The Unethical Exploitation of Shareholders in Management Buyout Transactions

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ABSTRACT. The accurate pricing of securities in the capital markets depends upon the markets being both efficient and fair. In management buyout transactions (MBOs), the price bid by inside managers enhances the efficient pricing of securities but raises a reasonable doubt about the fairness to existing shareholders. This study addresses this fairness question in MBOs and offers short-term and long-term legal alternatives which allow both the efficiency and fairness criteria to be met. In the short-term the case law established in the Basic v. Levinson decision for merger negotiation disclosures should be applied to MBO transactions. Over the longer horizon, legislative changes should be made to existing securities laws. Applying the investor protection principles of the 1933 and 1934 securities acts to MBO transactions will suppress the temptation of managers to extract shareholder wealth for their personal gain.

The pricing of securities in the capital markets has received much attention in the finance, accounting and economics literature. Such attention is justified for at least three reasons. The first reason is the vital role of capital markets for the efficient allocation of productive resources in a competitive market system. Secondly, the results of the resource allocation studies are needed as support for other theories which rely to some extent upon the absence of arbitrage opportunities for their equilibrium results (arbitrage pricing theory and some optimal capital structure models). A third role is in providing evidence to be used in determination of the need for and design of regulations dealing with fair trading among institution and individual investors in the capital markets.

These three objectives can best be met if trading in the financial markets results in the fair and accurate pricing of financial assets. Investors use current price information in conjunction with formed expectations to make their investment decisions. The functioning of the marketplace must be such that both the buyer and seller of a financial asset have an opportunity to trade at what each considers a fair price. After citing a number of legal cases supporting his contention, Norman Bowie (1988) concluded that the underlying concept that should control all business managers is "fairness." When an environment exists so that one of the parties in a trade is precluded from negotiating on an equal footing with the other party, "fairness" is absent and there exists an opportunity for exploitation. One situation where such a potential for exploitation is created is when the managers of a firm choose to purchase the common stock of the firm in a "going private" transaction.

The RJR Nabisco buyout and management/stockholder conflict

On October 21, 1988, F. Ross Johnson, President and CEO of RJR Nabisco, made an offer to the shareholders of that same firm to purchase their shares at a price of $75.00 per share. These shares had a
closing price of $55.875 on the day preceding this offer. As of December 1, 1988, Johnson was offering to pay $112.00 each for those same shares. When the firm was finally sold, the price per share was $109.00. The final purchaser was not Johnson but the investment firm of Kohlberg, Kravis, Roberts & Co. The difference in total market value between what was initially offered and the amount ultimately paid was approximately $7.5 billion. Had this $7.5 billion not been paid to the shareholders it could have ultimately become a profit to Johnson and the other limited number of investors taking over ownership through the transaction. This RJR Nabisco transaction is a recent example of the conflict that can arise between the managers of a corporation and the interests of the stockholders.

What Johnson was attempting to do was to take the firm private by placing ownership in the hands of a few individuals. In any "going private" transaction a group of individuals, frequently current management, will purchase the stock of the firm and thus take total ownership of the corporation. When the purchasing entity is current management the transaction is referred to as a management buyout (MBO). This article will examine some questions about MBOs, and in particular focus on the ethical conflict encountered by managers who have responsibilities to both the purchasers (themselves) of the firm as well as the sellers.

Recently, Parkman et al. (1988) argued that insider trading by employees was not harmful to the capital markets or to the investors who did not have access to the inside information. In their words, "Probably the only effect of the insider's action was that the price increased sooner." (p. 968). Although their research dealt with "insider trading" rather than the immediate question of taking over ownership of the entire firm, the issues are directly related. The difference lies in who is experiencing the windfall gain — managers or other traders. The results of the research offered here will be in disagreement with the contention of Parkman et al. on ethical grounds.

To accept the argument of Parkman et al. that the value would have increased anyway is similar to accepting the condition that it does not matter who has the wealth as long as total wealth actually exists. Although the authors are on a sound footing when viewed from the perspective of efficient markets, such reasoning goes totally against the intent of virtually all security laws.

Information and the security markets

A primary feature of the securities laws is to provide full disclosure to the investor to allow a fair and equitable pricing and marketing of securities. The registration requirements of the Securities Act of 1933, and the continued reports required by the Securities Exchange Act of 1934 were unquestionably designed to eradicate any fraudulent or deceptive practices which exploited investors not having open access to the information needed to make an informed judgement. Interpreting these laws to include MBO transactions would surely be of benefit to the investing public and reduce the ethical conflict between management and stockholders in MBO transactions.

Information is of vital importance to any investor attempting to achieve profitable financial investment in the capital markets. Investors understand the existence of uncertainty and include this lack of information as a variable to be considered when they undertake financial investments. The amount of uncertainty due to information is not constant across investors. As Gilson (1986) made clear in his book, the information set used by an investor can vary from being fully informed about certain information, such as knowledge of prior prices, to being completely uninformed, such as inside proprietary knowledge held perhaps only by management. Each investor's knowledge lies somewhere between these two extremes.

Decision-makers in the financial markets make investment choices based upon the information they have available and their interpretation of that information. In a hypothetically, perfect capital market environment where information is equally available to all participants in the market, the selection of the "best" alternative for each investor is axiomatic. However, under less than perfect conditions, the uncertainty encountered most likely will cause the ex-post outcome to be different from what may have been considered the "best" investment, ex-ante. Even if, ex-post, the decision is less than optimal, the problem lies not only with the competence of the