in the best interests of the common stockholders. In a number of older cases, for example, arrearages in the preferred stock dividends had built up and had to be eliminated (or paid) before the board could once again begin paying dividends to common stockholders. A favorable change in the business

(using phrases such as "so unfair as to amount to constructive fraud;" and "gross unfairness;" — but looking more like a fairness analysis under the old Delaware block approach); Barrett v. Denver Tramway Corp., 53 F. Supp. 198, 200 (D. Del. 1943), aff'd, 146 F.2d 701 (3d Cir. 1944) (using "constructive fraud," "bad faith" and "gross unfairness"); Bowman v. Armour & Co., 160 N.E.2d 753 (Ill. 1959) (using standard of "actual or constructive fraud" or "bad faith or reckless indifference," although analysis looks more like a fairness analysis); Bove v. Community Hotel Corp., 249 A.2d 89, 92 (R.I. 1969) (refusing to select a standard, since the recapitalization met even the most rigorous standard of fairness).

In some older cases, however, courts seem to indicate that no fiduciary or equitable rules are implicated by single company recapitalizations. Goldman v. Postal Tel., Inc., 52 F. Supp. 763, 767-68 (D. Del. 1948); Franzblau v. Capital Sec. Co., 64 A.2d 644, 649 (N.J. Super. Ct. Ch. Div. 1949).


Cases involving the elimination of preferred arrearages include Barrett v. Denver Tramway Corp., 53 F. Supp. 198 (D. Del. 1943), aff'd, 146 F.2d 701 (3d Cir. 1944); Western Foundry Co. v. Wicker, 85 N.E.2d 722 (Ill. 1949); Iowa ex rel. Weede v. Bechtel, 31 N.W.2d 853 (Iowa 1948), cert. denied, 337 U.S. 918 (1949); Dratz v. Occidental Hotel Co., 39 N.W.2d 341 (Mich. 1949); Wessel v.
fortune of the company generated cash for dividends, thereby creating a strong incentive in the common stockholders to eliminate the arrearages in order to claim the earnings for themselves through dividends.

Although such recapitalizations require approval of corporate stockholders, including, typically, the preferred stockholders voting as a class or a group, corporate managers are the linchpins in the transaction from both a legal and a practical point of view. Legally, any merger or any amendment to articles of incorporation changing the rights of the preferred, which are the techniques utilized to effect recapitalizations, must start as a board resolution approving the merger


Much has been written on this matter, although most pieces are somewhat older. See, e.g., Arno C. Becht, Alterations of Accrued Dividends, 49 Mich. L. Rev. 363, 365 (1951); E. Merrick Dodd, Accrued Dividends in Delaware Corporations—From Vested Rights to Mirage, 57 Harv. L. Rev. 894 (1944); E.R. Latty, Fairness—The Focal Point in Preferred Stock Arrearage Elimination, 29 Va. L. Rev. 1 (1942). Professor Brudney's piece on this matter is outstanding: Victor Brudney, Standards of Fairness and the Limits of Preferred Stock Modifications, 26 Rutgers L. Rev. 445 (1973) [hereinafter Brudney, Standards of Fairness].

47 REVISED MODEL BUSINESS CORP. ACT § 10.03 (1991) (requiring stockholder approval for amendments to the articles of incorporation) and § 11.03 (requiring shareholder approval for mergers).

48 REVISED MODEL BUSINESS CORP. ACT § 11.03 (1991) requires that each of the parties' boards of directors must approve the merger.

49 REVISED MODEL BUSINESS CORP. ACT § 10.03 (1991) requires such amendments be proposed and approved by the board of directors.


Examples of cases in which recapitalizations were effected through the merger mechanism include Dratz v. Occidental Hotel Co., 39 N.W.2d 341 (Mich. 1949); Bove v. Community Hotel Corp., 249 A.2d 89 (R.I. 1969); Matteson v.
or amendment. Practically, managers (in league with the common stockholders) always initiate and draft the plan of recapitalization and control the proxy machinery, the corporate treasury, information flows and the timing of the transaction.  

Finally, when managers facilitate such recapitalizations, their interests are aligned with common stockholders, and thus they are in a conflict of interest with respect to the preferred stockholders in the transaction. Not surprisingly, therefore, preferred stockholders subjected to recapitalizations often complain that they are treated unfairly or, in Pareto terms, made losers by the transactions.

Although courts, especially in earlier decades, often did quite poorly with these cases, a fiduciary limitation emerged on recapitalizations that make losers of preferred stockholders. Typically, this limitation, as stated above, is expressed in terms of a requirement that such recapitalizations be "fair" or free of "constructive fraud." The point is, however, that these fiduciary standards limit management actions that effect wealth transfers detrimental to preferred stockholders.


51 See, e.g., Brudney, Standards of Fairness, supra note 46.

52 This is true even if managers have no significant ownership interest in the common stock, since common stockholders elect managers. While this "election" is often indirect and certainly managers, as rational maximizers, will attempt to expropriate value for themselves, nonetheless in any allocation decision involving only common stockholders, on the one hand, and preferred stockholders, on the other, managers favor common stockholders, since common stockholders vote on managers and preferred stockholders usually do not.

53 Courts, for example, sometimes have failed to define with any precision the equitable norm limiting such transactions. See, e.g., Franzblau v. Capital Sec. Co., 64 A.2d 644 (N.J. Sup. Ct. Ch. Div. 1949). The Franzblau court spoke of both "unfairness" and "bad faith." Id. at 649. Later the court stated: "The fairness or unfairness of corporation action may not be considered where that action is in exercise of a power conferred upon the corporation by the Act under which it was organized. . . . [T]he Court . . . cannot operate to nullify the corporate power conferred by law . . . ." Id. Similar lack of precision regarding the applicable norm is found in Bailey v. Tubize Corp. 56 F. Supp. 418 (D. Del. 1944).

In other cases, for example, courts have merely presented narrative comparisons without any attempt to quantify the value of the interests of preferred stockholders before and after the recapitalization. See, e.g., Bowman v. Armour & Co., 160 N.E.2d 753 (Ill. 1959); Dratz v. Occidental Hotel Co., 39 N.W.2d 341 (Mich. 1949).
The results in cases involving affiliated mergers are also best explained by the prohibition against managers' decisions or actions that create losers in the stockholder-only universe. This time, however, it is common stockholders that complain of mistreatment.

In a typical affiliated merger case, a parent corporation that owns a majority of the common stock of the subsidiary corporation acquires the outstanding minority of the subsidiary's common stock in a transaction in which the parent, because of its control of the subsidiary and the subsidiary's board, is able to dictate terms, including price. Applying the intrinsic fairness standard in such instances, courts uniformly hold that common law fiduciary duties prohibit the completion of the transaction unless the transaction is "fair" to the minority common stockholders. Fairness requires, not surprisingly, that the minority common stockholders receive an amount of consideration that adequately compensates them for the value of what they lose in the merger. Stated in Pareto terms, therefore, corporate fiduciary duties prohibit managers from facilitating affiliated mergers that make losers of minority common stockholders.

B. Additional Cases

1. Lock-Ups

In a number of cases, courts have dealt with the question of whether the board of directors of a target company that is the subject of a bidding contest may, consistent with its fiduciary duties, grant a lock-up or a

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Lock-ups have been the subject of extensive commentary. Stephen M. Bainbridge, Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions, 75 MINN. L. REV. 239 (1990); Douglas M. Baron, Controlling
similar contractual concession\textsuperscript{56} to a favored bidder. While courts, to this point at least, have been unwilling to declare that the granting of a lock-up is per se violative of managers' fiduciary duties, lock-ups have not fared well in judicial decisions, an outcome that may be explained by the obligation of managers to pursue Pareto superior states on behalf of stockholders. Indeed, a consistent application of Pareto criteria may ultimately lead courts to declare a per se prohibition against the use of lock-ups.

A representative example and certainly one of the most famous of cases involving a lock-up is Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.,\textsuperscript{57} in which Revlon, the target of an unsolicited takeover bid from Pantry Pride, granted its favored suitor, Forstmann Little, an asset lock-up. The lock-up provided that if any competing bidder for Revlon acquired more than 40\% of Revlon's stock, Forstmann had the right to purchase two important divisions of Revlon at a price estimated to be $100 to $175 million below the market value of the divisions.\textsuperscript{58} Competing suitors for Revlon, such as Pantry Pride, therefore, were


\textsuperscript{56} In addition to lock-ups, parties in takeover battles have also utilized other devices, including no-shop provisions, best efforts provisions, and cancellation fees, as a way to terminate or at least diminish the bidding for the target. See supra note 5.

\textsuperscript{57} 506 A.2d 173 (Del. 1986).

\textsuperscript{58} Id. at 178.
forced to bid for a Revlon stripped of the prized divisions and without an amount of cash equal to the fair market value of the divisions.

The court in *Revlon* declared that a lock-up is not per se illegal.59 Nevertheless, the court held that in the circumstances the granting of the asset lock-up to the favored bidder, which essentially terminated the auction for Revlon, violated the fiduciary obligation of Revlon’s board to pursue the “maximization of shareholder profit.”60

In another, more recent, highly publicized case, *Paramount Communications Inc. v. QVC Network Inc.* (“QVC”),61 the Delaware Supreme Court reached a similar result regarding the grant of a stock option lock-up. In that case, Paramount was the subject of competing offers from Viacom and QVC.62 The Paramount board favored the Viacom offer and accordingly entered into a definitive merger agreement with Viacom. That merger agreement contained a no-shop provision, a $100 million termination fee and a “third and most significant deterrent device,”63 which was a stock lock-up that gave Viacom the option to purchase 23,699,000 shares of Paramount stock at $69.14 per share if Viacom lost the deal because of a competing bid or if the Paramount stockholders refused to approve the Viacom acquisition. The enormity of this lock-up became apparent when QVC’s opening bid for Paramount came in at $80 per share.64

Again, as in *Revlon*, the *QVC* court struck down these provisions as inconsistent with the fiduciary duty of Paramount’s board of directors to maximize the wealth of the target’s stockholder-only universe. The court found that the lock-up and other such provisions “were impeding the realization of the best value reasonably available to the Paramount stockholders.”65

Such hostility to lock-ups and similar provisions is best understood in terms of the obligation of the target’s board to pursue Pareto superior states. Specifically implicated here is managers’ obligation to pursue wealth-enhancing moves on behalf of the stockholder-only universe. Also entwined in all this is the suspicion of courts, articulated well in *Revlon*,

59 Id. at 176.
60 Id. at 185.
61 637 A.2d 34 (Del. 1994).
62 Id. at 36.
63 Id. at 39.
64 Id.
65 Id. at 50.
that managers' decisions to grant lock-ups to favored bidders are often biased by managers' own self-interest.

To understand this better, it is helpful to isolate the lock-up and consider it as a valuable property right of the target company and its stockholders. Viewed thusly, granting or selling the lock-up to the favored bidder is like selling any other valuable corporate property right. Accordingly, the question of whether or not such sale is consistent with the obligation of managers to move the stockholder-only universe to a Pareto superior state should seemingly be analyzed the same way as other transactions involving the sale of valuable corporate property, such as a machine, a piece of real property, or a whole division. One might, therefore, question the propriety of the clear, special hostility to the sale of lock-ups so apparent in cases like Revlon and QVC.

Courts, of course, view the sale of the lock-up in a bidding contest differently than they view the sale of other corporate property because of the courts' articulated doubt regarding the objectivity of a target's board in executing the sale of the lock-ups. Courts find that boards have a "specter of a conflict" in such situations, and this perceived bias infects managers' objectivity and leads courts to apply a different analysis in such instances.66

This analysis may ultimately lead courts to a per se prohibition of lock-ups. Such a prohibition may appeal to courts as an efficient way to

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ensure that managers pursue Pareto superiority on behalf of the stockholder-only universe.

If a target's managers were fully aligned with the interests of the target stockholders, courts could reasonably assume that over time lock-ups would be priced properly, as self-interested buyers and sellers bargain in a reasonably competitive market for the allocation of lock-ups and more broadly for companies. Under these assumptions, while a lock-up may be over-priced or under-priced in any one particular acquisition, viewed more broadly from the perspective of society, lock-ups generally would be priced properly in the same way that any corporate asset (a chair, for example) sold by managers in a reasonably competitive market would be priced properly. A per se prohibition of the sale of lock-ups, therefore, would not make economic sense under such assumptions.

If, on the other hand, the facts surrounding the sale of lock-ups are accurately perceived by courts in that the decisionmakers on the target side of the transactions are persistently biased by self interest, lock-ups allocated in market transactions will over time be systematically mispriced, and as a result companies will be systematically misallocated. More specifically, lock-ups will be underpriced to favored bidders, which, in turn, will result in an inefficient allocation of companies. This result means, in consideration of Pareto criteria, that the sale of lock-ups will not be value-maximizing for the stockholder-only universe and thus not a Pareto superior move.

A per se prohibition against the sale of lock-ups may be, therefore, an attractive way for courts to deal with this inefficiency. Such a prophylactic rule prohibiting the premature termination of the auction process may be considered by courts to be the most effective and cost efficient way to drive managers to conduct consistent with Pareto criteria.

2. Freezeouts and the Business Purpose Doctrine

"Freezeout" is a term used to describe a transaction in which a majority stockholder forcibly eliminates minority stockholders from any further equity participation in a particular company. Freezouts can occur in various business settings and can be effected through various

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67 For a representative list of articles on freezeouts, see supra note 7.
68 See Brudney & Chirelstein, A Restatement, supra note 7 (describing and analyzing the appropriate treatment of freezeouts by considering whether the
corporate mechanisms, but the fundamental aspect of the transaction is that the majority stockholder exercises its raw power to acquire for itself the minority’s equity interest in the company.

Courts are hostile toward freezeouts, and one manifestation of this hostility is the adoption by some (but not all) jurisdictions of the business freezeout eliminates a longstanding subsidiary or a subsidiary recently acquired through a tender offer).

Probably the most usual structure for a freezeout is through a merger (or, under more modern corporation laws, a share exchange) either into the majority stockholder (the “parent”) or an affiliate of the parent. See, e.g., Santa Fe Industries v. Kirby, 430 U.S. 462 (1977); Berkowitz v. Power/Mate Corp., 342 A.2d 566 (N.J. Super. Ct. Ch. Div. 1975). Additionally, majority stockholders have attempted to execute freezeouts as dissolutions, see, e.g., Kellogg v. Georgia-Pacific Paper Corp., 227 F. Supp. 719 (W.D. Ark. 1964); Zimmerman v. Tide Water Associated Oil Co., 143 P.2d 409 (1943), reverse stock splits, see, e.g., Teschner v. Chicago Title & Trust Co., 322 N.E.2d 54 (Ill.) (converting over two million shares into 3,722 shares, and cashing out any fractional shares), appeal dismissed, 422 U.S. 1002 (1974); Leaderv. Hycor, Inc., 479 N.E.2d 173 (Mass. 1985) (converting two million shares with a par value of one cent into 500 shares with a par value of $40, and cashing out any fractional shares), and sales of substantially all the corporation’s assets otherwise than in the regular course of business, see, e.g., Cathedral Estates, Inc. v. Taft Realty Corp., 157 F. Supp. 895, 897 (D. Conn. 1954), aff’d, 251 F.2d 340 (2d Cir. 1957); Theis v. Spokane Falls Gaslight Co., 74 P. 1004 (Wash. 1904).

While the hostility of the common law toward freezeouts is explained in this Article by reference to Pareto criteria, courts may be influenced by notions of property rights, even in cases adjudicated under more traditional ideas of business purpose and intrinsic fairness. Some courts, therefore, may view minority stockholders’ stock as “their” stock and thus are reluctant to permit the majority stockholder to exercise power of private eminent domain by taking the stock forcibly from the minority. Coggins v. New England Patriots Football Club, Inc., 492 N.E.2d 1112 (Mass. 1986) has always struck the author as such a case. The court described the plaintiff, Coggins, thusly: “Coggins, a fan of the Patriots from the time of their formation, was serving in Vietnam in 1967 when he purchased the shares through his brother. Over the years, he followed the fortunes of the team, taking special pride in his status as an owner.” Id. at 1115. Commentators have provided interesting analyses of eminent domain and the question whether, in some instances, private parties should be permitted to exercise private eminent domain. See Posner, supra note 1, at 56-61.
purpose doctrine. Under this doctrine, a freezeout is prohibited unless the transaction serves some "legitimate corporate purpose," a criterion, courts have said, that is not met if the freezeout "serves no business purpose other than the termination of the minority stockholder's interest ..."

This business purpose doctrine is applied in addition to the more general intrinsic fairness test in affiliated mergers. Accordingly, either unfairness in the terms of the transaction or the absence of a valid business purpose is an independent basis for enjoining a freeze-out.

Requiring that freezeouts have a business purpose, as defined by courts, promotes wealth-maximizing transactions, which are essential to

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71 The most famous articulation of the business purpose doctrine was by the Delaware Supreme Court in Singer v. Magnavox, 380 A.2d 969, 979 (Del. 1977). Six years later, in Weinberger v. UOP, Inc., 457 A.2d 701, 704 (Del. 1983), the Delaware Supreme Court reversed itself and abandoned the business purpose test.


72 Coggins, 492 N.E.2d at 1118.


Pareto superior moves. The application of a business purpose test to freezeouts, therefore, is consistent with a commitment to Pareto criteria, although a more complete explanation of the business purpose doctrine and its development is required to explain this point.

Freezeouts are initiated by the majority stockholders (or, more accurately, by their surrogates, corporate managers) and accordingly are designed to promote the self interest of the majority stockholders. Referring back to the discussion in Part I, a freezeout, like any other corporate transaction, can advance majority stockholders' financial self interest only through an increase in the total value of the stockholder-only universe or through an expropriation by majority stockholders of part of the wealth of the minority stockholders.\(^7\)

A freezeout fueled by the first of these incentives, an increase in the total wealth in the stockholder-only universe, would meet the business purpose test. This conclusion is predicated on the premise that a move that advances total stockholder wealth is a move that advances a valid business purpose of the "corporation."\(^6\) This wealth-increasing freezeout would also be a Pareto superior move within the stockholder-only universe, assuming, of course, that minority stockholders' value is not expropriated in the transaction.

Managers acting on behalf of a majority stockholder may, however, have an incentive to pursue a freezeout that does not increase the total stockholder wealth if the freezeout is a vehicle through which the majority stockholder is able to expropriate part of the value of minority stockholders' interest in the corporation. In such a case, where the transaction does not increase total stockholder wealth but, instead, is fueled solely by expropriation, the freezeout is without a "legitimate corporate purpose" and thus is illegal. Prohibiting such a freezeout under the business purpose doctrine is, again, consistent with Pareto criteria, since that freezeout, by definition, makes losers of minority stockholders.

The results under the business purpose analysis in a third factual configuration, however, are impossible to explain under Pareto criteria.

\(^7\) See supra notes 10-27 and accompanying text. Majority stockholders' interest can, of course, be advanced by a combination of an increase in total stockholder wealth and expropriation of minority wealth.

\(^6\) Typically, for example, courts are willing to find a business purpose if the elimination of minority stockholders generates financial savings or efficiencies. See, e.g., Cross v. Communication Channels, Inc., 456 N.Y.S.2d 971 (Sup. Ct. 1982); Laird v. Interstate Commerce Commission, 691 F.2d 147 (3d Cir. 1982).
In this situation, the freezeout is value-maximizing within the stockholder universe, but at the same time expropriates part of the value of the minority stockholders’ interest in the corporation. Assume for example that by freezing out the minority stockholders the corporation is able to save reporting expenses under the Securities Exchange Act of 1934 (“1934 Act”)\(^7\) and able to eliminate certain recordkeeping expenses necessary to allocate employees and services between the parent and the subsidiary. At the same time, however, the terms of the freezeout underpay the minority stockholders for their interest in the corporation. Thus, the majority stockholder gains two ways: by the savings (which are an increase in the wealth of the stockholder-only universe) and by underpaying the minority for their interest.

In this factual configuration, the freezeout would likely survive against an attack alleging that it had no valid business purpose, because the total wealth in the stockholder-only universe increases as a result of the savings generated by the forced elimination of the minority stockholders. The freezeout, however, is not a Pareto superior move in the stockholder-only universe, since the minority stockholders are made losers. As a result, failing to forbid the freezeout under the business purpose doctrine is not an outcome that is consistent with Pareto criteria.

To conclude, however, that the business purpose doctrine does not always ensure an outcome that is consistent with Pareto criteria does not mean that managers are free to facilitate freezeouts that create losers. Such non-Pareto freezeouts as the one described above, which may be permissible under the business purpose doctrine, still cannot pass muster under common law fiduciary concepts, since the transactions fail the intrinsic fairness test.

As stated at the beginning of this section, jurisdictions that apply the business purpose doctrine also continue to apply the intrinsic fairness test to freezeouts. *Weinberger v. UOP, Inc.*\(^8\) and other cases\(^9\) emphasize that the obligation to pay a fair price to stockholders is the very heart of the intrinsic fairness requirement. Accordingly, even if a freezeout that

\(^7\) 15 U.S.C. § 78a (1934) [hereinafter “1934 Act”].

\(^8\) 457 A.2d 701 (Del. 1983).

increases total wealth in the stockholder-only universe but expropriates minority stockholder value is considered to meet the business purpose test, the transaction does not meet the intrinsic fairness test since the minority stockholders do not receive a “fair price” for their stock. While courts and commentators over the years have expressed differing views about the calculation of “price” within the intrinsic fairness test, the raw expropriation of minority stockholder wealth by the majority is impossible to reconcile with the fair price obligation in such transactions.

Together, therefore, the business purpose test and the intrinsic fairness test protect against non-Pareto freezeouts. The business purpose test requires that the freezeout be value-maximizing, and the intrinsic fairness test prohibits freezeouts that make minority stockholders losers.

This discussion, however, raises the question of whether the business purpose doctrine is merely superfluous, in light of the ubiquitous application of the intrinsic fairness doctrine to all freezeouts. Delaware, of course, in Weinberger v. UOP, Inc. concluded that the doctrine had (in an amazingly short time) outlived its usefulness and that minority stockholders subjected to freezeouts were adequately protected by the intrinsic fairness doctrine alone.

The Delaware court was probably on sound ground when it eliminated the business purpose doctrine, since the Pareto function of that doctrine, which is to ensure that the freezeout is wealth-maximizing for the stockholder-only universe, is also performed by the intrinsic fairness test. Assume, for example, that a freezeout is not a wealth-enhancing move for the stockholder-only universe but, instead, is driven entirely by expropriation. In that case, the price received by minority stockholders, which impounds the negative value of an expropriation in the context of a non-wealth-enhancing freezeout, necessarily creates a loss for minority stockholders.


81 457 A.2d 701 (Del. 1983).

82 Delaware adopted the business purpose doctrine in 1977 in Singer v. Magnavox, 380 A.2d 969, 979 (Del. 1977) and repealed the doctrine six years later in Weinberger, 457 A.2d at 704.
stockholders and thus violates the fair price component of the intrinsic fairness test. The intrinsic fairness test, therefore, even without help from the business purpose doctrine, appears to ensure that freezeouts both are limited to wealth-maximizing transactions and create no losers in the relevant universe.

While one may conclude that the business purpose doctrine is superfluous, the general common law hostility toward freezeouts, which led courts, perhaps without necessity, to adopt the business purpose doctrine, is understandable in relation to a commitment to Pareto criteria, reflecting, it seems, the judgment by courts that freezeouts are driven more by expropriation than by efficiencies. Freezeouts that expropriate value from minority stockholders, of course, create losers and thus are not Pareto superior moves.

The savings or efficiencies proffered by majority stockholders as a justification for freezeouts must always be evaluated closely. Broadly stated, savings in agency costs should result if the number of owners is reduced from a significant number of owners to one owner, which is the typical result of a freezeout. These savings might result from the elimination of the strictures of compliance with the reporting and other requirements under the 1934 Act and certain recordkeeping costs, such as the cost associated with allocating the salary of employees who may serve both the subsidiary and its parent.

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83 Easterbrook and Fischel offer up the following as examples of gains from freezeouts: “economies of scale, centralized management and corporate planning, . . . economies of information”; reduction in “the cost of policing conflicts of interest”; ability of the merged firm “to make additional cost-justified investments”; “lower agency costs”; elimination of “costs attributable to public ownership”; gains that result from the fact that the concentration of ownership “facilitates a takeover” by eliminating the free rider problem. Frank H. Easterbrook & Daniel R. Fischel, Corporate Control Transactions, 91 YALE L.J. 698, 706 (1982).

84 A freezeout is not necessary to avoid duplication of functions in the parent and the partially owned subsidiary. If the two companies need only one personnel manager, for example, the extra personnel manager can be terminated, even without a freezeout merger, and each company can pay its pro rata cost of the single, shared personnel manager. What the freezeout merger would eliminate, therefore, is not the extra personnel manager but the recordkeeping necessary to allocate the personnel manager’s time between the two companies.
Such savings may in a relative sense, however, be modest, and the more likely benefit to majority stockholders may come from the possibility of expropriating the wealth of minority stockholders. Much has been written about the considerable strategic and informational advantages that insiders have over outsiders in various “rebargaining” situations.

85 The significance of the relativity of the size of the savings from the freezeout compared to the size of the company and its other expenses and revenues should not be overlooked. Thus for example, an annual savings of $100,000 is a stronger incentive for a $1 million dollar company than it is for a $1 billion company.

86 For example, as described supra note 84, elimination of duplicative positions between the parent and the partially owned subsidiary does not depend on a freezeout.

The savings associated with elimination of the applicability of the 1934 Act to a company is an interesting matter and difficult to estimate. In a quiet, typical year, the principal obligations of a 1934 Act company that generate costs are the periodic reporting requirements and the proxy solicitation requirements. Even in a quiet year, the company will encounter other, less significant costs due to the 1934 Act (companies typically assist their officers and directors in their filings under Section 16(a)), and in an unusual year, such as a year in which the company may be involved in a takeover contest or a self-tender, the 1934 Act can generate significant additional costs.

Costs to the company generated by the 1934 Act include the internal costs of employees who prepare SEC filings and the external costs of attorneys and auditors. One CEO of a 1934 Act company with 215 employees and $22 million in annual revenue estimated annual reporting costs to be $50,000 for attorneys’ and auditor’s fees. See Rami Grunbaum, Go Public! Cheap! Fast!, PUGET SOUND BUS. J., Nov. 20, 1989, at 2. Having had experience representing companies in 1934 Act filings, these estimates seem high to me, at least if the numbers are offered as the savings a 1934 company will recognize in quiet years if it is able to avoid the jurisdiction of the 1934 Act. One must recognize, in that regard that many of the 1934 Act expenses may be so intertwined with other aspects of the business that no savings will result. For example, accounting data, information about management, etc., may be required by other regulatory agencies, lenders, or the public generally. It seems unlikely that the information demanded by the Securities Exchange Commission about the partially owned subsidiary will become unimportant or unnecessary to collect and render merely because certain owners are eliminated at the subsidiary level.
tions, including freezeouts. If one imagines a freezeout involving minority stockholders of a company having assets of $500 million, an efficient exploitation of majority stockholders' strategic and informational advantages may seem likely to generate more new value for the majority stockholder than the majority stockholder could expect from elimination of agency costs, such as recordkeeping for shared functions and reporting under the 1934 Act. In freezeouts, therefore, courts may well conclude that majority stockholders in most instances probably can make more money from expropriation than from efficiencies. The hostility toward freezeouts is likely explained in this manner.

For example, the following articles deal with the possible advantages that corporate managers (the insiders) have over public stockholders (the outsiders) in bargaining for the nature and scope of duties that corporate managers owe to stockholders: Victor Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 COLUM. L. REV. 1403, 1420 (1985) [hereinafter Brudney, Corporate Governance] ("[I]nvestors in large publicly held corporations have little or no ability to choose or negotiate the terms of management with original owners who go public or with corporate management . . . ."); Melvin A. Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1521 (1989) ("It is no more likely that buyers in an initial public offering would know of variations in core fiduciary and structural rules than that buyers of insurance policies will know the fine print in their policies."); Thomas L. Hazen, The Corporate Persona, Contract (and Market) Failure, and Moral Value, 69 N.C. L. REV. 273, 300 (1991) ("Consent is no more meaningful in a firm that is about to go public than it is in a firm that is already publicly held.").

Professor Brudney has written extensively about the bargaining failures when preferred stockholders (the outsiders) bargain with common stockholders and their surrogates, corporate managers (the insiders), regarding the alteration of the terms of the preferred stockholders contract. Brudney, Standards of Fairness, supra note 46. This matter generally was the subject of extensive earlier literature. See, e.g., Becht, supra note 46, at 565; Dodd, supra note 46; Latty, supra note 46.

See generally Brudney & Chirelstein, A Restatement, supra note 7, at 1354; and Victor Brudney & Marvin A. Chirelstein, Fair Shares in Corporate Mergers and Takeovers, 88 HARV. L. REV. 297 (1974) [hereinafter Brudney & Chirelstein, Fair Shares], which proffer, among other things, the majority or insider advantage through control of the proxy machinery. Superior bargaining power against fractured interests, control of transaction timing, and knowledge of pending upturns in the corporate future which knowledge is non-public and not reflected in the market value of shares.
3. Revlon Duties

In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., the Delaware Supreme Court held that once the break-up of the target, Revlon, "was inevitable," the duty of Revlon's board "changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at the sale of the company." So stated, these Revlon duties (this form of the Revlon duties is hereinafter referred to as "Revlon's affirmative duties") seem unremarkable and entirely consistent with the obligation of corporate managers to pursue Pareto superior states on behalf of the stockholder-only universe, since stating that in the sale of the target company the target managers must get "the best price for the stockholders" is merely to articulate in specific circumstances the obligation to maximize the total value of the stockholder-only universe.

The negative implication of Revlon (hereinafter referred to as "Revlon's negative implication") is a problem, however, since the indication is that at all other times (i.e., at all times in a corporation's life except when the break-up is inevitable) the fiduciary duties of the board of the target do not require the board to pursue wealth maximization on behalf of the stockholder-only universe. Thus, in the context of a

89 506 A.2d 173 (Del. 1985).
90 Id. at 182. In 1985, the Delaware Supreme Court indicated that the Revlon duties attach when the target is to be broken up. Revlon, 506 A.2d at 173, 185. In 1989, in Paramount Communications Inc. v. Time Inc., 571 A.2d at 1150, the same court concluded that Revlon duties attach when a company "initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company" and also when "in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the break-up of the company." In 1994, the Delaware Supreme Court held that the Revlon duties attach when there is a "sale or change of control" of the target. Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 42 (Del. 1994). In a confusing footnote in that case, however, the court stated that it uses "the terms 'sale of control' and 'change of control' interchangeably without intending any doctrinal distinction." Id. at 42 n.10.
91 Language in Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 37, 43 n.13 (Del. 1994) continues this negative implication ("Under the circumstances of this case, the pending sale of control ... required the Paramount Board ... to secure the best value reasonably available to the stockholders. ... [W]here a potential sale of control by a corporation is not the consequence of a board's action, this Court has recognized the prerogative of a board of directors to resist a third party's unsolicited acquisition proposal or
hostile acquisition, for example, this means that if the target’s board
determines not to accede to the hostile takeover bid but, instead, to fight
to retain its control of the target, the board may engage in defensive
tactics that fail to maximize stockholder wealth.

Obviously, Revlon’s negative implication cannot be explained by
reference to Pareto criteria, since it permits non-wealth-maximizing
moves by corporate managers. Not surprisingly, therefore, Revlon’s
negative implication generates confusion and difficult interpretation
problems for courts.

The most prevalent interpretation matter for courts in relation to the
Revlon duties is the question of whether a particular situation is governed
by Revlon’s affirmative duties or Revlon’s negative implication. Inevita-
bly, a hostile suitor who believes its bid represents wealth maximization
for the target’s stockholders argues that the circumstances trigger
Revlon’s affirmative duties, while the defensive-minded target board
argues that Revlon’s negative implications control and that, accordingly,
it does not have to accede to the hostile bid, even if the hostile bid is
wealth-maximizing for the stockholder-only universe. Much of the
litigation generated by Revlon, therefore, involves attempts by courts to
define those circumstances where, in the words of the Revlon court, the
“break-up” of the target is “inevitable.” If the “break-up” is “inevita-
ble,” the situation is governed by Revlon’s affirmative duties; if the
“break-up is not “inevitable,” the situation is governed by Revlon’s
negative implication.

Under a broad and consistent application of Pareto criteria, this entire
line of inquiry is unnecessary and, indeed, misdirected. Corporate
managers under Pareto criteria are required to make wealth-maximizing
moves. If the offer of a hostile or friendly bidder for the target is wealth-
maximizing for the target’s stockholder, Pareto criteria dictate that
target’s managers should facilitate the acquisition by the bidder. If, on the
other hand, either the managers of the target are able to manage the target
in a way that renders value to stockholders in excess of the value offered
by the bidder or a second bidder is willing to pay more for the target,
managers of the target should resist the bid of the first suitor.

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92 See, e.g., Paramount Communications Inc. v. Time Inc., 571 A.2d 1140
(Del. 1989); Bershad v. Curtiss-Wright Corp., 535 A.2d 840, 844 (Del. 1987);
Ivanhoe v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987); In re
Santa Fe Pacific Corp., 1995 Fed. Sec. L. Rep. (CCH) ¶ 98,845 (Del. Ch.), aff’d
in part and rev’d in part, 669 A.2d 59 (Del. 1995).
To ask in any of these cases, as the court did in both Revlon\textsuperscript{93} and QVC\textsuperscript{94} whether the targets were "for sale" or whether a change of control was anticipated confuses a Pareto analysis. In all cases, if the obligation of corporate managers is to pursue Pareto superiority by maximizing the value of the stockholder-only universe, whether or not in the mind of the target's board the company is "for sale" is entirely irrelevant.

Part of the explanation for Revlon's negative implication may be the sensitivity of courts to the increasing pressures that a complex and acquisition-minded business climate puts on managers, which, in turn, increases at least one aspect of agency costs.\textsuperscript{95} Articulating fiduciary obligations in this area in terms that more closely approximate Pareto criteria and thus rejecting Revlon's negative implication would mean that managers could never just say in the face of an offer to acquire their company that "the company is not for sale." Even more extreme, managers would be saddled with the ubiquitous obligation to troll for suitors. Courts may fear that such a persistent obligation on managers to treat every offer of acquisition seriously and affirmatively to search for suitors who can manage more efficiently than they would be oppressive to managers. In an economic sense the obligation may raise agency costs and thus ultimately result in a net loss for stockholders. Such pressures, in other words, would create their own inefficiencies.

These concerns, however, are unfounded. If Revlon's negative implication is eliminated, managers will be obligated to invest in searching for and responding to bids by suitors only to the extent that such conduct moves the stockholder-only universe to a Pareto superior state. In other words, managers should invest in such activity only if it is profitable. Further, if the failure of managers to invest in this activity is challenged by, for example, an unhappy stockholder who claims that managers are not aggressive enough in pursuing suitors, managers are protected by the due diligence defenses of the business judgment standard or the negligence standard applicable in duty of care cases. Managers are liable, therefore, only if their failure to pursue suitors or respond to a bid is either a deviation from ordinary care or an extreme deviation from ordinary care.


\textsuperscript{94} Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34 (Del. 1994).

\textsuperscript{95} In simple economic terms, if pressures on managers and thus risks of personal liability increase, managers will charge the stockholders more for their management services, which increases one form of agency costs. On the other hand, to the extent managers manage more efficiently because of the increased pressures, agency costs decrease.
In any event, *Revlon*’s negative implication is impossible to square with the Pareto criteria that courts otherwise apply in fiduciary duty situations. Additionally, *Revlon*’s affirmative duties add nothing to the longstanding, previously well-articulated obligation of managers to maximize the total wealth of the stockholder-only universe, a duty that is part of Pareto criteria. One would therefore expect courts to discard any separate articulation of the *Revlon* duties.

C. The Limits (Apparent and Real) of the Pareto Analysis

1. Permissible Non-Pareto Moves by Managers

Corporate managers sometimes, and often without serious challenge, intentionally undertake transactions that appear to diminish the financial well-being of particular stockholders. Such moves seemingly are inconsistent with an obligation to pursue Pareto superior states on behalf of the stockholder-only universe, and thus the outcomes in these cases require some explanation.

Perhaps the most obvious example of such a move by corporate managers is a call or redemption of preferred stock. A decision by a board of directors to exercise a preferred stock redemption privilege appears to generate a loss for the redeemed preferred stockholders, since the redemption denies the preferred stockholders the right to participate in any increase in value in their stock caused by, most typically, falling interest rates.96 One might assume, therefore, that such preferred stockholders could legitimately claim that the directors initiating the call violated their fiduciary duty to the preferred stockholders by effecting a non-Pareto superior move.

Generally, except for a few cases involving special circumstances not relevant to this discussion,97 no serious challenge to the right to redeem callable preferred stock is made. The reason courts are not prepared to prevent such redemptions as inconsistent with the common law fiduciary

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96 For a description of the economics of call provisions generally, see JAMES C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 573-75 (9th ed. 1992) (describing the impact and pricing of call provisions in debt instruments).

97 In Delaware ex rel. Waldman v. Miller-Wohl Co., 28 A.2d 148, 152 (Del. Super. Ct. 1942), for example, the court rescinded a redemption that it apparently believed was intended only for the purpose of ridding the company of a preferred stockholder who had made certain demands for inspection of corporate books and records. Zahn v. Transamerica Corp., 162 F.2d 36, 38 (3d Cir. 1947), involved the exercise of a redemption right without the disclosure of material information that would have led preferred stockholders to exercise their conversion rights instead of taking the cash offered pursuant to the redemption provisions.
duties of managers is because the preferred stockholders contracted for and were paid to take the risk of the redemption. In Pareto terms, therefore, courts can assume that the parties to the contract (i.e., the preferred stockholders, on the one hand, and the corporation or the common stockholders, on the other hand) made an *ex ante* Pareto superior move by agreeing at the time the preferred shares were sold to the redemption provision. The consent by the parties to that trade (i.e., the voluntariness of the agreement regarding the terms of redemption) demonstrates that both parties to the transaction considered themselves at the time of the sale better off as a result of the trade, and no third party effects are apparent as a result of the transaction. Courts enforce the contract and the subsequent move by managers in calling the preferred stock, therefore, as a way to ensure that such *ex ante* Pareto superior moves by parties are possible.

Managers of corporations undertake a myriad of other moves that, considered alone, seem to permit them to expropriate at least some portion of the value of one group of stockholders for the benefit of another group of stockholders. Another example of such a move by managers is found in the old dividend credit cases\(^9\) in which preferred stockholders claimed that the failure by corporate managers to pay non-cumulative preferred dividends violated the fiduciary duties they were owed.\(^9\) Other examples of such cases

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\(^9\) The discussions of the courts in these cases did not always focus on fiduciary duties as a limit on the refusal to pay non-cumulative preferred dividends. Since, however, the preferred stockholders' contract omitted any term regarding a right to any past, unpaid dividends, the claim of the prefereds to arrearages necessarily invoked other bases, and some non-contractual, overarching fiduciary duty was inevitably the heart of the matter.
include managers’ decisions to pay dividends on common stock,\textsuperscript{100} repurchase common stock,\textsuperscript{101} or defer the paying off of arrearage on preferred stock.\textsuperscript{102} Even such managers’ decisions as making an unusually risky investment\textsuperscript{103} or adding significantly to the company’s debt\textsuperscript{104} can effect a wealth transfer between or among certain stockholders.

\textsuperscript{100} Paying dividends on common stock may reduce the value of the preferred stock by reducing the pool of assets available to meet the obligations owed to preferred stockholders.

\textsuperscript{101} Preferred stockholders can be harmed by repurchases of common stock, since the outflow of corporate assets may increase the risk that the company will be unable to meet its obligations to such preferred stockholders.

\textsuperscript{102} Preferred stockholders whose dividends are in arrears will benefit by the rapid or immediate elimination of the arrearage. Any delay in elimination of the arrearage, therefore, is contrary to the best interests of preferred stockholders.

\textsuperscript{103} Commentators have pointed out that fixed investors, such as preferred stockholders, and residual investors, who are the common stockholders, may have different investment objectives. Thus, even if a particular investment maximizes the value of the corporation, it may nonetheless reduce the wealth of fixed investors, who have no right to participate in earnings above their fixed, contractual amount. See, e.g., Hurst & McGuinnis, supra note 6, at 195.


The same principles of expropriation apply with respect to the investment of preferred stockholders. Specifically, the addition by a company of large amounts of debt can adversely affect the value of the preferred stockholders’ investment by making the company’s ability to live up to its obligations to preferred stockholders more uncertain.
An explanation for the permissibility of all of these moves by managers, each of which appears, at least to some extent, to make losers of some stockholders and thus not be a Pareto superior move, is the same as the explanation offered regarding the redemption of preferred stock. In all these instances courts can conclude that the parties made an ex ante Pareto superior move in striking the original bargain and that, therefore, the courts’ enforcement of the bargain is essential to protect the Pareto superior trade.

2. The Obligation to Share Gains

Pareto criteria provide no rules for the sharing of any gains that may be generated by corporate transactions. Accordingly, a Pareto superior move is not made otherwise by the fact that one of the parties in the relevant universe is able to garner most or even all of the gain from the move. For example, return to Figures A and B and the accompanying discussion in Part I of this Article.\(^{105}\) The fact that all of the value created by the purchase of the profitable machine, represented in Figure B by the area between circles \(V'\) and \(V^2\), is captured by the common stockholders does not render the purchase a non-Pareto superior move.

Consistent with this, courts in most instances do not require managers, as a part of their fiduciary duties, to allocate gains among stockholders pursuant to any prescribed pattern.\(^{106}\) Instead, the limit of managers’ duties is set by the obligation to pursue Pareto superior states for stockholders as a group. Referring again to Figures A and B and the discussion in Part I, therefore, managers’ fiduciary duties do not require that they carve out and render to preferred stockholders any part of the gain from the purchase of the profitable machine.

To a significant degree, the failure by courts to prescribe any pattern of gain allocation may be driven by the same idea expressed in the

105 See supra notes 9-10 and accompanying text.

106 Even in more significant transactions, cases often indicate no obligation to share gains. See, e.g., Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 114 (Del. 1952) (“[U]pon a merger the minority stockholder shall receive the substantial equivalent in value of what he had before.”). Judge Easterbrook and Professor Fischel have offered economic justifications for an unequal apportionment of gains in the context of acquisitions. See Easterbrook & Fischel, supra note 83, at 708-11. Not surprisingly, Professors Brudney and Chirelstein, express a contrary view. Brudney & Chirelstein, Fair Shares, supra note 88, at 297.
immediately preceding section. Accordingly, preferred stockholders in Figures A and B, by electing not to be the residual beneficiaries, consented to the allocation of most or all of such gains to common stockholders. In such circumstances, courts may be content that the preferred and common stockholders contracted ex ante for the allocation of gains, a contract that was itself a Pareto superior move by the parties. By staying out of the matter and permitting the contract to govern, therefore, courts further a Pareto superior outcome.

Occasionally, however, courts have ventured into the area of gain allocation as a part of their monitoring of corporate fiduciary duties. Two examples of such cases are Levin v. Great Western Sugar Co. and Mills v. Electric Auto-Lite Co. Although Levin proceeded under a state law intrinsic fairness test, while Mills involved a claimed violation of the federal proxy antifraud provision contained in Rule 14a-9, both cases involved claims by minority common stockholders that they were treated unfairly when the majority stockholders grabbed all the gains generated in an affiliated merger. The courts in both cases held that the majority stockholder must share with minority stockholders the gains generated in the transactions.

Obviously, the outcomes in cases such as Levin and Mills, which require apportionment of gains between or among various stockholders, are not dictated by the obligation of managers to pursue Pareto efficiency. Further, these outcomes are inconsistent with the more usual outcomes in

107 See supra notes 96-104 and accompanying text. Another, perhaps more cynical, reason one may find for the general absence in the common law of an allocation of gain obligation is the difficulty and ubiquity of the problems created by any mandatory allocation requirement. See Campbell, Corporate Fiduciary Principles, supra note 3.

110 406 F.2d at 1114.
111 552 F.2d at 1240.
112 406 F.2d at 1114; 552 F.2d at 1240.
113 406 F.2d at 1120; 552 F.2d at 1250.
which courts prescribe no special rules of apportionment of gain. Unfortunately, neither Levin nor Mills articulate any principled reason why in those cases, as opposed to other situations, fiduciary duties require a particular pattern of gain sharing.\textsuperscript{114}

3. The Limited Universe

This Article defines the obligations of corporate managers to pursue Pareto superior moves within a universe limited to corporate stockholders. This somewhat esoteric statement of the obligations of corporate managers is more understandable and more usually stated in terms of the rule that corporate managers owe no fiduciary duties to corporate constituencies\textsuperscript{115} or interests other than stockholders.\textsuperscript{116}

\textsuperscript{114} The author has written normatively on the question of whether or not managers should be left unfettered in the allocation of gains. See Campbell, Corporate Fiduciary Principles, supra note 3.

\textsuperscript{115} The term "corporate constituencies" is applied to various groups of entities that have some relationship with or investment in the corporation. The constituencies that have attracted the most attention in recent years include the following: corporate creditors, see, e.g., infra note 122, employees, see, e.g., Maureen A. O'Connor, Restructuring the Corporation Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers, 69 N.C. L. Rev. 1189 (1991); Katherine V. Stone, Employees as Stakeholders under State Nonshareholder Constituency Statutes, 21 STETSON L. REV. 45, 48-53 (1991), suppliers and the community in which the corporation (or a part of the corporation) is located, see Campbell, Corporate Fiduciary Principles, supra note 3.

\textsuperscript{116} This, of course, is a longstanding, well-established rule of corporate law that probably has been discussed most often with regard to whether creditors are owed any fiduciary duty or are able to enforce fiduciary duties derivatively. See, e.g., Henry W. Ballantine, CORPORATIONS 184 (rev. ed. 1946) ("Creditors have no direct right of action against directors or officers for mismanagement . . . by the better view."); see also the following cases, which are consistent: Nuclear Corp. v. Hale, 355 F. Supp. 193, 198 (N.D. Tex.), aff'd, 479 F.2d 1045 (5th Cir. 1973) ("[I]f officers of a corporation act in good faith and with prudence and diligence they are not personally liable to creditors for the corporation's insolvency absent fraud or some provision of positive law."); Skinner v. Hulsey, 138 So. 769, 773 (Fla. 1931) ("Directors are not liable to the creditors on the theory of being fiduciaries."); Conrick v. Houston Civic Opera Ass'n, 99 S.W.2d 382, 385 (Tex. 1936) ("Directors are not personally liable to creditors for mismanagement, or for waste of assets except upon proof of the
Often, corporate managers’ wealth-maximizing moves on behalf of a stockholder-only universe are at the expense of other corporate constituencies, although the vast majority of such moves raise no significant objections or even attract any attention. For example, a decision by managers to switch from Supplier A, who is able to supply superior quality widgets for $10, to Supplier B, who is able to supply superior quality widgets for $5, increases the wealth of the stockholders at the expense, at least to some extent, one might argue, of Supplier A, its owners and employees. No one seems to question, however, the propriety of the obligation of corporate managers to switch to the more efficient supplier of widgets, even though the move creates losers in Supplier A and its constituencies.

Notwithstanding that courts over the years usually have limited the scope of fiduciary duties to the protection of stockholders or, in the terms of this Article, applied the Pareto superior obligation to a stockholder-only universe, courts have occasionally in compelling circumstances expanded the universe protected by the fiduciary obligations beyond that of stockholders. Generally, however, such cases are isolated and


Derivative remedies are also generally unavailable for creditors for any breach of fiduciary duties by managers. See, e.g., REVISED MODEL BUSINESS CORP. ACT § 7.41(1) (1994); PRINCIPLES OF CORPORATE GOVERNANCE § 7.02 (American Law Institute 1994).

117 E.g., Swinney v. Keebler Co., 329 F. Supp. 216, 224 (D.S.C. 1971) (holding that a dominant shareholder owed a fiduciary duty to debenture holders not to sell the corporation to a looter), rev’d, 480 F.2d 573, 578 (4th Cir. 1973)
aberrational.\textsuperscript{118}

(reversing the district court because the facts were insufficient to show that the dominant shareholder should have been suspicious of the purchaser); see also, e.g., Pepper v. Litton, 308 U.S. 295, 306-07 (1939) (holding that a dominant shareholder owes a fiduciary duty to creditors when dealing with the corporation and the burden is on the dominant shareholder to prove good faith and inherent fairness of the transaction from the point of view of the corporation); Ford Motor Credit Co. v. Minges, 473 F.2d 918, 920-21 (4th Cir. 1973) (applying North Carolina law to find that "where a creditor . . . has sustained an identifiable loss peculiar and personal to himself by reason of the fraud or negligent mismanagement of the corporation's business by its directors, he has a cause of action against the directors . . . ."); W. H. Elliot & Sons Co. v. Gotthardt, 305 F.2d 544, 547 (1st Cir. 1962) (holding that a transfer by a debtor corporation to a "newly organized corporation, thinly financed with $1,000 capital and 40% of whose common stock was owned by [the debtor's officers]" could involve a fiduciary duty violation by that officer); United States v. AT&T, 552 F. Supp. 131, 205 (D.D.C. 1982) (holding that a majority shareholder in local operation companies to be divested under proposed antitrust consent decree "has the fiduciary duty to protect all those with interests in these companies, including creditors."); aff'd mem. sub. nom. Maryland v. United States, 460 U.S. 1001 (1983); Sternberg v. Blaine, 17 S.W.2d 286, 288 (Ark. 1929) ("[T]he director whose negligence causes loss is liable for such losses to stockholders and creditors."); Western Producers Co-Operative v. Great Western United Corp., 613 P.2d 873, 878 (Colo. 1980) (holding that a contract requiring the directors to use their "best efforts" to gain approval of the debenture holders for recapitalization did not give the directors authority to violate their legal duties of "fidelity, good faith, and prudence with respect to the interests of the debenture holders"); Francis v. United Jersey Bank, 432 A.2d 814, 824-25 (N.J. 1981) (finding a corporate director personally liable in negligence for failure to prevent misappropriation of trust funds by other directors who were also officers and directors of the corporation); Underwood v. Stafford, 155 S.E.2d 211, 212 (N.C. 1967) (holding that under the North Carolina "trust fund doctrine," "the officers and directors occupy fiduciary position in respect to stockholders and creditors, which charges them with the presentation and proper distribution of those assets."); Anthony v. Jeffress, 90 S.E. 414, 415 (N.C. 1916) (holding director liable to creditors for damages due to "negligence, fraud or deceit.").

\textsuperscript{118} McDaniel, however, opines that "California courts recognize . . . a fiduciary duty to bondholders." McDaniel, Bondholders and Stockholders, supra note 6, at 275.
More recently, the spate of highly leveraged acquisitions of the 1980s generated a number of cases, some of which confused the universe with respect to which the fiduciary duties of corporate managers are defined. In one case growing out of these acquisitions, Metropolitan Life Insurance Co. v. RJR Nabisco, Inc., the bondholders mounted a nearly direct attack of the concept of the limited universe. The bondholders of RJR Nabisco claimed that as a result of the acquisition of RJR Nabisco the value of their bonds was "drastically impaired,... in effect, misappropriating the value of those bonds" for the benefit of stockholders, who, the plaintiffs claimed, received an "enormous windfall." The RJR Nabisco court, however, easily denied the claims of the bondholders, in part based on its conclusion that no fiduciary duty was owed to creditors.

The outcome in the RJR Nabisco case is not surprising, since it is consistent with the obligation of corporate managers to pursue Pareto superior states on behalf of the stockholder-only universe. The highly leveraged transaction in RJR Nabisco apparently increased the total value of the stockholder-only universe and created no losers within that universe, and, therefore, the transaction was a Pareto superior move within the relevant universe. Losers were created, but those losers were bondholders, who, of course, are not part of the relevant universe.

In fact, the consistent application of the Pareto criteria to the stockholder-only universe means not only that managers of RJR Nabisco were permitted to engage in this wealth-transferring transaction, but also that they were required to do so. Failure to increase the stockholders' wealth through expropriation would have been a violation of the managers' fiduciary duty to the same extent as would be a failure to switch to the more efficient supplier of widgets in the prior example. The outcome in RJR Nabisco, therefore, is entirely appropriate in the sense

120 Id. at 1506.
121 Id. at 1524.
that it is consistent with the Pareto obligations of RJR Nabisco’s managers.

In theoretically closely related cases, however, the responses of courts have been more equivocal regarding the obligation of corporate managers to promote only the interests of stockholders. In these cases, target managers were sued by their stockholders as a result of defensive tactics employed by the managers in response to hostile takeovers. Managers then defended their tactics by claiming that their actions benefited other, non-stockholder constituencies, such as creditors or employees, and that, as a result, such defensive tactics were appropriate. Disgruntled stockholders, however, claimed that the particular tactics did not maximize stockholder wealth and thus violated the fiduciary obligations owed to them.

The disposition of these issues should have been as easy for courts as those generated in the more direct attacks in cases such as RJR Nabisco. Strangely, however, courts had more trouble here. In Revlon, for example, when the board of the target attempted to defend a particular defensive tactic on the grounds that the move helped stabilize the price of certain of the target’s publicly held debt instruments, the court equivocally and confusingly answered that managers may have regard for various constituencies in discharging their responsibilities, provided there are “rationally related benefits accruing to the stockholders.” Later, in Paramount Communications Inc. v. Time Inc., the Time board attempted to legitimize its actions in that heated takeover contest by, inter alia, the need to protect Time’s “culture,” which clearly incorporated the interests of constituencies other than the Time stockholders. While not mentioning the “Time culture” specifically, the Delaware court added to the confusion created in Revlon by concluding that target boards, such as Time’s, when dealing with takeovers can consider “the impact [of such takeovers] on ‘constituencies’ other than shareholders . . . .”

The courts in both Revlon and Paramount Communications Inc. v. Time Inc. head down the same wrong track. The simple answer in both

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125 571 A.2d 1140 (Del. 1989).
126 Id. at 1152. Time’s “culture” consisted of “its perceived editorial integrity in journalism.” Id.
127 Id. at 1153.
of those cases is that the creditors and the "Time culture" count for nothing in the analysis. In light of the long-standing, relevant universe for judging the appropriateness of corporate managers, concern for neither creditors nor the "Time culture" can justify any defensive tactics, and such defensive tactics by corporate managers are absolutely prohibited if they do not lead to the maximization of stockholder wealth.

The confusion generated by this language from Revlon and Paramount Communications Inc. v. Time Inc. is interesting, however, since it likely indicates moral uneasiness with actions by corporate managers that create losses in other constituencies. Courts may be starting to understand that stockholder wealth maximization can at times be totally or partially based on expropriation from other constituencies that, in the minds of some at least, \textsuperscript{128} deserve protection. Courts may, therefore, be starting to rethink the matter of whether a moral justification exists for limiting the application of the Pareto universe to only stockholders.

If this is the case, however, and accordingly courts no longer have the stomach for a continuing limitation on the relevant universe, such a move by courts to expand the relevant universe beyond stockholders involves a major policy shift away from the longstanding, contrary rule. To state the obvious, such a dramatic change in the common law should be articulated in clear language by any court. The shoddy judicial language on this matter in Revlon and Paramount Communications Inc. v. Time Inc. is insufficient. While one may or may not agree in a normative sense with the outcome in RJR Nabisco, the case, at least, is clear and consistent with the obligation of managers to pursue Pareto superiority only on behalf of corporate stockholders.

CONCLUSION

This Article attempts to explain the fiduciary duties of corporate managers in terms of an obligation by managers to make all possible Pareto superior moves on behalf of stockholders. Courts, of course, recognize the near impossibility of applying Pareto criteria in their pristine form and thus accept certain practical concessions, such as the stockholder-only universe and the use of financial, instead of economic, costs. So modified, however, courts, when dealing with fiduciary duty claims, again and again return to the essential concepts of obligations to maximize wealth and refrain from wealth transfers, concepts which are the essence of the obligation to pursue Pareto superior states.

\textsuperscript{128} See supra note 122.
The Article is intended as a positive analysis, although the Article at times generates something of a prescriptive flavor, as applications of Pareto criteria point toward certain solutions for unresolved or confusing fiduciary duty problems. Thus, for example, the analysis suggests that the obligation of corporate managers to pursue Pareto superior moves on behalf of stockholders may lead courts to declare that lock-ups are per se illegal, that the business purpose doctrine should be scrapped as superfluous, and that the Revlon duties are superfluous in their affirmative form and wrong in their negative form.

The positive analysis of this Article also, hopefully, explains the broad appeal of Pareto criteria. Understandably, courts are attracted to solutions that generate wealth for society without creating individual losers.