Equity Valuation and Corporate Control

Linda Elizabeth DeAngelo
University of Michigan

ABSTRACT: The proliferation of control contests for large public corporations at 50% + premiums above market illustrates the wide divergence between open-market stock prices and equity exchange values. This paper considers equity valuation in corporate control transactions—e.g., management buyouts and hostile takeovers—that engender potentially severe manager-stockholder conflicts. These conflicts generate a demand for independent assessments of equity values by investment bankers who specialize in these appraisals. The paper provides evidence from (1) a large sample of fairness opinions on management buyouts, and (2) a small sample of investment bankers’ working papers which indicates that investment bankers’ valuation techniques make extensive use of accounting data. This demand for accounting information in equity valuation is distinct from that previously recognized in the capital markets or contracting literatures.

Equity exchange values in corporate control transactions—e.g., mergers, tender offers, management buyouts, leveraged recapitalizations—routinely deviate substantially from open-market stock prices. For example, management buyouts of exchange-listed corporations typically occur at a 50% + premium above the pre-offer stock price (DeAngelo et al. 1984), as do interfirm tender offers (Comment and Jarrell 1987). Moreover, multiple bids for the same firm often differ substantially from each other, and open-market stock prices do not at each moment equal the highest current (or eventual winning) bid (Bradley 1980).

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How are equity exchange values determined? The answer is important because these values divide the gains from a change in corporate ownership between stockholders and other corporate claimants, hence they affect the feasibility of control transactions. The answer is empirically important, given the proliferation of takeovers of large public corporations at 50% + premiums above market. Obviously, a target corporation's pre-offer stock price is an inadequate measure of its acquisition value. Perhaps less obviously, its post-offer stock price is also inadequate, given uncertainty about the outcome of the current bid, the price the current bidder is ultimately willing to pay, and the existence of other bidders and their possible offer terms. In short, capital market efficiency does not ensure that market prices perfectly reveal equity values in each feasible alternative use, and to each feasible alternative user.

The inability to rely on anonymous capital markets to value a given control transaction generates disagreement among stockholders over the exchange values of their claims. Since stockholders' cooperation is required to effect these transactions, such disagreement can potentially cause the failure of transactions that are overall value-increasing. This difficulty is exacerbated because equity exchange values can be negatively affected by the actions of managers who have (1) inside information about the value of target shares in alternative uses, and (2) interests that conflict with those of their stockholder constituents. Manager-stockholder conflicts are especially severe in management buyouts and in hostile takeover attempts that offer target stockholders a substantial premium, while potentially costing managers their jobs.

In this paper it is argued that managerial conflicts of interest in corporate control transactions generate a demand for an independent valuation of shares. The evidence presented indicates that the terms of management buyouts are evaluated by investment bankers whose valuation techniques predominantly rely on accounting information. For example, discounted cash flow techniques employed in practice use historical accounting relations to estimate future cash flows. By imposing impartial, external constraints on equity exchange values, an independent valuation helps ensure these values are perceived as "fair" by the outside stockholders whose cooperation is required to effect a control transaction. This process facilitates transactions that increase overall firm value, yet that also generate manager-stockholder conflicts of interest.

Section I develops the demand for an independent valuation of shares. Section II describes the valuation process and generally accepted valuation techniques. Section III reports evidence from a large sample of management buyouts that investment bankers unanimously cite accounting information as influencing their evaluations of the terms of these transactions. Section IV reports evidence from detailed case studies of a small sample of investment bankers' working papers, recently required to be filed with the SEC for management buyouts, that virtually all valuation techniques used by investment bankers rely on accounting information. Section V provides a brief summary.

1 It is impossible to ascertain whether the primary motivation of participants in this valuation process is to estimate equity values, or simply to justify selected values to outside stockholders and the courts. In either case, accounting information affects equity values to the extent that it defines the feasible range of "fair" values. These issues are discussed in Section II.
I. The Demand for an Independent Valuation of Shares

Insider-managers of corporations with equity claims in place have some ability to take actions that reduce the value of outsiders' claims (Jensen and Meckling 1976). One such action is to issue or redeem equity at other than "intrinsic" value, given managers' superior information. Competitive capital markets imperfectly protect outside stockholders from these welfare-reducing transactions when information is costly (Myers and Majluf 1984). Stock prices reflect the expected value of managers' inside information, conditional on the proposed transaction. While expectations should be realized on average, the shares of a given firm will trade at other than intrinsic value. Thus, issuing and redeeming shares at market prices does not ensure "fair" treatment of all stockholders or resolve all intra-stockholder conflicts over share values.²

When a corporation originally sells shares to outsiders, the offer price will reflect investors' perceptions of managers' ability to effect welfare-reducing equity transactions. Hence, managers have incentives to contractually pre-commit to limit their discretion over the terms of these transactions. Such responses include corporate charter provisions that pre-specify permissible transactions, e.g., anti-greenmail provisions and preemptive rights that provide proportionate access to future equity issuances.³ They also include valuation formulas for equity exchange terms, e.g., common stock redemption rights (so-called "poison pill" securities), conversion features for convertible preferred stock and debt, and fair price provisions that stipulate a minimum offer price in mergers with a substantial stockholder (Smith 1978).

Not all future circumstances are foreseeable, however, nor are all potential manager-stockholder conflicts amenable to resolution via simple ex ante numerical sharing rules. Moreover, the technology for resolving intra-claimant conflicts can change over time, such as via changes in the legal system. Unforeseen financial innovations—including a wide variety of corporate control transactions—can expand the set of feasible equity transactions. For example, hostile cash tender offers were first attempted in the 1960s. Management buyouts were a rare occurrence until the late 1970s, and only recently have financing innovations such as "junk" bonds made these buyouts feasible for the largest corporations. The first leveraged recapitalization was proposed in the 1980s.

Table 1 describes the major corporate control transactions and the managerial conflicts they generate. These conflicts are likely to be relatively mild in friendly acquisitions, especially those that involve multiple bidders with equal access to information about the target firm.⁴ At the other end of the spectrum are management buyouts and hostile takeovers, in which managerial conflicts are

² For open-market trades among anonymous individuals, a well-functioning capital market harmonizes the interests of all stockholders (H. DeAngelo 1981). Stockholder unanimity fails in the current case because managers with monopolistic access to firm-specific information can influence the terms of subsequent equity issuances and redemptions.

³ Proportionate stock issuances and redemptions mitigate intra-stockholder conflicts by providing all stockholders with equal or "fair" access to the offer.

⁴ A competitive auction is not sufficient to guarantee that target stockholders receive "fair" value for shares, however, except in the unlikely case that managers can (and do) costlessly reveal and credibly verify all relevant inside information to all potentially relevant bidders.
Table 1
Corporate Control Transactions and Managerial Conflicts of Interest

<table>
<thead>
<tr>
<th>Arm's Length Acquisitions:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. <em>Friendly merger or tender offer</em> in which target management negotiates the offer terms with one or more bidders. Managers have incentives to favor bidders that promise them the most lucrative future employment opportunities. Mergers require voting approval of target stockholders, convey judicial appraisal rights, and target managers virtually always provide an investment banker’s fairness opinion. Tender offers are ratified by target stockholders’ tendering decisions.</td>
</tr>
<tr>
<td>2. <em>Hostile tender offer</em> in which target management opposes the takeover attempt. Managers have incentives to resist external bids that they believe will cost them their jobs, at the loss of a premium payment to their stockholders. Managerial takeover resistance is virtually always justified by an investment banker’s opinion that the offer price is inadequate.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Non-Arm's Length Acquisitions and Partial Acquisitions:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. <em>Parent-subsidiary acquisition</em> in which parent management purchases the public (often, the minority) shares of a partially-owned subsidiary. Parent managers have incentives to propose offer terms that favor parent over subsidiary stockholders. These acquisitions generally require subsidiary stockholder approval, convey judicial appraisal rights, and parent managers virtually always provide an investment banker’s opinion that the terms are fair to subsidiary stockholders. These acquisitions require extensive disclosure under SEC Rule 13e-3.</td>
</tr>
<tr>
<td>2. <em>Management or leveraged buyout</em> in which managers (perhaps with the help of third party equity investors) purchase all shares held by outsiders. As purchasers, managers have incentives to minimize the price paid, and these incentives conflict with their fiduciary duty to obtain the best terms for outside stockholders. The disclosure and procedural requirements are the same as for parent-subsidiary acquisitions.</td>
</tr>
<tr>
<td>3. <em>Leveraged recapitalization</em> in which managers cause the corporation to pay out substantial cash to stockholders that is financed with new borrowing. Managers have incentives to “front-end” load the cash portion of these offers to compete with a hostile bid. In general, recapitalizations require stockholder approval and are accompanied by an investment banker’s fairness opinion.</td>
</tr>
</tbody>
</table>

Potentially severe. In management buyouts, managers have a fiduciary duty to negotiate the best possible terms for stockholders, offset by incentives as purchasers to pay the lowest possible price. Moreover, managers have some ability to suppress favorable inside information in order to purchase shares at less than “fair” value. Similar conflicts of interest characterize acquisitions of a subsidiary’s publicly-traded stock by a parent corporation.

In non-arm’s length acquisitions, the target’s post-offer stock price reflects market expectations about insiders’ valuations, but it does not fully reveal those valuations to outside stockholders. Critically, stock prices understate “fair” value because they reflect all publicly-available information, including managers’ perceived ability to buy shares at “unfair” terms and to otherwise

As a theoretical matter, there is no unique “fair” value for shares when a control transaction generates gains whose realization requires the cooperation of more than one claimant group—in this case, managers and outside stockholders. Rather, the manager-stockholder relation is a bilateral monopoly, for which no unique sharing rule for joint gains exists.
reduce outside stockholder welfare. Similar difficulties plague a target's stock price during a hostile takeover attempt. Outside stockholders cannot rely on stock prices to indicate definitively whether they should tender because market prices will not fully reveal managers' inside valuation of shares, either as an independent entity or if auctioned to the highest bidder.

Even absent these information problems, the target's post-offer stock price will not fully reveal the market's evaluation of its acquisition value, given uncertainty about the success of the current bid, the price the current bidder is ultimately willing to pay, and the existence of other bidders and their offer terms. To see this latter difficulty, consider the post-offer market price as a probability-weighted average of the values expected to accrue to target stockholders under different outcomes:

\[ P_M = \pi_A P_A + (1 - \pi_A) P_S \]  

where:
- \( P_M \) = the open-market stock price after an offer is announced, but before it expires,
- \( \pi_A \) = the market-assessed probability the target will ultimately be acquired (by the current or another bidder),
- \( P_A \) = the market's expectation of the ultimate acquisition price conditional on the current bid,\(^7\) and
- \( P_S \) = the post-offer expiration market price expected to obtain if the target remains independent, which capitalizes target stockholders' expected values under all other perceived outcomes.

Equation (1) reveals that, while the target's post-offer stock price incorporates the market's assessment of its ultimate acquisition value, \( P_A \), it does not perfectly reveal that value to outsiders, who observe only \( P_M \). Individuals cannot costlessly invert market prices, which are weighted averages of conditional expected values, to obtain one of the priced components. Such inversion requires knowledge of the market-assessed probabilities and stockholder values under all other priced outcomes. The very characteristic that makes open-market stock prices good trading prices (they incorporate all publicly-available information) makes them inadequate measures of acquisition values, i.e., makes them insufficient to themselves determine the terms at which corporate control will (or should) be exchanged.

The failure of market prices to perfectly reveal acquisition values implies that potential bidders must themselves formulate an offer price for shares—they cannot rely on the capital market to costlessly provide it. Similarly, outside

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\(^6\) Lev (1988) discusses how investors' perceptions of the fairness of open-market trading prices determine their willingness to trade shares. The current paper argues that their perceptions of the fairness of future equity issuance and redemption terms determine their willingness to invest equity capital in public corporations. Both effects are likely to be important determinants of economically relevant variables, such as open-market stock prices, equity exchange values, and bid-ask spreads.

\(^7\) Equation (1) is a simplification, since \( P_A \) is itself a weighted average of the target's acquisition value to various bidders, each of which may put target assets to different uses or effect different synergistic combinations of target and bidder assets.
stockholders and the board of directors must incur resource costs to evaluate that price—a service the market does not costlessly provide. In other words, the parties to a control transaction cannot infer the relevant $P_A$ (which can differ according to attributes of the bidder, as well as the target firm) from the target's open-market stock price. The function of the equity valuation process is to generate an independent estimate of the relevant value.

This paper emphasizes the demand for accounting information in the process through which acquisition values are determined. It is not directly concerned with the effect of accounting information on open-market stock prices as in capital markets research (e.g., Beaver 1973, 1981; Lev 1988). Because stock prices aggregate all public information, accounting data can have a relatively small marginal impact on open-market prices. In contrast, acquisition values are neither directly observable nor invertible from open-market stock prices, so that accounting data can be relatively important in determining acquisition values. The role for accounting information discussed here is conceptually distinct from its role in determining open-market stock prices.

### II. The Equity Valuation Process

Managers of firms engaged in a wide variety of control transactions hire an independent investment banker to evaluate the fairness of the transaction to the firm's outside stockholders. An investment banker's fairness opinion is virtually always provided to target stockholders in arm's length and non-arm's length mergers, and in leveraged recapitalizations. Managers who resist a hostile bid typically rely on an investment banker's opinion that the offer terms are inadequate. In short, corporate control transactions motivate a target firm's internal governance system to provide an independent valuation of shares. The extent to which this valuation process (1) is itself fair, and (2) generates fair equity values, is subject to review by the judicial system and the SEC.

Evaluating the fairness of a corporate control transaction is complex, since the gains from these transactions require the cooperation of multiple groups of corporate claimants. Akin to the usual analysis of bilateral monopoly, there is no one theoretically correct way to divide joint gains in these cases, hence no one "fair" price for shares. Moreover, while managers and investment bankers may claim that a given offer price represents fair value, their actual beliefs are not observable. One possibility is that these parties believe what they claim. Another

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8 The shares originally sold to outsiders should be priced to reflect the expected resource costs of evaluating future control transactions. Because such price protection is sunk in future periods, it does not alter managers' future incentives to engage in welfare-reducing transactions. Hence, outsiders face ongoing evaluation costs, which managers have incentives to reduce by providing a governance process that helps ensure that outsiders receive fair value in corporate control transactions.

9 Of course, these two perspectives are not mutually exclusive, but rather they are related via the specification in equation (1). In particular, to the extent that accounting information affects $P_A$, it has a feedback effect on $P_m$.

10 The landmark Smith v. Van Gorkom (1985) case highlights the importance of an internal governance process that appears capable of generating fair value for stockholders. The Delaware court found the directors of Trans Union Corp. had breached their fiduciary duty by approving an arm's length merger, even though the offer price was at a 48 percent premium to market, without "formal analysis" of the offer price or an investment banker's fairness opinion (Fischel 1985).
is that investment bankers simply "rubber stamp" whatever equity values managers select. In this latter view, investment bankers judiciously manipulate elaborate financial models to generate numbers that rationalize managements' chosen equity values to public stockholders and the courts.

Absent an ability to infer individuals' actual beliefs, this "excuse" motivation is not refutable. Hence, one cannot rule out the possibility that the primary function of the valuation process is to justify managerially-dictated terms to outsiders. It is, however, worth noting that this view is analogous to the assertion one sometimes hears that certified public accountants routinely "rubber stamp" whatever income figure management selects. In fact, the parallels between the investment banking and auditing professions are striking. Each certifies the fairness of managements' financial representations, each relies to some extent on data compiled by managers, and each has economic incentives to maintain a reputation for independence and quality work (L. DeAngelo 1981). The economic benefits from that reputation give investment bankers and auditors incentives to avoid "rubber stamp" approvals of managerial representations.

It is important to note that whichever motivation for an independent appraisal is the dominant one—whether the process generates a good faith estimate of fair value or simply justifies managerially-dictated terms—the valuation techniques used in this process affect real resource allocation, hence stockholder wealth. To see this point, consider the extreme case in which the sole motivation for an independent valuation is to justify equity values that are entirely chosen by other means. Even in this extreme scenario, the valuation information that justifies the selected exchange values to outside stockholders and the courts helps determine those values because it sets bounds on the feasible range of equity exchange values. Hence, the investment banker's valuation techniques affect stockholder wealth even if the valuation process simply serves as an elaborate "excuse" to justify managerially-imposed decisions.

Finally, the information used to determine equity exchange values need not be the same as that used to justify those values to outsiders who possess neither (1) managers' inside information about the firm's future prospects, nor (2) investment bankers' valuation expertise. Outsiders who lack these advantages rationally demand (and insiders will therefore supply) valuation data that incorporate well-understood, external constraints on managers' ability to disadvantage outside stockholders via the exchange values set on corporate equity.

Table 2 summarizes the major equity valuation techniques for corporate control transactions. A common element of the comparable firms (row 1) and comparable acquisitions (row 2) approaches is that both use historical pricing relations from a trading market in shares (companies). For example, comparable firms analysis mimics the capital market's pricing function for earnings or book value, while comparable acquisitions analysis mimics the control market's pric-

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11 The differences are also striking. Investment bankers have no codified rules for gathering and evaluating the evidence that underlies their opinion. Nor do they prohibit contingent fees, which are both routine and substantial.

12 Investment bankers do sometimes refuse to issue a fairness opinion. In the Fort Howard management buyout analyzed in Section IV, management's initial $50 offer was judged unfair by the banker representing the outside directors, and management subsequently raised the offer to $53.
Table 2
Alternative (Nonmarket) Valuation Approaches
Used to Value Publicly-Traded Equity
in Corporate Control Transactions

1. **Comparable firms approaches** that develop an average relation between open-market prices and accounting variables. The primary method is to capitalize the current firm's per-share earnings at an average price/earnings ratio for comparable publicly-traded firms. Market-to-book and market-to-sales ratios are also sometimes employed.

2. **Comparable acquisitions approaches** that develop an average relation between prior acquisition prices and open-market prices or accounting variables. The primary method is to multiply an acquisition target's pre-offer stock price by an average premium paid in comparable acquisitions of publicly-traded corporations.

3. **Discounted cash flow (DCF) analysis**, sometimes operationalized as the capitalization of forecasted earnings or dividends (these approaches are detailed in Brealey and Myers (1988) and Weston and Copeland (1986)).

4. **Asset-based approaches** that develop an estimate of company value based on the appraised value of its assets, e.g., liquidation value. Liquidation values are not used to value going concerns, although asset appraisals are sometimes used to value companies with material real estate and/or natural resource holdings.


On the surface, it is puzzling that DCF analysis is not the sole equity valuation technique, given its prominence in finance textbooks (e.g., Brealey and Myers 1988; Weston and Copeland 1986). One plausible explanation is that DCF-generated equity values are sensitive to the cash flow and discount rate assumptions of insider-managers. Thus, while DCF analysis may be useful in assessing equity values in a given use or to a given bidder, it is not a very credible means of convincing outside stockholders that those values are fair.

In practice, DCF techniques are largely accounting-based valuation approaches. First, DCF valuations use historical accounting relations to forecast future earnings, from which future cash flows are estimated. Second, the terminal values that typically constitute the majority of DCF-generated values are commonly estimated from projections of future earnings. Finally, investment bankers rely on historical accounting relations to evaluate the reasonableness of managerial earnings forecasts, a practice that appears designed to reduce the

13 In the landmark Wetnberger v. UOP (1983) case, the Delaware court initially "rejected the plaintiff's discounted cash flow method of valuing UOP's stock as not corresponding with 'either logic or the existing law.'" The Delaware Supreme Court reversed upon appeal, paving the way for future acceptance of the DCF and comparable acquisitions approaches.
credibility problems with DCF analysis. These facts suggest that it is inappropriate to view DCF analysis as a substitute for accounting-based valuation methods, since it is itself largely an accounting method in practice.

Several other aspects of the valuation process seem designed to protect outside stockholders from managerial opportunism. First, investment bankers' valuations rely to a large extent on publicly-available, objective and verifiable data, such as market prices, acquisition values, and accounting data. Managers would seem to have little discretion over market prices, while their discretion over accounting data is limited by impartial institutional and regulatory constraints, including GAAP. When investment bankers use managerial forecasts, they attempt to evaluate their reasonableness. Thus, much of the evidence underlying a fairness opinion is either outside managers' control or incorporates well-understood, external constraints on managers' ability to affect that evidence.

Second, while there may be debate about cash flow and discount rate assumptions, investment bankers use explicit valuation models that generate arguably objective, mechanical share values. Third, they use a number of such models. The use of multiple, semi-independent valuation techniques avoids reliance on any one imperfect (potentially biased) approach. It thereby reduces the likelihood that a given control transaction is welfare-reducing for outside stockholders. The output of this process is a set of valuation working papers that typically runs 100–300 pages, and that generates a range of values that underlies the investment banker's opinion. This opinion serves as one basis upon which the board of directors evaluates a proposed control transaction.

If outside stockholders are not satisfied that their firm's internal governance process and/or the equity values it generates are fair, they can seek redress in court. Because the courts are a costly means of resolving conflicts, all parties have incentives to settle their disputes privately. Whether or not the parties to a given transaction actually go to court, court-sanctioned valuation methods set bounds on the feasible exchange values. In other words, managers can reduce the resource costs of litigation by structuring the transaction and its terms to satisfy the relevant court's fairness tests.

Legally, managers have the right (in fact, the obligation) to resist external offers they evaluate as inadequate (Easterbrook and Fischel 1981). Directors can be held liable for breach of fiduciary duty if they fail to consider explicit valuation evidence before acting on a bid. This standard of care is usually satisfied by an investment banker's opinion that the offer is inadequate (Giuffra 1986, 124–125; Lipton 1979; McAtee 1977).

Stockholders who dissent to a management buyout can demand the court-appraised value of their shares. Before *Weinberger v. UOP* (1983), Delaware courts assessed fair value via a weighted average of pre-offer stock prices, net asset value, and the capitalized value of historical earnings (Fischel 1983; Banks 1972, 1974). Since *Weinberger*, Delaware courts can accept other valuation approaches, e.g., comparable acquisitions and DCF techniques.\(^{14}\)

\(^{14}\) Delaware courts have recently held that, once a decision is made to sell the firm, the board has a duty to facilitate an auction (*MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.* 1986). An auction does not eliminate the demand for an independent equity valuation since outside stockholders cannot be sure that the information managers provide external bidders ensures the auction is "fair."
III. Equity Valuation in Management Buyouts: Some Preliminary Evidence

This section provides evidence on the valuation information cited as influencing investment bankers' fairness evaluations of management buyouts. The source documents are 60 fairness opinions from the DeAngelo (1986) sample of 64 buyout proposals for New York and American Stock Exchange firms. As detailed in DeAngelo (1986), the initial sample was obtained by direct inspection of The Wall Street Journal over the ten-year period 1973-1982. While proxy materials for 61 (95 percent) of the 64 buyout proposals reference a fairness opinion, one firm did not supply its text and, therefore, was dropped for this analysis.

Thirty-one of the 64 buyout proposals do not include third party equity investors. These non-leveraged buyouts tend to involve firms that are majority controlled by management—in the 31 non-leveraged buyouts, management owned a mean 50.1% (median, 51.7%) of the common stock. The potential for a majority owner to coerce the minority to accept an "unfair" acquisition proposal has led to the popular term "minority freezeout" for these buyouts.\footnote{There is a very limited role for a competitive auction in these cases, since the majority owner often does not want to, and cannot be forced to sell its interest to another party.} Proxy materials for 28 proposals (90.3%) contain the text of a fairness opinion. Pre-offer managerial ownership averages 24.5% (median, 15.4%) for the 33 leveraged buyouts, and proxy materials for 32 (97.0%) contain the text of a fairness opinion.

Table 3 reports the information cited in the investment banker's fairness opinion and/or management's proxy discussion as influencing the buyout terms. Column (1) reports data for the 28 non-leveraged buyouts, and column (2) reports data for the 32 leveraged buyouts. For both subsamples, 100 percent of the proxy materials cite accounting information as influencing the banker's evaluation of the offer terms. The same percent cites open-market prices as influential. Prices paid in other acquisitions are also widely cited (64.3% of the non-leveraged, and 81.3% of the leveraged buyouts), as are managerial forecasts (67.9% and 62.5%, respectively). The latter are probably used in DCF analysis, which will also include some portion of the 17.9% (and 9.4%) incidence reported for cash flow analysis (the two categories most likely overlap).

Dividend capacity and asset appraisals are less frequently cited. For example, the firm's dividend capacity or past dividend record is referenced in 39.3% of the non-leveraged and 25.0% of the leveraged buyouts. Other influences on fairness opinions in leveraged buyouts are the buyout specialist's memo to investors, exchange values for other negotiated transactions in the firm's equity, and the results of the investment banker's attempt to "shop" the company. The latter is not cited in any of the non-leveraged buyouts, perhaps because of the high degree of managerial stock ownership in these firms.

The Table 3 evidence indicates that investment bankers unanimously cite accounting information as influencing their fairness evaluations of management buyouts. Unfortunately, the data do not indicate exactly how accounting information is used in equity valuation. However, the SEC has recently strongly encouraged firms contemplating a management buyout to file the valuation infor-
Table 3  
Valuation Evidence Cited as Influencing the Terms of a Management Buyout: 60 Management Buyouts (1973–1982) with Text of Investment Bankers’ Fairness Opinions Published in Proxy Materials

<table>
<thead>
<tr>
<th></th>
<th>28 Non-Leveraged Buyouts with No Outside Equity Participants</th>
<th>32 Leveraged Buyouts with Outside Equity Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>n</td>
<td>Percent</td>
</tr>
<tr>
<td>Accounting information</td>
<td>28</td>
<td>100.0</td>
</tr>
<tr>
<td>Open-market stock price</td>
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<tr>
<td>Prices paid in other acquisitions</td>
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<td>Management forecasts</td>
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<tr>
<td>Cash flow analysis</td>
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<td>17.9</td>
</tr>
<tr>
<td>Dividend history or capacity to pay</td>
<td>11</td>
<td>39.3</td>
</tr>
<tr>
<td>Asset appraisal</td>
<td>8</td>
<td>28.6</td>
</tr>
<tr>
<td>Buyout specialist’s memo to investors</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>Actual or contemplated price of prior equity transaction</td>
<td>6</td>
<td>21.4</td>
</tr>
<tr>
<td>Banker’s attempt to shop the company</td>
<td>0</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Information presented to the board of directors by their financial advisers in their Schedule 13e-3 filings. According to the SEC Office of Tender Offers, this valuation information has been included in firms’ Schedule 13e-3 filings since 1987. According to Disclosure, firms sometimes receive confidentiality from the SEC so that this information is only available (at considerable delay and expense) under the Freedom of Information Act.

IV. Equity Valuation in Management Buyouts: A Closer Look

I obtained a list of 1988 Schedule 13e-3 filings from Disclosure and requested valuation information for six firms that are reasonably representative of recent buyouts, according to consultations with investment bankers. Disclosure was able to supply the relevant filings for three of these firms—Bell & Howell Com-
Table 4
Valuation Techniques Used by Four Investment Bankers
to Evaluate the Fairness of a Management Buyout
According to Details of Rule 13e-3 Filings

<table>
<thead>
<tr>
<th>Valuation Approach</th>
<th>Morgan Stanley</th>
<th>Salomon Bros.</th>
<th>Dillon Read</th>
<th>First Boston</th>
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</thead>
<tbody>
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<td>Comparable firms analysis</td>
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<td>yes</td>
<td>yes</td>
<td>yes</td>
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<tr>
<td>Comparable acquisitions analysis</td>
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<td>yes</td>
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<td>yes</td>
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<tr>
<td>Discounted cash flow analysis</td>
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<td>yes</td>
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<tr>
<td>Asset appraisal</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
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<tr>
<td>Investment banker’s attempt to shop the company</td>
<td>yes^</td>
<td>yes</td>
<td>no</td>
<td>no</td>
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<tr>
<td>Dividend history or capacity to pay</td>
<td>no</td>
<td>no</td>
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<td>Leveraged buyout model</td>
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</tr>
</tbody>
</table>

^ These filings are for the proposed 1988 management buyouts of Bell & Howell Company (investment bankers, Morgan Stanley and Salomon Bros.), Foodmaker, Inc. (Dillon Read), and Fort Howard Corporation (First Boston).

Morgan Stanley did not itself shop the company, but its opinion refers to the Salomon Bros. attempt to solicit other offers.

Salomon Bros. had performed this analysis for management before any external bidder made its intentions public.

Dillon Read cautions that DCF analysis is of limited usefulness in leveraged acquisitions because of the sensitivity of its results to changes in its assumptions.

Managers of all three companies proposed a buyout in 1988 and all have since gone private. Their filings contain fairness opinions with valuation documentation from four different “blue chip” investment bankers. Foodmaker and Fort Howard each provide one fairness opinion, and Bell & Howell provides two opinions.

This section’s case study analysis is, therefore, based on four sets of valuation documents—Morgan Stanley’s and Salomon Brothers’ reports on the Bell & Howell management buyout, Dillon Read’s report on the Foodmaker buyout, and First Boston’s on the Fort Howard Corp. buyout. These documents range from 92 to 309 pages in length, and detailed tables of numbers and sensitivity analyses comprise most of that length. I also rely on the investment banker’s discussion of the factors that influenced the fairness evaluation, contained in the proxy statement or offering document, and on the fairness opinion itself. The Appendix reproduces Morgan Stanley’s fairness opinion on the Bell & Howell management buyout.

Table 4 categorizes the valuation approaches used by each investment
banker, according to my reading of these source documents. These materials exhibit the wide range of valuation techniques and sensitivity analyses that underlie a fairness opinion. The table cannot convey the large volume of financial data that support these opinions. It does, however, report the major approaches taken by the four investment bankers to highlight their differences and similarities.

With respect to the latter, all four investment bankers provide analyses of comparable firms, comparable acquisitions, and DCF analyses. As detailed below for the Fort Howard management buyout, all these valuation approaches (including DCF techniques) rely heavily on published accounting information. None of the investment bankers performs or relies upon direct asset appraisals.

Both investment bankers that evaluated the Bell & Howell management buyout acknowledge the Salomon Bros. attempt to solicit competing acquisition proposals in their fairness opinions (see Morgan Stanley’s opinion, reproduced in the Appendix). The directors of the other two firms had not actively solicited competing bids at the time the fairness opinion was issued, and both investment bankers cite that fact in their opinions. The observation that all four bankers’ opinions discuss the solicitation of competing bids highlights the importance placed by courts in recent years on whether the directors held an open auction for the company. To some degree, a competitive auction substitutes for the valuation process discussed here, but not completely (see fns. 4 and 14).

Table 4 indicates that First Boston is the only banker to use a dividends capitalization approach. They use it to estimate stock prices if the company were to remain publicly-traded. Three bankers perform a leveraged buyout analysis and two also estimate equity values under a leveraged recapitalization. Leveraged buyout models assess financial feasibility under various assumptions about the offer price, proceeds from asset dispositions, and financing terms. The general approach is to project net income under various scenarios. Interest coverage ratios are then calculated, based on both earnings and cash flows, to assess financial risk. Returns to equity investors are also computed, and their sensitivity assessed to changes in underlying assumptions.

Table 5 reports the summary valuation of one investment banker to give readers a better feel for (1) the range of equity values generated by the valuation process, and (2) specific valuation techniques. First Boston’s summary valuation of Fort Howard Corp. reports a preliminary price range of $35–62 per share, obtained from nine different valuation approaches (management’s offer was $53 per share). They provide two DCF analyses of the entire firm. The first relies on management’s long-run projections, while the second incorporates First Boston’s adjustments to those projections (the “upside case”). The upside scenario assumes higher product prices, sales growth, and operating profit margins than do management’s long-run projections.

Terminal values typically constitute a large portion of DCF-generated values. Consequently, investment bankers typically use several approaches to estimate

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20 Dillon Read’s opinion on the Foodmaker management buyout states that “the Agreement and Plan of Merger does not prohibit the Special Committee from soliciting competing proposals, and the Special Committee has advised us that it intends to request us to do so.” First Boston’s opinion on the Fort Howard management buyout states that “We were not requested to, and did not, solicit third party indications of interest in acquiring all or any part of the Company.”
Table 5
Summary Valuation for the 1988 Management Buyout of Fort Howard Corporation: Prepared by The First Boston Corporation

<table>
<thead>
<tr>
<th>Valuation Approach</th>
<th>Preliminary Range Per Share(^1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Consolidated DCF analysis(^2)—</td>
<td>$49–$54</td>
</tr>
<tr>
<td>Base case (management's long-range plan)</td>
<td></td>
</tr>
<tr>
<td>2. Consolidated DCF analysis(^2)—</td>
<td>57–62</td>
</tr>
<tr>
<td>Upside case (First Boston adjustments to managerial projections)</td>
<td></td>
</tr>
<tr>
<td>3. Break-up value(^3)</td>
<td>46–57</td>
</tr>
<tr>
<td>4. Comparable company analysis</td>
<td>45–53</td>
</tr>
<tr>
<td>5. Comparable acquisition analysis</td>
<td>38–46</td>
</tr>
<tr>
<td>6. Dividend discount model</td>
<td>50–60</td>
</tr>
<tr>
<td>7. Historical multiples</td>
<td>35–50</td>
</tr>
<tr>
<td>8. LBO analysis</td>
<td>50–54</td>
</tr>
<tr>
<td>9. Recapitalization analysis</td>
<td>49–54</td>
</tr>
</tbody>
</table>

Sources: Exhibits (b)(4) and (d)(1) to the Schedule 13e-3 filing of Fort Howard Corporation dated July 1, 1988.

1 The price at which the company went private in 1988 was $53 per share.
2 Derived by estimating terminal values as multiples of 14–16 times 1998 projected unlevered net income and using a 12.0% discount rate.
3 Derived using DCF and comparable publicly-traded company analyses for each of the four business segments, and comparable acquisition analysis for the two segments for which acquisition data were available.

these values. For the Fort Howard buyout, First Boston used three methods to estimate terminal values—a multiple of 1998 unlevered income, a multiple of 1998 book value, and a perpetual growth model applied to 1998 cash flows. As an example of the impact of terminal value assumptions on DCF equity values, First Boston’s terminal value estimates constitute (1) 53–71 percent of equity values when estimated as a multiple of earnings, (2) 56–73 percent of equity values when estimated as a multiple of book value, and (3) 53–80 percent of equity values using a perpetual growth model.

Table 5 reports equity values of $49–62 from First Boston’s DCF analysis, assuming terminal values of 14–16 times 1998 projected unlevered net income and a 12 percent discount rate. This range widens to $39–133 under the full set of assumptions considered by First Boston. First Boston points out in the offer materials that this wide range of values “demonstrates the sensitivity of discounted cash flow analysis” to terminal value assumptions and expresses a preference for the earnings multiple approach.\(^{21}\)

\(^{21}\) First Boston is not the only investment banker to cite the limitations of DCF analysis. The offer materials for the Foodmaker buyout report that “Dillon Read indicated that it regarded the discounted cash flow analysis as less useful in this instance, because the company is highly leveraged and small changes in certain assumptions can produce large changes in per share values.”
First Boston’s $46–57 estimate of Fort Howard’s break-up value is derived from DCF and comparable company analyses of each of the company’s four major segments, and from comparable acquisition analysis of the two segments for which acquisition data were available. As noted in Table 5, First Boston also uses comparable company and comparable acquisition techniques on the entire firm. Company-wide comparable firm analysis generates equity values of $45–53, while First Boston’s analysis of historical multiples generates values of $35–50. Their valuation working papers use data on the price/sales, price/cash flow, price/operating income, price/earnings, and price/book value multiples of Fort Howard compared to those of Scott Paper Company, James River Corp., and Kimberly-Clark Corp. These are clearly accounting-based valuation approaches.

First Boston also performs extensive additional analyses on the P/E ratios of Fort Howard compared to those of Scott Paper, James River, and Kimberly-Clark, and to the P/E ratios of 11 other paper companies that they deem less comparable. These analyses consider market prices and P/E ratios both before and after the October 1987 market crash. They use both historical EPS figures (as of June 30 and December 31, 1987) and the average Institutional Brokers’ Estimate System (I/B/E/S) earnings forecast. First Boston also compares Fort Howard’s monthly and quarterly P/E multiples since 1983 to averages for the Standard & Poor 400, using both actual earnings and I/B/E/S forecasts. These analyses generate a range of P/E (and price-to-book) multiples that First Boston applies to Fort Howard’s projected EPS and book values to estimate equity values.

First Boston’s comparable acquisition analysis describes the attributes of nine acquisitions of (and by) companies in the paper industry. These attributes are not acquisition premiums—rather they all relate acquisition values to various accounting variables. Specifically, First Boston reports acquisition values as a multiple of the latest 12-month net income, book value, sales, operating income, and operating cash flow. They also summarize attributes of completed tender offers in 1988 (as of May 1988), partitioned into hostile and friendly offers. These attributes include acquisition premiums—measured relative to market prices one day, one week, and four weeks prior to announcement. They also include acquisition values as a multiple of accounting variables—the latest 12-month sales, net income, and book value.

First Boston uses a “dividend discount” model to estimate the trading value of the company, should it remain public in substantially unchanged form. Despite the “dividend discount” label, this approach in essence capitalizes future earnings. Future dividends are assumed to be 40 percent of earnings projections for five years, and terminal value is a multiple of 1992 earnings. Earnings projections are based on (1) management’s long-run plan, and (2) First Boston’s upside case. First Boston estimates trading values as the present value of expected dividends and terminal values under various discount rates. They also estimate trading values should the firm engage in a leveraged recapitalization.

Dillon Read takes a similar approach to estimate the trading value of Foodmaker equity in substantially unchanged form. (Foodmaker paid no dividends as a public company.) Dillon Read estimates equity value in 1993 as a multiple of terminal earnings, assuming managers’ earnings projections are realized, and discounts that value using various required rates of return on equity.
Finally, First Boston performs a leveraged buyout analysis of the company (under various assumptions about offer prices, proceeds from future asset sales, and financial terms) to assess the financial feasibility of the proposed transaction. Their general approach is to project future earnings based on (1) management's long-range plan, (2) management's projections, assuming divestiture of certain assets, and (3) First Boston's upside scenario. Table 5 reports a range of $50–54 which is based on assumed, not derived equity values under this approach. First Boston's leveraged buyout analysis leads them to conclude that $54 is at the upper range of financial feasibility, and the offer materials report their opinion that "in light of the corresponding financial projections, it would be difficult to finance a leveraged buyout at higher prices."

The available evidence does not allow determination of the precise effect of a given valuation method on the final transaction price of $53 per share paid for Fort Howard equity. However, it does appear that $53 falls in the approximate mid-range of equity values generated by First Boston. Specifically, $53 lies within the range of values generated by six (two-thirds) of the nine valuation methods summarized in Table 5. Importantly, it lies below the range only for DCF-generated values in the upside case (and above the range implied by comparable acquisitions and historical multiples). In short, it appears that the ultimate transaction price is constrained to fall within the approximate range of values implied by a broad variety of valuation techniques.

Overall, accounting information and accounting statement formats—balance sheets, income statements, analysis of funds flows—permeate investment bankers' valuation techniques. Importantly, their use of accounting data is not confined to analysis of historical P/E or market-to-book multiples. Rather, accounting variables and relations are used in every valuation technique documented here. They are used in DCF analysis to evaluate managers' earnings projections and to estimate the terminal values that commonly drive DCF values. They are used to evaluate cash flow forecasts for leveraged buyout and leveraged recapitalization analyses, and in dividend and equity valuation models. They are used in comparable acquisition analysis to link acquisition values to firm-specific attributes. In fact, the equity valuation process can be reasonably characterized as one that predominantly employs accounting information to estimate fair compensation to outside stockholders.

V. Summary

The proliferation of control contests for large public corporations at 50% + premiums above market illustrates the wide divergence between open-market stock prices and equity exchange values. This paper considers equity valuation in corporate control transactions—e.g., management buyouts and hostile takeovers—that engender potentially severe managerial conflicts of interest. These conflicts generate a demand for independent assessments of equity values by investment bankers who specialize in these appraisals. The paper provides evidence on the valuation information used by investment bankers to evaluate the fairness of a large sample of management buyouts. It also provides a closer look at their valuation techniques via a detailed case study of investment bankers' valuation working papers.
This evidence indicates that accounting information permeates the valuation process for management buyouts. It is, therefore, consistent with the hypothesis that accounting information affects real resource allocation, hence stockholder wealth, via the terms of corporate control transactions. Importantly, this inference holds whether the valuation process documented here is actually used to estimate equity exchange values, or whether it serves primarily to justify values selected via other means to public stockholders and the courts. The evidence also suggests that accounting information may affect equity valuation in other control transactions—e.g., hostile tender offers and leveraged recapitalizations—that represent promising areas for future research.

Finally, the analysis suggests that accounting information plays a more extensive role in the governance of manager-stockholder relations than previously recognized in the contracting or capital markets literatures. Specifically, it isolates a potentially important demand for accounting information beyond that associated with managerial wage agreements, debt contracts, and the political process (Watts and Zimmerman 1986). Moreover, the demand for accounting data in equity valuation is conceptually distinct from that posited in the capital markets literature, which restricts attention to open-market stock prices. In short, the role of accounting information in equity valuation (and corporate governance) is broader than previously thought.

**Appendix**

Morgan Stanley & Co. Incorporated  
1251 Avenue of the Americas  
New York, New York 10020

December 14, 1987

Special Committee of the  
Board of Directors  
Bell & Howell Company  
5215 Old Orchard Road  
Skokie, Illinois 60077-1076

Dear Sirs and Madam:

We understand that Bell & Howell Company ("Bell & Howell" or the "Company") is entering into a Merger Agreement, dated December 14, 1987 (the "Merger Agreement"), with BHW Acquisition Corp. ("Parent"), a Delaware corporation formed and controlled by a group of investors led by Robert M. Bass Group, Inc. and including certain members of the Company's management (the "Bass Group"), and BHW Merger Corp. ("Merger Sub"), a Delaware corporation and a directly or indirectly wholly-owned subsidiary of Parent. Pursuant to the Merger Agreement, on the terms and subject to the conditions thereof, Merger Sub will be merged with and into the Company (the "Merger"), and each then outstanding share of the Company's Common Stock, without par value (the "Common Shares") and each then outstanding share of the Company's Cumulative Convertible Preferred Stock, Series A, without par value (the "Preferred Shares" and collectively with the Common Shares, the "Shares"), other than Shares owned by Parent, Merger Sub, any other direct or indirect subsidiary of Parent and Shares held by stockholders of the Company who properly exercise any appraisal rights available under applicable law, will be converted in the Merger into the right to receive $64 in cash (the "Merger Consideration").

You have asked for our opinion as to whether the Merger Consideration to be received by the holders of Shares is fair to such holders (other than Parent and its affiliates) from a financial point of view.
For the purposes of this opinion we have, among other things,

(i) reviewed the audited and unaudited financial statements for the three most recent fiscal years and interim periods to date and certain other financial and operating data relating to Bell & Howell made available to us by Bell & Howell;

(ii) analyzed certain internal financial and operating data of Bell & Howell, including financial projections for the period 1987-1997 prepared by Bell & Howell management relating to the earnings, cash flow, assets, and prospects of the Company's business;

(iii) conducted discussions with members of senior management of Bell & Howell and its subsidiaries with respect to the Company's business, operating performance, and prospects;

(iv) reviewed the financial terms, to the extent publicly available, of certain recent acquisition transactions deemed relevant;

(v) compared the financial information relating to certain of the Company's businesses with published financial information concerning certain companies whose businesses we deemed to be comparable, in whole or in part, to those of the Company;

(vi) analyzed the market price and trading characteristics of Bell & Howell common stock for recent periods to date;

(vii) reviewed the Certificate of Designation relating to the Preferred Stock;

(viii) reviewed the Merger Agreement; and

(ix) performed such other analyses and examinations and conducted such other discussions as we have deemed appropriate.

In preparing our opinion, we have relied upon the accuracy and completeness of all information supplied or otherwise made available to us by Bell & Howell, and we have not independently verified such information or made or obtained an independent evaluation or appraisal of the Company's business. We have also assumed that the Company’s projections have been reasonably prepared, and have been generated on bases reflecting the best currently available estimates and judgments of the future financial performance of the Company's business segments. We have relied on your counsel with respect to legal matters relating to the Merger Agreement and the transactions contemplated thereby. It should be noted that our opinion is necessarily based upon market conditions prevailing, and other circumstances and conditions existing at the present time.

As you know, we have been retained, and have received a fee therefor, solely for the purpose of rendering to you our opinion as to the fairness, from a financial viewpoint, of the consideration to be received by the Company’s stockholders (other than Parent and its affiliates) pursuant to the Merger Agreement. Accordingly, we were not requested to solicit, and did not solicit, other potential purchasers for the Company or any of its business segments. Nor have we participated in any of the discussions or negotiations with the Bass Group or any other potential purchasers of the Company or any of its business segments with respect to the Merger Agreement or other possible alternative transactions. We understand that Salomon Brothers Inc. conducted a solicitation of acquisition proposals for the Company during November-December 1987, and we have discussed the results of such solicitation with Salomon Brothers Inc.

As we have advised you, in the past we have rendered financial advisory and investment banking services to Robert M. Bass Group, Inc. and certain affiliated entities (in matters not relating to the Company) for which we have received customary compensation.

Based upon the foregoing, and such other factors as we deem relevant, including our assessment of general economic, market, and monetary conditions, we are of the opinion that the Merger Consideration to be received by the holders of Shares is fair to such holders (other than Parent and its affiliates) from a financial point of view.

Very truly yours,

MORGAN STANLEY & CO. INCORPORATED
By: ________________________________
Steven Rattner
Managing Director

(Source: proxy statement dated April 16, 1988 for Bell & Howell Company)
DeAngelo—Equity Valuation

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