

Item #3

SEMINAR IN LAW AND ECONOMICS

Professor Shavell

Tuesday, September 23, 2003

Pound 201, 4:30 p.m.

**BARGAINING IN THE SHADOW
OF TAKEOVER DEFENSES**

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Bargaining in the Shadow of Takeover Defenses

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Draft – September 8, 2003

Forthcoming *Yale Law Journal*, Vol. 113, No. 3 (December 2003)

Among the arguments that have been put forward to support the view that takeover defenses increase shareholder returns when a company becomes a takeover target, the “bargaining power hypothesis” is the most commonly cited argument today. Under this theory, takeover defenses allow the target to extract more in a negotiated acquisition because the bidder’s no-deal alternative, to make a hostile bid, is worsened. Despite its centrality to the current debate on takeover defenses, the bargaining power hypothesis has never been subjected to a careful theoretical analysis or to a correctly-specified empirical test. In this Article I present a model of bargaining in the “shadow” of takeover defenses that introduces alternatives away from the table, hostile bid costs, asymmetric information, and agency costs into the standard bargaining model. I confirm the features of this model using interviews with the heads of mergers and acquisitions at ten major New York City investment banks, which collectively account for 96% of U.S. M&A deal volume. I also present econometric evidence that is consistent with this model. The theoretical model, practitioner interviews, and econometric evidence presented here indicate that the bargaining power hypothesis is unlikely to be valid in many if not most negotiated acquisitions. This conclusion has implications for whether defenses increase or decrease shareholder wealth, and whether the recent pro-takeover movements in the Delaware courts will lead to negative consequences for target shareholders in negotiated acquisitions.

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Bargaining in the Shadow of Takeover Defenses

Guhan Subramanian

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I. Introduction

For decades, practitioners and academic commentators who believe that target boards should have broad discretion to resist a hostile takeover attempt have put forward the “bargaining power hypothesis” to support their view.¹ This hypothesis states that a target with strong takeover defenses will extract more in a negotiated acquisition than a target with weaker defenses, because the acquirer’s no-deal alternative, to make a hostile bid, is less attractive against a strong-defenses target. The hypothesis helped usher in the modern era of takeover defenses: in endorsing the poison pill in *Moran v. Household International*, the Delaware Chancery Court framed the question as a balance between “the unrestricted right of shareholders to participate in nonmanagement sanctioned tender offers” and “the right of a Board of Directors to increase its bargaining powers.”² The bargaining power hypothesis has been voiced more frequently over the past few years³ as other shareholder-focused arguments in favor of takeover defenses, such as protection against “structural coercion”⁴ and protection against “substantive coercion”⁵ have been rendered less important through federal and state intervention⁶ or refuted by recent empirical evidence.⁷ Yet despite its

¹ For early work putting forward this view, see e.g., William H. Steinbrink, *Management’s Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882, 893 (1978); Leo Herzel, John R. Schmidt & Scott J. Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 61 CHI. B. REC. 152, 154 (1979); Martin Lipton, *Takeover Bids in the Target’s Boardroom*, 35 BUS. LAW. 101, 108 (1979). For work from the 1980s, see, e.g., Dale A. Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 121-22 (1986); David D. Haddock, Jonathan R. Macey & Fred S. McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 705-06 (1987); Rene M. Stulz, *Managerial Control of Voting Rights*, 20 J. FIN. ECON. 25 (1988).

² 490 A.2d 1059, 1074 (Del. 1985).

³ See, e.g., Steven M. Bainbridge, *Director Primacy in Corporate Takeovers*, 55 STAN. L. REV. 791, 808 (2002); Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 823 (2002); Marcel Kahan & Edward Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, forthcoming U. PENN. L. REV. (2003); John C. Wilcox, *Two Cheers for Staggered Boards*, CORP. GOV. ADVISOR at 3-4 (Nov/Dec 2002).

⁴ See, e.g., Herzel, Schmidt & Davis, *supra* note 1 (advocating takeover defenses to prevent shareholders from being coerced into tendering); Steinbrink, *supra* note 1 (same).

⁵ See, e.g., Lipton, *supra* note 1 (presenting empirical evidence that target shareholders achieved higher returns by remaining independent rather than selling).

⁶ See, e.g., Pub. L. No. 90-439, 82 Stat. 454 (1968) (Williams Act); CONN. GEN. STAT. ANN. §§ 33-840 to 33-842 (fair price statute).

⁷ See Lucian Ayre Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) [hereinafter Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*]; Lucian Ayre Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of*

venerable heritage and recent revitalization, the bargaining power hypothesis has generally been asserted by defense proponents and conceded by defense opponents,⁸ never subjected to a careful theoretical analysis or to a correctly-specified empirical test.

This Article attempts to fill this gap. I use negotiation analytic tools to construct a model of bargaining in the “shadow” of takeover defenses.⁹ This model identifies the conditions that must exist in order for the bargaining power hypothesis to hold in a particular negotiated acquisition. I demonstrate that the bargaining power hypothesis only applies unambiguously to negotiations in which there is a bilateral monopoly between buyer and seller, no incremental costs to making a hostile bid, symmetric information, and loyal sell-side agents. These conditions suggest that the bargaining power hypothesis is only true in a subset of all deals, contrary to the claim of defense proponents that the hypothesis applies to all negotiated acquisitions.

I confirm the features of this model with evidence from practitioner interviews. It is interesting to note that while the bargaining power hypothesis lies squarely at the intersection of law and business – namely, legal rules on takeover defenses influencing the business issue of price – to my knowledge the businesspeople who actually negotiate price have been silent on this question. I take the novel step of interviewing the heads of mergers and acquisitions at ten major New York City investment banks.¹⁰ Collectively these firms represented

Staggered Boards: Further Findings and a Reply to Symposium Commentators, 55 STAN. L. REV. 885 (2002) [hereinafter Bebchuk, Coates & Subramanian, *Reply to Commentators*]; Lucian Ayre Bebchuk, John C. Coates IV & Guhan Subramanian, *The Effect of Takeover Defenses* (working paper June 2003) [hereinafter Bebchuk, Coates & Subramanian, *Effect of Defenses*].

⁸ See, e.g., Jonathan R. Macey, *Displacing Delaware: Can the Feds Do a Better Job Than the States in Regulating Takeovers?*, 57 BUS. LAW. 1025, 1039 (2002) (asserting bargaining power as a matter of “common sense intuition”). See generally Elazar Berkovitch & Naveen Khanna, *How Target Shareholders Benefit from Value-Reducing Defensive Strategies in Takeovers*, 45 J. FIN. 137, 137 (1990) (“Proponents of defensive strategies maintain that they increase the ability of target management to extract a higher price for target shares. Opponents of such strategies . . . generally conced[e] this point.”). An exception is Lucian Bebchuk, who argues that giving shareholders the right to circumvent the bargaining process and directly accept a bidder’s offer does not necessarily reduce management’s bargaining power, and that management may use bargaining power to extract private benefits rather than a higher premium for shareholders. See Lucian Ayre Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 1007-08 (2002). I discuss these arguments at note 97 and Part III.E *infra*.

⁹ Cf. Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L. J. 950, 951 (1979) (demonstrating how the “shadow of the law” provides endowments that influence outcomes).

¹⁰ The interviewees are: Steven Baronoff, Co-Head of Mergers & Acquisitions, Merrill Lynch & Company; Michael Biondi, Chairman of Investment Banking, Lazard Freres & Company; Doug Braunstein, Head of Investment Banking Coverage, J.P. Morgan Securities; Louis P. Friedman, Global Head, Mergers & Acquisitions, Bear, Stearns & Company; Robert A. Kindler, Global

either the acquirer or the seller, or both, in 72% of negotiated acquisitions by number, and 96% by size, during the 1990s deal wave. The evidence compiled from these practitioner interviews confirms the features of the theoretical model presented here.

I then test the bargaining power hypothesis against a database of negotiated acquisitions of U.S. public company targets between 1990 and 2003 (n=1,692). If the hypothesis is correct, then premiums should be higher in states that authorize the most potent pills (Pennsylvania, Georgia, Virginia, and Maryland), and lower in the state that provides the least statutory validation for pills (California), relative to Delaware which takes a middle ground on the pill question. However, consistent with the predictions of my model, I find no evidence that premiums are statistically different across these states, either overall, or in sub-samples in which bargaining power is most likely to manifest itself. I further test for intra-state differences using the Maryland Unsolicited Takeover Act (MUTA) of 1999 as the basis for a natural experiment, and also find no empirical support for the bargaining power hypothesis.

These findings have implications for the current anti-managerial, pro-takeover trajectory of Delaware's corporate law jurisprudence in the aftermath of Enron. Proponents of the status quo warn that such doctrinal movements will weaken targets' bargaining power in negotiated acquisitions, which will in turn reduce overall returns for target shareholders. However, by unpacking the "black box" of negotiated acquisitions and examining the micro-level underpinnings of the bargaining process, this Article suggests that a return to the original promise of intermediate scrutiny as articulated in *Unocal v. Mesa Petroleum*¹¹ is unlikely to yield these negative shareholder wealth consequences. Rather, as I and others have argued,¹² a controlled revitalization of the hostile takeover marketplace can help restore effective corporate governance in the post-Enron era.

Head of Mergers & Acquisitions, J. P. Morgan Securities; Donald Meltzer, Vice Chairman of Global Investment Banking and Head of Mergers & Acquisitions, Credit Suisse First Boston; Stephen Munger, Global Co-Head of Mergers & Acquisitions, Morgan Stanley; James Neissa, Co-Head of Mergers & Acquisitions, UBS Investment Bank; Gregg S. Polle, Managing Director and Head of Merger & Acquisitions, Salomon Smith Barney; Howard Shiller, Co-Head of U.S. Mergers & Acquisitions, Goldman Sachs; and Steve Wolitzer, Head of Mergers & Acquisitions, Lehman Brothers. All interviews were conducted in person in New York City, except one interview, which was conducted over the phone. All interviews were conducted during the summer of 2003. Interviews lasted between 20 minutes and 1 hour, with an average length of approximately 40 minutes. I am grateful to all of the interviewees for their time and thoughtful comments.

¹¹ 493 A.2d 946 (Del. 1985).

¹² See, e.g., Guhan Subramanian, *A New Takeover Defense Mechanism: Using an Equal Treatment Agreement as an Alternative to the Poison Pill*, 23 DEL. J. CORP. L. 375 (1998); Bebchuk, Coates & Subramanian, *Reply to Commentators*, *supra* note 7.

The remainder of this Article proceeds as follows. Part II provides relevant background, including the origins of the bargaining power hypothesis and the evidence put forward to date to support it. Part III constructs a theoretical model of bargaining power in the negotiated acquisition context, beginning with a baseline case in which the bargaining power hypothesis clearly holds, and then adding real-world complexities that make it less plausible in many if not most negotiated acquisitions. Part IV provides new econometric evidence on the bargaining power question. Part V discusses implications of these findings. Part VI concludes.

II. Background

A. The Modern Arsenal of Takeover Defenses

Among the takeover defenses that have been developed over the past thirty years, the poison pill is by far the most important defense today. A pill gives shareholders the right to buy shares of the target (a “flip in” provision), the acquirer (a “flip over” provision), or both, at a substantially discounted price in the event that a single shareholder, or affiliated group of shareholders, acquires more than a specified percentage of the company’s shares (typically between ten and twenty percent). If triggered, the pill provides target shareholders with a stake in the acquirer (flip-over), or dilutes the potential acquirer’s stake in the target (flip-in), thus making a hostile takeover considerably more expensive. Since the pill was invented in 1983, it has never been deliberately triggered, and is generally understood to be a complete barrier to a direct attack in the form of a conventional tender offer. Because a pill (as a formal matter) is a dividend of warrants to purchase stock, and the board has the exclusive authority to issue dividends,¹³ a pill can be adopted without a shareholder vote, in a matter of hours if necessary. Therefore virtually every company has a “shadow pill” that it can, and usually does, put in to place if it does not have one before the hostile bid is launched.¹⁴

While their basic mechanics are generally the same, pills vary in their potency due to important differences in the background state corporate law. Delaware, which is home to approximately 50% of U.S. public companies,¹⁵ originally adopted a middle ground position on the pill. In 1985, the Delaware Supreme

¹³ See DEL. GEN. CORP. L. § 157, 173.

¹⁴ See John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271 (2000).

¹⁵ See Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. PENN. L. REV. 1795, 1815 (Table 2) (2002); Lucian Arye Bebchuk & Alma Cohen, *Firms’ Decisions Where to Incorporate*, NBER Working Paper No.9107, forthcoming J. L. & ECON. (2003).

Court validated the pill in *Moran v. Household International*, but cautioned that the ability to maintain a pill under *Unocal* was not absolute: “The ultimate response to an actual takeover bid must be judged by the Directors’ actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its shareholders. . . . Their use of the [poison pill] will be evaluated when and if the issue arises.”¹⁶ In a line of late-1980s cases, Delaware courts took up the invitation issued in *Moran*, invalidated defensive tactics that were not “reasonable in relation to the threat posed” under *Unocal*, and confirmed that the right to use a pill against a hostile bidder was not absolute.¹⁷

In the 1990s, however, Delaware courts endorsed more potent pills by approving the “Just Say No” defense. In *Paramount Communications v. Time*,¹⁸ the Court upheld Time’s defensive tactics to preserve a strategic merger between Time and Warner, despite a clearly superior hostile takeover offer for Time from Paramount. Many commentators interpreted the Court’s language – that a hostile takeover target could protect its friendly merger “unless there is *clearly no basis* to sustain the corporate strategy”¹⁹ – to mean that a target could “Just Say No” to a hostile bidder by refusing to redeem its poison pill.²⁰ Six years later, in *Unitrin v. American General Corp.*,²¹ the Delaware Supreme Court read *Unocal*’s reasonableness requirement to mean that defensive tactics, provided that they are not “coercive” or “preclusive,” must fall within a “range of reasonable responses.”²² According to then-Chancellor William Allen of the Delaware Chancery Court, a prominent New York City practitioner commented to him after *Unitrin*: “So it looks like we’re back to business judgment review, aren’t we?”²³ Thus the “limited use” pill identified in *Moran* was transformed into a more potent “Just Say No” pill.

A standard pill, even a “Just Say No” pill, is still vulnerable to a proxy contest: if a bidder can gain control of the target’s board, it can redeem the pill

¹⁶ *Moran v. Household Int’l, Inc.*, 500 A.2d 1346 (Del. 1985).

¹⁷ See *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986) (enjoining defensive recapitalization under *Unocal*); *Grand Metropolitan PLC v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988) (enjoining defensive spin-off and mandating redemption of pill under *Unocal*); *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988) (enjoining recapitalization and mandating redemption of pill under *Unocal*); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1989) (enjoining management buyout, following earlier decision to enjoin defensive recapitalization).

¹⁸ 571 A.2d 1140 (Del. 1989).

¹⁹ 571 A.2d at 1154 (emphasis added).

²⁰ See, e.g., James C. Freund & Rodman Ward, Jr., *What’s ‘In,’ What’s ‘Out’ in Takeovers in Wake of Paramount v. Time*, NATL. L. J. 22, 25 (Mar 26, 1990).

²¹ 651 A.2d 1361 (Del. 1995).

²² 651 A.2d at 1367.

²³ See Conversation with William T. Allen, in New York City (Feb. 20, 2003).

and proceed with its tender offer for a majority of the shares.²⁴ There are two ways in which a target can nevertheless slow down this kind of collateral attack. First, a staggered board²⁵ that cannot be dismantled,²⁶ packed,²⁷ or otherwise evaded²⁸ by a hostile bidder forces the bidder to wait through two annual elections of directors, which can take as long as two years, before it can gain a majority of seats on the target's board that would then allow it to redeem the target's pill.²⁹ Approximately 50% of U.S. public companies have "effective" (non-evadable) staggered boards (ESB's).³⁰ In the mid-1990s, three hostile takeover bids involving Delaware targets with ESB's (Younkers, Wallace Computer, and Circon) all ended in failure for the bidder, even though the bidder had won a first proxy contest to gain one-third of the target's board seats.³¹ Although a target's ability to maintain a pill after losing a first proxy is still an open question under Delaware law,³² this trilogy may have implicitly endorsed the combination of a poison pill and ESB as a takeover defense.³³

A second way in which a target board can slow down a bidder's proxy contest challenge is through a "dead hand" or "slow hand" pill. A dead hand (or "continuing director") provision mandates that the pill can only be redeemed by

²⁴ See Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*, *supra* note 7, at 905. The need for board control against a poison pill eliminates the substantive bite of other defensive measures that mattered in the pre-pill era, such as supermajority voting provisions and fair price provisions. See Coates, *supra* note 14, at 321 (arguing that the pill "completely dominates fair price and supermajority provisions").

²⁵ If a company has a staggered board, directors are grouped into classes (typically three), with each class elected at successive annual meetings. See DEL. GEN. CORP. L. § 141(d) (permitting staggered boards with either two or three-year terms for directors).

²⁶ If the staggered board is established through the corporation's bylaws (not charter), then shareholders can usually amend the bylaws and declassify it.

²⁷ If shareholders can set the size of the board and fill the resulting vacancies, they can increase the number of directors and "pack the board."

²⁸ If shareholders can remove directors "without cause," they can remove all directors and then petition the court to order a new election of directors.

²⁹ See Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*, *supra* note 7, at 916.

³⁰ See *id.* at 895.

³¹ Carson Pirie Scott announced its bid for Younkers in October 1994; Moore announced its bid for Wallace Computer in July 1995; and U.S. Surgical announced its bid for Circon in August 1996. In Younkers, the Carson Pirie Scott slate was elected in May 1995; Younkers promptly expanded its board and re-seated the incumbent directors who had been voted out. Moore won its proxy contest in December 1995, continued negotiating with Wallace, and eventually withdrew in August 1996. U.S. Surgical won its proxy contest in October 1997 and withdrew in May 1998, when it was itself taken over by Tyco International which had a policy of not making hostile bids.

³² See Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 54 STAN. L. REV. 863, 871-73 (2002).

³³ See Guhan Subramanian, *The Disappearing Delaware Effect*, J. L. ECON. & ORG. (forthcoming April 2004).

the continuing directors, defined as the directors who were in office when the pill was adopted, or their approved successors. A slow hand (or “delayed redemption”) provision prevents any redemption of the pill for a limited period of time (e.g., six months) after a change in board composition. Dead hand and slow hand pills were invalidated by Delaware courts in the late 1990s.³⁴ In contrast, dead hand pills have been endorsed in Virginia,³⁵ Pennsylvania,³⁶ and Georgia,³⁷ and slow hand pills have been endorsed in Maryland.³⁸ These “high octane” pills are far more potent than the plain vanilla pills that are valid in Delaware; the dead hand pill in particular is generally understood to be a complete defense against a hostile takeover bid.

At the other end of the pill potency spectrum, one state – California – has not validated the “flip in” pill, which is the most common version of the pill today. The leading treatise on California corporate law suggests that such a pill “appears to be violative” of section 203 of the California Corporate Code,³⁹ which prohibits distinctions among shareholders in the absence of explicit shareholder authorization.⁴⁰ Even if a California court were to uphold the poison pill at some point in the future, the uncertain status of the pill today indicates that it cannot be used as a bargaining tool in California as effectively as it might be used in other states.

Figure 1 summarizes the varying potency of poison pills as described in this Part:

³⁴ See *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998) (invalidating dead hand pill); *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998) (invalidating slow hand pill).

³⁵ See VA. CODE ANN. § 13.1-646(B) (Michie 2002); *Chesapeake Corp. v. Shore*, 771 A.2d 293, 302 (Del. Ch. 2000).

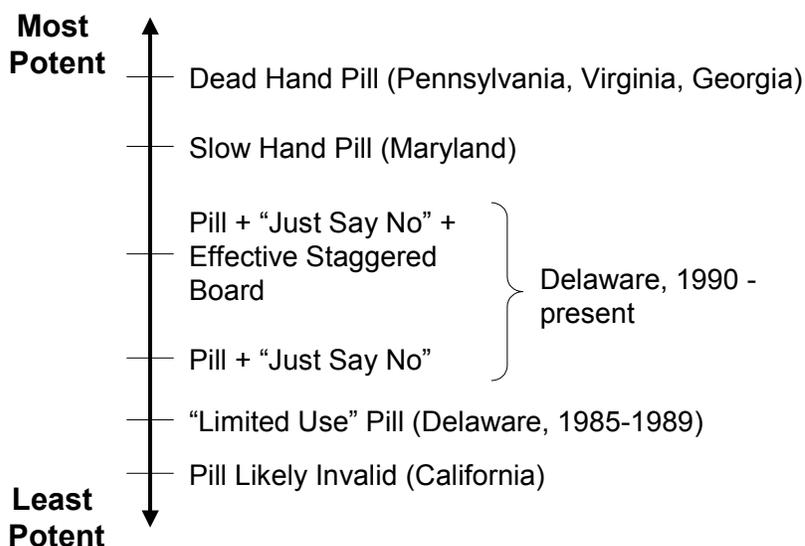
³⁶ See PA. CONS. STAT. TIT. 15 §611; *AMP Inc. v. Allied Signal Inc.*, No. 98-4405, 1998 U.S. Dist. LEXIS 15617, at *34-35 (E.D. Pa. Oct. 8, 1998).

³⁷ See GA. CODE ANN. §14-2-624(c); *Invacare Corp. v. Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997).

³⁸ MD. CODE ANN., CORPS. & ASS’NS §2-201(c)(2)(ii) (Supp. 2001) (allowing directors to limit the power of future directors to vote for redemption, modification, or termination of a pill for up to 180 days).

³⁹ HAROLD MARSH, JR., R. ROY FINKLE, & LARRY W. SONSINI, *MARSH’S CALIFORNIA CORPORATION LAW* §2.05[F], at 2-50 (4th ed. 2001). See also E-mail from Keith Paul Bishop, Commissioner of Corporations in California from 1996 to 1997, to Guhan Subramanian (Feb. 5, 2002) (“Because pills discriminate against holders, [Section 203] would seem to be a problem.”) cited in Subramanian, *supra* note 15, at 1855 n.199; Peter F. Kerman, *Hot Issues in Executive Compensation-Stock Option Grants by Delisted Companies*, 503 PLI/TAX 465, 481 (2001) (“California has . . . a policy of disfavoring shareholder rights plans or ‘poison pills.’”).

⁴⁰ Section 203 states in full: “Except as specified in the articles or in any shareholders’ agreement, no distinction shall exist between classes or series of shares or the holders thereof.”

Figure 1: Pill Potency Spectrum

With this background in place, I now describe and assess the arguments that have been put forward to permit stronger takeover defenses. While these are general arguments, applicable to any takeover defenses, in the modern (post-pill) era they essentially amount to arguments in favor of more potent poison pills.

B. The Bargaining Power Hypothesis

Many defense proponents rely on the bargaining power hypothesis to argue that boards should have broad discretion in installing and maintaining a poison pill against a hostile bidder. For example, Mark Gordon, a partner at Wachtell, Lipton, Rosen & Katz, states that takeover defenses “should give targets the leverage to negotiate a better premium . . . in friendly transactions . . . because the target can effectively counter the acquirer’s implicit threat to ‘go hostile’ if its various demands are not met.”⁴¹ Gordon continues that “even a [trivially small] benefit applied over thousands of friendly deals amounts to a massive net benefit to stockholders of companies that employ an ESB.”⁴²

Gordon, like many practitioners in favor of takeover defenses, states the hypothesis as if it were applicable to all friendly transactions. Although the validity of the bargaining power hypothesis does not depend on its universality, it

⁴¹ Gordon, *supra* note 3, at 823. See also Wilcox, *supra* note 3, at 4.

⁴² Gordon, *supra* note 3, at 824.

is usually stated in these terms by its proponents. In a recent *University of Pennsylvania* symposium, for example, Marcel Kahan and Edward Rock echo Gordon's claim that the bargaining power benefit applies to all friendly deals: "The number of friendly deals dwarfs the number of hostile bids. Thus, even if staggered boards have only a miniscule effect on the target's ability to obtain a better offer in friendly deals, the net effect of such improvement is likely to outweigh the loss from hostile bids blocked by staggered boards."⁴³

An obvious implication of the bargaining power hypothesis is that takeover defenses increase overall target shareholder value. Therefore target boards should have broad discretion to install and maintain takeover defenses, because the costs of bid resistance and possible bid deterrence are outweighed by higher premiums in completed deals.⁴⁴ In Part II.D below I examine the empirical evidence that has been offered thus far to support the bargaining power hypothesis. Before doing so, I briefly review other shareholder-focused arguments that have been put forward to support takeover defenses, and explain why these arguments are less persuasive than they may have been two decades ago when takeover defenses first appeared.

C. The Decline of Other Arguments

1. Preventing structural coercion

Two arguments, in addition to the bargaining power hypothesis, have been put forward to support the view that takeover defenses increase shareholder value when a hostile takeover bid has been launched. The first is that takeover defenses prevent "structurally coercive offers,"⁴⁵ such as two-tier tender-offers, "Saturday Night Specials,"⁴⁶ and cascading tender offers.⁴⁷ The problem with structurally coercive offers is that they place shareholders in a "social dilemma" with respect to the tender decision.⁴⁸ When an offer is coercive, the dominant strategy is to tender, even if one believes that the offer does not represent fair value for the

⁴³ Kahan & Rock, *supra* note 3, manuscript at 26-27.

⁴⁴ Kahan & Rock, *supra* note 3, manuscript at 27; Gordon, *supra* note 3, at 823-24; Bainbridge, *supra* note 3, at 808; Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1039, 1064 (2002).

⁴⁵ See Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 256 (1989).

⁴⁶ A "Saturday Night Special" is a tender offer that is open for only a short period of time, typically just a few days, thereby forcing shareholders to decide quickly whether or not to tender. The term was introduced as part of a public relations campaign against Colt Industries' hostile tender offer for Garlock in 1975. See PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 40 (1996).

⁴⁷ A "cascading tender offer" offers lower consideration for each tranche of shares that is tendered.

⁴⁸ See Subramanian, *supra* note 12, at 387.

company.⁴⁹ Thus structural coercion might permit inefficient transfers of corporate control.

The coercion problem is well-understood and well-accepted by practitioners and academic commentators on all sides of the defenses debate. Takeover defenses effectively solve this problem on the sell-side by allowing the target board to resist structurally coercive offers. However, over the past thirty-five years, important regulation has provided a buy-side solution as well. The Williams Act, passed by Congress in 1967, substantially reduces a bidder's ability to make a structurally coercive offer. Section 14(e) of the Act requires that all tender offers stay open for at least twenty business days, thus eliminating the possibility of "Saturday Night Specials."⁵⁰ Rule 14d-8, promulgated by the SEC under the authority of the Act, requires an acquirer to purchase all shares on a pro rata basis if the offer is over-subscribed.⁵¹ Rule 14d-10, the "all-holders rule," requires the acquirer to open its tender offer to all shareholders, and to pay all those who tender the same "best" price.⁵²

At the state level, fair price statutes directly prohibit coercive offers by setting procedural criteria to determine a fair price in takeover contests,⁵³ and control share acquisition statutes indirectly prohibit coercive offers by requiring an (uncoerced) shareholder vote in order to make the acquirer's shares votable beyond a certain threshold (typically 20%).⁵⁴ Thirty-five states passed a fair price statute, a control share acquisition statute, or both, during the 1980s and early 1990s (though, notably, Delaware was not one of them).⁵⁵

As a result of these buy-side reforms, structurally coercive offers became virtually non-existent by the 1990s.⁵⁶ The one place where they continue to

⁴⁹ See Lucian Arye Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911, 922-23 (1987); Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985).

⁵⁰ See Rule 14e-1.

⁵¹ See Rule 14d-8.

⁵² See Rule 14d-10.

⁵³ See, e.g., CONN. GEN. STAT. ANN. §§ 33-840 to 33-842 (requiring an acquirer to pay the highest of the twenty-four month high, market price at the bid announcement date, and a formula that combines these two factors).

⁵⁴ See, e.g., OHIO REV. CODE ANN. §§ 1701.01, 1701.831 (requiring disinterested shareholder approval for acquirer to be able to its vote shares beyond 20% threshold).

⁵⁵ See Subramanian, *supra* note 15, at 1827-28 & Table 3 (2002).

⁵⁶ Patrick McGurn, Special Counsel for Institutional Shareholder Services, makes this point humorously in a recent panel discussion at the Harvard Business School: "[Structurally coercive offers] have been used forever as this justification for the belt, suspenders, duct-tape, and all the various things holding up management's pants at this point. . . . [I]t's this great monster that's out there, still today, even though we haven't seen one in almost twenty-five years, that this thing is approaching. It's the two-tiered tender offer that's going to get us all! You guys [takeover defense proponents] have to give up on that. Find a new bad guy at this point." *reprinted in*

appear is in dual consideration offers: in earlier work I identify the point that part-cash, part-stock offers, which are legal under state and federal rules, may become structurally coercive if the stock portion (typically, the back-end) does not have the same value as the cash portion.⁵⁷ In fact, an acquirer who raises the front-end cash portion of a takeover bid might make the overall offer more coercive, because the market will take this increase in value out of the back-end stock that is being offered.⁵⁸ Because the Williams Act does not apply to these kinds of bids,⁵⁹ sell-side defenses might be necessary in order to prevent structural coercion. But this argument would only justify defensive measures for offers that are part-cash, part-stock, and only until shareholders have had the opportunity to vote on the transaction (indirectly) through a board election.⁶⁰ Proponents of

BRIAN HALL & GUHAN SUBRAMANIAN, CIRCON TEACHING NOTE (Harvard Business School case 902-220) (May 7, 2002).

⁵⁷ See Subramanian, *supra* note 12 at 403-410.

⁵⁸ See Interview with Morris Kramer, Skadden, Arps, Slate, Meagher & Flom, in New York, NY (March 14, 1997), transcript at 8 (“Every time you raise the front end, your stock goes down on the back end. That’s the problem: you can keep raising the front end, but your back end keeps going down, and it just becomes more coercive.”), *cited in* Subramanian, *supra* note 12, at 404 n.174.

⁵⁹ See *Wellman v. Dickinson*, 475 F. Supp. 783 (S.D.N.Y. 1979) (establishing eight-part test to determine what constitutes a tender offer for purposes of the Williams Act); Robert Owen Ball, III, *Second Step Transactions in Two-Tiered Takeovers: The Case for State Regulation*, 19 GA. L. REV. 343, 351 (1985) (“Since the second step merger transaction proceeds virtually free of federal regulation, bidders are able to employ whatever measures they wish to ensure the success of their offer.”).

⁶⁰ Lucian Bebchuk argues that even an all-cash offer to be followed by a back-end freeze-out at the same price is still structurally coercive because shareholders who are frozen out in the back end receive their cash later than shareholders who tender in to the front end. See Bebchuk, *supra* note 8, at 983-85. However, a buyer typically executes its back-end freeze-out immediately after closing its front-end tender offer. For example, in Marathon Oil’s all-cash acquisition of Pennaco Energy in 2001, Marathon bought 86% of Pennaco’s shares in a tender offer that closed on February 5th, announced a special meeting of shareholders on February 26th, and held the special meeting to complete the freeze-out on March 26th. See *Pennaco Energy/Marathon Oil Merger Agreement*, Schedule 14C (filed Feb. 26, 2001), at 21. In fact, the second step freeze-out can be executed on the same day as the closing of the first-step tender offer, if the buyer gains 90% or more in the first step and thereby qualifies for a short-form merger. See DEL. GEN. CORP. L. § 253. As a business matter, acquirers generally want to execute the second-step freeze-out as soon as possible in order to begin implementing operational changes. In fact, not moving quickly creates significant legal risk due to uncertainty in applying dissenters’ appraisal rights. See, e.g., *Cede v. Technicolor, Inc.*, 684 A.2d 289, 293-294 (Del. 1996) (target in 100% all-cash, two-step transaction alleging that acquirer should be required to pay fair share of operational improvements implemented during twelve-month window between closing of the first-step tender offer and second-step freeze-out). Even if shareholders’ cost of capital were sufficiently high to make this delay significant (and the offer, by extension, structurally coercive), Bebchuk advocates defensive tactics only until shareholders have had the opportunity to express their view on the transaction through a non-coercive vote. See Bebchuk, *supra* note 8, at 981-82.

takeover defenses generally do not condition their argument on the type of consideration being offered, nor do they concede that the board should defer to the outcome of a non-coercive shareholder vote.⁶¹ Thus the structural coercion argument would seem to apply to only a small fraction of the cases in which proponents of takeover defenses would wish to uphold their use.

2. Preventing substantive coercion

The other argument that has been put forward in support of takeover defenses is that management knows better.⁶² Because target shareholders can sometimes gain more by remaining independent than from selling to the hostile bidder, there is the risk of “substantive coercion,” defined by Ronald Gilson and Reinier Kraakman as “the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management’s representations of intrinsic value.”⁶³ In an influential article published in 1979, Martin Lipton, a founding partner of Wachtell, Lipton, Rosen & Katz and the inventor of the poison pill, examined a sample of 36 hostile takeover targets from the period 1973 to 1979 that remained independent, and concluded that “shareholders have profited in the *overwhelming majority* of defeated takeovers.”⁶⁴ Assuming that a majority of the shareholders would have tendered into these offers,⁶⁵ Lipton’s data suggested that management did in fact know better, and, by extension, that the threat of substantive coercion was real.

The idea that remaining independent is beneficial to target shareholders, and therefore that takeover defenses should be permitted to allow this realization of value, gained traction through a series of Delaware Supreme Court cases from the mid-1980s to the mid-1990s. In 1985, the Delaware Supreme Court cited Lipton’s “rather impressive study” in upholding Unocal’s defensive measures against hostile bidder T. Boone Pickens.⁶⁶ Four years later, the Court upheld Time’s defensive measures against Paramount’s hostile bid based on a perceived threat of “ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce.”⁶⁷ While many read *Time Warner* itself

⁶¹ See, e.g., Gordon, *supra* note 3, at 826-27; Bainbridge, *supra* note 3, at 807-08; Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 861 (2002).

⁶² For an example of this argument being made in a real-world deal, see, e.g., *Pennzoil Board Spurns Pacific Offer, Sues in Federal Court*, WALL. ST. J. (Oct. 15, 1997) at B8 (“[Pennzoil] said its board believes shareholders will benefit more from its efforts to improve its earnings and future performance than they will from tendering their shares to Union Pacific Resources.”).

⁶³ See Gilson & Kraakman, *supra* note 45, at 267.

⁶⁴ Lipton, *supra* note 1, at 108-109 (1979) (emphasis added).

⁶⁵ See *id.* at 113 (“[T]he special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion – they will tender.”).

⁶⁶ *Unocal v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985).

⁶⁷ *Paramount Communications v. Time*, 571 A.2d 1140 (Del. 1989).

to endorse substantive coercion,⁶⁸ to the extent that there was any doubt about the issue the Delaware Supreme Court squarely endorsed the concept six years later, in upholding Unitrin's defensive measures against hostile bidder American General Corp.: "The record appears to support Unitrin's argument that the Board's justification for adopting the Repurchase Program was its reasonably perceived risk of substantive coercion, i.e., that Unitrin's shareholders might accept American General's inadequate Offer because of 'ignorance or mistaken belief' regarding the Board's assessment of the long-term value of Unitrin's stock."⁶⁹

The problem with this line of Delaware cases is that its underlying empirical basis – that target shareholders will achieve better returns if the target remains independent – is on average no longer true (if it ever was) in the 1990s M&A marketplace. In 1981, Ronald Gilson pointed out several methodological flaws in Lipton's 1979 study, including the lack of any adjustment for industry effects, market effects, or time value of money.⁷⁰ In recent work, Lucian Bebchuk, John Coates and I correct these and other deficiencies and update the sample to examine the outcomes of all hostile takeover contests between 1996 and 2002 (n=112).⁷¹ We track the stock price performance of the forty-one targets from this sample that remained independent, and find that shareholders of these targets, on average, received 15-20% lower buy-and-hold abnormal returns than they would have received if the company had been sold to the initial hostile bidder or to a white knight.⁷² Management, at least in the late 1990s market for corporate control, did not on average know better than their shareholders who wished to accept a hostile offer.

We reported preliminary results from this project in an article published in the June 2002 issue of the *Stanford Law Review*.⁷³ In December 2002, the *Stanford Law Review* published a symposium with six commentaries on our work. Surprisingly, even ardent supporters of takeover defenses did not question our finding that shareholders of targets that remained independent would have

⁶⁸ See, e.g., Strine, *supra* note 32.

⁶⁹ *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995). In the same year as *Unitrin*, *Moore v. Wallace Computer*, 907 F. Supp. 1545 (D. Del. 1995), similarly endorsed substantive coercion, though the case was decided in the federal district court for Delaware and therefore did not generate binding precedent under Delaware corporate law.

⁷⁰ See Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 857-858 (1981). See also Frank H. Easterbrook & Gregg A. Jarrell, *Do Targets Gain from Defeating Tender Offers?*, 59 NYU L. REV. 277 (1984) (surveying existing studies and presenting new evidence to conclude no).

⁷¹ See Bebchuk, Coates & Subramanian, *Effect of Defenses*, *supra* note 7.

⁷² See *id.*

⁷³ Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*, *supra* note 7.

achieved higher returns if they had sold.⁷⁴ Thus the evolution of the Delaware case law during the 1980s and 1990s, which culminated in the endorsement of substantive coercion by 1995, is based on an empirical foundation that takeover defense commentators agree is incorrect in the 1990s marketplace.⁷⁵

D. Evidence in Favor of the Bargaining Power Hypothesis

To summarize, the problem of “Saturday Night Specials,” cascading tender offers, and other structurally coercive offers was largely solved by the Williams Act in 1968, subsequent SEC rules, and certain state antitakeover statutes; moreover, to the extent that structural coercion remained, it could only justify a far more limited set of defensive tactics than defense proponents wished to permit. And the argument that takeover defenses allowed targets to remain independent and achieve greater returns for their shareholders was refuted in a series of empirical studies by Bebchuk, Coates, and myself, without protest (or even mild objection) from even the most fervent of defense proponents. The final refuge for supporters of takeover defenses in the new millennium seems to be the bargaining power hypothesis. Not surprisingly, with the decline of other arguments, this argument has been stressed more frequently in the past few years.⁷⁶ This Part reviews the evidence that has been put forward to support this theory.

1. Pill premium studies

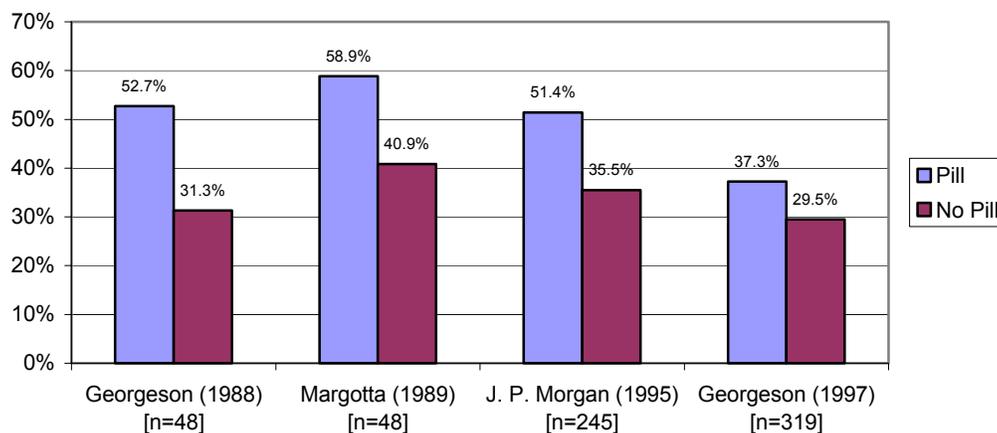
Practitioners and academic commentators generally rely on the numerous “pill premium” studies as evidence in favor of the bargaining power hypothesis. Jonathan Macey, for example, states that the pill premium studies “confirm the common sense intuition that, despite the fact that poison pills and other anti-takeover devices are subject to abuse, such devices provide incumbent managers with greater power to negotiate with outside bidders, and this greater negotiating power results in higher premiums for target firm shareholders.”⁷⁷ Figure 2 summarizes this evidence:⁷⁸

⁷⁴ See, e.g., Bainbridge, *supra* note 3, at 807 n.92 (“[M]y response to Bebchuk, Coates, and Subramanian’s argument that shareholders are injured by the tandem of a staggered board and poison pill can be stated simply as: So what?”); Stout, *supra* note 61, at 856-57 (acknowledging that our study did “a nice job of undermining the argument that [takeover defenses] increase target shareholders’ *ex post* returns.”).

⁷⁵ See Patrick S. McGurn, *Classification Cancels Corporate Accountability*, 55 STAN. L. REV. 839, 840 (“Professors Bebchuk, Coates, and Subramanian shatter the shareholder-value-enhancement mythology that some boards have used to justify their staggered structures in recent years.”).

⁷⁶ See sources cited *supra* note 3.

⁷⁷ Macey, *supra* note 8, at 1039. See also Mark Gordon, *Poor Study Habits*, THE DAILY DEAL at 16 (June 20, 2002) (citing pill premium studies as evidence in favor of the bargaining power hypothesis); Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor*

Figure 2: Pill Premium Study Results

Although the sample sizes, methodologies, and time frames differ, Figure 2 shows that the results are quite consistent across studies: targets with pills achieve higher premiums than targets without pills. However, a basic flaw in all of the pill studies arises from the fact that virtually all targets that do not have pills have the option to put them in at any point during the takeover negotiation – thus friendly acquisitions are generally negotiated in the “shadow” of the poison pill.⁷⁹ Because acquirers will know this fact as well, it is unclear how to interpret the results from the pill premium studies. Practitioners,⁸⁰ judges⁸¹ and most corporate law academics⁸² (other than those who rely on the pill studies) have generally accepted this point, that the results from the pill premium studies are ambiguous at best, and perhaps meaningless. Rather than a “bargaining power” interpretation, John Coates puts forward several more plausible explanations: firms may adopt pills because these firms are more difficult to value without

Gilson, 27 DEL. J. CORP. L. 1, 20 (citing pill premium studies as evidence that pills increase shareholder returns).

⁷⁸ Comment & Schwert also report results that are consistent with these other studies, but because they do not report univariate statistics their findings therefore are not included in Figure 2. See Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3 (1995).

⁷⁹ See Coates, *supra* note 14.

⁸⁰ See, e.g., R. Franklin Balotti & J. Travis Laster, *Professor Coates Is Right. Now Please Study Stockholder Voting*, 54 U. MIAMI L. REV. 819 (2000).

⁸¹ See, e.g., Jack B. Jacobs, *Comments on Contestability*, 54 U. MIAMI L. REV. 847 (2000) (Delaware Vice-Chancellor reporting “no reason to disagree” with Coates’ conclusion).

⁸² See, e.g., Jeff Gordon, *Poison Pills and the European Case*, 54 U. MIAMI L. REV. 839, 840 (2000) (“I agree with Professor Coates that the empirical evidence on poison pills is difficult to assess.”).

private information gained through due diligence, and so may attract higher premiums; firms may be more likely to adopt pills in consolidating industries, in which competition among industry players may drive bid prices upward; or pills may be adopted by poorer performing companies, which can then extract higher premiums from acquirers because the opportunity for improvement is greater.⁸³

Kahan & Rock nevertheless attempt to salvage the pill premium studies as evidence in favor of the bargaining power hypothesis with the argument that “the adoption of a pill signals that management is *ready to use this power* to extract a higher premium (at the risk of defeating a bid).”⁸⁴ Kahan & Rock present no evidence to support this view, and others who have examined this precise issue more closely find no evidence to support it.⁸⁵ M&A practitioners reject the Kahan & Rock argument as well.⁸⁶ As described by [Banker G], Global Head of Mergers & Acquisitions at [Bank G]:

Whether a company has a pill in place is not meaningful . . . There are many companies that for lots of reasons don’t have pills. I have always counseled – as a lawyer⁸⁷ and as a banker – companies that don’t have poison pills, that they should not put them in, because if you put a poison pill in all you’re doing is attracting attention to yourself. I don’t think it’s a prudent thing to put a pill in place if you don’t have one, because you can always put one in in a half an hour.⁸⁸

2. Anecdotal evidence

Disarmed of the pill premium evidence, proponents of takeover defenses have resorted to the realm of anecdote to support their view. Martin Lipton in a *University of Chicago Law Review* symposium,⁸⁹ and his partner Mark Gordon in

⁸³ See Coates, *supra* note 14, at 313-14.

⁸⁴ Kahan & Rock, *supra* note 3, manuscript at 28 (emphasis in original).

⁸⁵ See Coates, *supra* note 14, at 301 (noting the “belief that companies that have adopted pills prior to a bid in fact resist more frequently than companies that have not” but also reporting “no empirical evidence supporting such a belief”). See also JAMIL ABOMERI, POISON PILLS AND SHAREHOLDER VALUE, 1992-96 (1997) (finding that companies with pills were *less* likely to defeat hostile takeover bids than companies without pills).

⁸⁶ See, e.g., [Banker E] Interview (“Anyone can drop in a pill overnight. . . . The only way I would put some significance on [the absence of a pill] is if a company said, ‘We don’t intend to use a pill under most circumstances.’ I would pay attention to that, but I’m not aware of any company that has ever said that.”); [Banker I] Interview (“The lack of a pill is a function of the heritage of the company. . . . I don’t think that the lack of one speaks to the willingness of a target to be a willing seller. I would also add that the presence of one doesn’t necessarily speak to the willingness or unwillingness of someone to be a seller.”).

⁸⁷ Before joining [Bank G], [Banker G] was a corporate partner at [Law Firm G] in New York City.

⁸⁸ [Banker G] Interview.

⁸⁹ See Lipton, *supra* note 44, at 1057.

the *Stanford Law Review* symposium described above,⁹⁰ both describe Willamette's use of an ESB defense against Weyerhaeuser as (in Lipton's words) a "shining example of how a staggered board and poison pill operate to the benefit of shareholders."⁹¹ The story, in brief, is that Weyerhaeuser launched a hostile bid for Willamette at \$48 per share in November 2000; Willamette resisted for fourteen months, lost a first proxy contest but retained board control due to its ESB, and finally sold to Weyerhaeuser for \$55.50 per share, a 15.6% increase over Weyerhaeuser's initial offer. Lucian Bebchuk responds that a 15.6% increase over a fourteen month period was not a particularly good return for Willamette's shareholders, and offers Bosch Telecom's bid for Detection Systems as an example of a target achieving an even better improvement relative to the initial offer without the need for potent takeover defenses.⁹² Gordon counters that 15.6% was a good return compared to the S&P 500 and the relevant industry index during this fourteen month period.⁹³

The obvious problem with anecdotal evidence is that examples can be chosen selectively, without providing any sense for whether the particular case is representative or an outlier. In fact, a more systematic analysis demonstrates that Willamette's 15.6% increase is average among all targets in the modern takeover era, including targets without strong defenses. There have been thirty successful hostile bids between 1996 and 2002, nine against targets with ESB's (including Willamette), and twenty-one against targets without ESB's.⁹⁴ Among these thirty bids, I find that every bidder except one eventually paid more than its first publicly announced offer.⁹⁵ The average increase over the initial offer was 14.8%, broken down as 13.6% against ESB targets and 15.4% against non-ESB targets. Thus Willamette's bargaining power yielded a 0.8% greater increase than the average target was able to achieve, and a 0.2% higher increase than the average non-ESB target was able to achieve.⁹⁶ This difference, of course, is not statistically significant. In fact, though statistically insignificant, it is instructive to note that non-ESB targets achieved on average a 1.8% *greater* increase from

⁹⁰ See Gordon, *supra* note 3, at 834-835.

⁹¹ Lipton, *supra* note 44, at 1057.

⁹² See Bebchuk, *supra* note 8, at 1031.

⁹³ See Gordon, *supra* note 3, at 835.

⁹⁴ See Bebchuk, Coates & Subramanian, *The Effect of Defenses*, *supra* note 7.

⁹⁵ These results are derived from a proprietary database of all hostile takeover bids between 1996 and 2002, constructed by Lucian Bebchuk, John Coates, and myself. [hereinafter BEBCHUK, COATES & SUBRAMANIAN, HOSTILE BIDS DATABASE].

⁹⁶ Moreover, using a (conservative) 6% cost of capital, the fact that Willamette took fourteen months to achieve this increase, compared to approximately five months for the average target that sold to a hostile bidder, suggests that Willamette used its bargaining power to the detriment of its shareholders: the extra nine months would require an additional 4.5% increase in the premium received in order for the Willamette shareholders in order to earn a 6% annualized return; instead the Willamette shareholders received an extra 0.8% return for this nine months

the initial bid than ESB targets, a result that is directionally opposite from what Gordon, Lipton, and other proponents of the bargaining power hypothesis would predict.

III. A Model of Bargaining with Defenses

In the previous Part I challenged the arguments that have been put forward to date in support of the view that takeover defenses increase shareholder value when a company becomes a takeover target. I argued that structural coercion is largely a historical artifact; that substantive coercion is in tension with the empirical evidence that shareholders of hostile bid targets, on average, do better when they sell; and that the bargaining power hypothesis cannot be supported by the pill premium studies or by the anecdotal evidence that has been put forward.

Among these three arguments, the bargaining power hypothesis nevertheless remains plausible, because (unlike the structural coercion and substantive coercion arguments) there is no theoretical model or empirical evidence to date that would clearly refute it.⁹⁷ In this Part I put forward a theory of bargaining in the “shadow” of takeover defenses using basic negotiation analytic tools. In Part III.A I develop a baseline model involving a bilateral monopoly between acquirer

⁹⁷ Two recent discussions of the bargaining power hypothesis reach opposite conclusions. Kahan & Rock argue that board entrenchment through takeover defenses is necessary in order for the board to have bargaining power against a potential bidder. See Kahan & Rock, *supra* note 3, manuscript at 14 (“If a board’s power is not entrenched, any board decision can be overridden at any time by shareholders. But this makes it more difficult for the board to make credible threats or commitment or employ other strategic devices.”). Bebchuk argues that management may have bargaining power even if shareholders have the right to circumvent the bargaining process and directly accept a bidder’s offer. See Bebchuk, *supra* note 8, at 1008 (“[Shareholders] might defer to the board and take no action to remove management’s bargaining mandate. . . . But they might sometimes choose to take away the bargaining mandate and to accept the bidder’s offer if they conclude that management’s recommendation is likely the product of self-serving reasons or cognitive bias.”). The problem with Kahan & Rock’s analysis is that it moves no further than the baseline model presented here, failing to recognize alternatives away from the table, hostile bid costs, asymmetric information, and agency costs. As discussed in Part III.E *infra*, the introduction of these factors substantially undermines the authors’ conclusion that “the net effect of [a target board’s bargaining power that arises from defenses] is likely to outweigh the loss from hostile bids blocked by staggered boards.” See Kahan & Rock, *supra* note 3, manuscript at 27. The problem with Bebchuk’s argument is that, as demonstrated in the baseline model presented in Part III.A and described qualitatively by Kahan & Rock, a bidder’s direct access to target shareholders does in fact reduce a target board’s bargaining power. For example, consider a target with a stock price of \$100, and a bidder who makes an offer of \$130. If the bidder has an option to go directly to shareholders, and there is some positive probability that shareholders would accept (perhaps due to pressure-to-tender problems, see Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1722-23 (1985)), then a target board would be more likely to accept \$130 rather than holding out for (e.g.) \$140.

and target, no incremental costs of making a hostile bid, symmetric information, and loyal agents. In this stylized model I find clear theoretical support for the bargaining power hypothesis. In the remainder of this Part, I relax each of these constraints, individually and additively, and find that the bargaining power hypothesis becomes considerably narrower in its scope of application.

Throughout this Part, I use evidence compiled from interviews with the heads of mergers and acquisitions at ten major New York City investment banks.⁹⁸ While the interview methodology is not new in legal scholarship,⁹⁹ the interview findings take on special significance in this project because the interviewees account for virtually the entire market of interest. Using a database of all completed friendly acquisitions of U.S. public-company targets announced between January 1990 and December 2002 (n=6,414),¹⁰⁰ I calculate the fraction of targets and acquirers that retained one of the firms represented by my interviewees. Table 1 reports the results:

Table 1: Representation of Interviewed Firms Among U.S. Negotiated Acquisitions, 1990-2002

| | % of deals | % of deal volume |
|---------------------------|------------|------------------|
| Advisor to target | 44.1% | 87.0% |
| Advisor to acquirer | 53.6% | 88.5% |
| Advisor to either or both | 71.7% | 96.4% |

Table 1 shows that the mergers & acquisitions departments headed by my interviewees accounted for 96% of deal volume since 1990, on either the buy-side, the sell-side, or both.¹⁰¹ While in previous work I have used practitioner interviews to illustrate theoretical points or results from econometric analysis,¹⁰² the concentrated market for high-end financial advisors allows me here to draw conclusions from the interviews themselves. That is, because the interviewees

⁹⁸ For a list of the interviewees, see *supra* note 10

⁹⁹ See, e.g., Ronald J. Mann, *Explaining the Pattern of Secured Credit*, 110 HARV. L. REV. 625 (1997); Subramanian, *supra* note 12; Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999*, 56 BUS. LAW. 653 (2001).

¹⁰⁰ This sample is larger than the sample I use in Part IV because of the exclusions noted in Part IV.A.1, notably the exclusion there of deals less than \$50 million in value.

¹⁰¹ The lawyer market for negotiated acquisitions is much less concentrated. See John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1325-26 (2001).

¹⁰² See, e.g., John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory & Evidence*, 53 STAN. L. REV. 307 (2000); Guhan Subramanian, *The Drivers of Market Efficiency in Revlon Transactions*, J. CORP. L. (forthcoming 2003).

represent 96% of the relevant market, consensus among them on a particular point is important evidence.

A. Baseline Case: Bilateral Monopoly, No Hostile Bid Costs, Symmetric Information, and Loyal Agents¹⁰³

I begin with a stylized takeover negotiation between the target board and the acquirer. Assume that the target's shares are widely held, and that the target board is loyal to its shareholders. Assume further that the acquirer and target have a bilateral monopoly, i.e., the only options for the target are a deal with the given acquirer or no deal at all; and the only options for the acquirer are a deal with the given target or no deal at all. Finally, assume that the target is worth \$100 as a standalone entity and \$200 to the acquirer, and that the acquirer would incur no incremental costs (i.e., beyond the costs of the negotiated acquisition) in making a hostile bid.

With these assumptions in place, I introduce takeover defenses. For purposes of this baseline example I take only the two extremes: complete defenses, in which the acquirer cannot gain control of the target unless the target board agrees to the acquisition; and no defenses, in which the acquirer can at any point in the negotiation with the target board make a take-it-or-leave-it, costless tender offer to the target's shareholders.¹⁰⁴ If such a take-it-or-leave-it offer is made, the target shareholders will tender if and only if the offer price is strictly greater than the stand-alone value of the target.

Finally, I assume common knowledge, that is, that the target board, the target shareholders, and the acquirer know all of these facts, and that all parties know that all parties know, etc.

I begin with the case of no takeover defenses. The expected outcome in this case is that the acquiring company will make an offer of \$101 to acquire the target, which the target's board will accept. The reason is that the acquirer's walk-away alternative is to make a tender offer directly to the target shareholders for \$101.¹⁰⁵ Because there are no incremental costs to making a hostile bid, the acquirer will immediately resort to a hostile bid as soon as the target board rejects \$101. Because \$101 is greater than \$100, the target shareholders will accept. Finally, because of the common knowledge assumption, the target board can predict this sequence of events *ex ante* and will therefore accept \$101.

¹⁰³ I thank George Baker for helpful conversations in developing this baseline model.

¹⁰⁴ Therefore, a target with no defenses cannot put in a poison pill during the negotiations, either due to its jurisdiction or its charter.

¹⁰⁵ Because the target shareholders cannot bargain with the acquirer, the acquirer can make a credible commitment to \$101 even though target shareholders are aware (under the common knowledge assumption) that the acquirer can pay up to \$199. See generally THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* (1960). See also *supra* note 97.

Now consider the case of complete takeover defenses. In this scenario, the acquirer's walk-away alternative is no deal, with expected profit of zero. The acquirer knows that the target board would accept as little as \$101; the target board knows that the acquirer would be willing to pay as much as \$199. The bargaining range in this negotiation, then, is from \$101 to \$199. Modeling this negotiation as a Nash bargaining game with equal bargaining weights yields an expected outcome of \$150.¹⁰⁶

This baseline example formalizes the mechanisms that underlie the bargaining power hypothesis. Surprisingly, despite the widespread acceptance of the bargaining power hypothesis (or perhaps because of it), no one has previously specified the underlying negotiation mechanisms that make it true. Here, we see bargaining power in action: without takeover defenses, the target shareholders receive \$101; with takeover defenses, the target shareholders receive \$150 in expectation. In the remainder of this Part, I introduce a series of real-world factors that make the influence of takeover defenses on the negotiated outcome more ambiguous.

B. Alternatives Away from the Table

As a starting point, I relax the assumption that the bidder and target negotiate in a bilateral monopoly situation. In the real world, both the target and the acquirer have options away from the table; among these alternatives, each party has a best alternative. While this point is obvious and comes out of basic negotiation theory,¹⁰⁷ it has implications that are far from obvious and that have been overlooked by commentators to date: the existence of a walk-away alternative places a constraint, often an important constraint, on the ability of the target to extract more from the acquirer through the use of defenses. If defenses are not a binding constraint in the takeover negotiation, then they do not influence the reservation prices of the parties. And if defenses do not influence the

¹⁰⁶ In a Nash bargaining game, two players each request a certain amount of the surplus (here, \$100). If their requests are compatible (here, summing to \leq \$100), each player receives the amount requested; if their requests are not compatible (summing to $>$ \$100), each player receives nothing. Assuming Pareto optimality, independent of irrelevant alternatives, symmetry, and invariance to positive linear transformations, the Nash bargaining game solution is that each player demands half of the surplus. *See generally* J. Nash, *Two-Person Cooperative Games*, 21 *ECONOMETRICA* 128 (1953). Changing the bargaining weights of the players changes the division of the surplus but does not change any of the conclusions that follow regarding the bargaining power hypothesis. *See also* RICHARD SHELL, *BARGAINING FOR ADVANTAGE* 189 (1999) (outcome in single-issue distributive negotiation is typically close to the midpoint of the two opening offers); Colin Camerer & Richard H. Thaler, *Anomalies: Ultimatums, Dictators, and Manners*, 9 *J. ECON. PERSP.* 209 (1995) (proposers in two-party Ultimatum Game typically offer 40-50% of the sum to be divided).

¹⁰⁷ *See* ROGER FISHER, WILLIAM URY, AND BRUCE PATTON, *GETTING TO YES* at 99-100 (2nd ed. 1991) (coining the acronym "BATNA" for "best alternative to a negotiated agreement").

reservation prices of the parties, then basic negotiation theory predicts that they will not influence the expected outcome of the negotiation.

1. Buy-side alternatives

Beginning on the acquirer's side, consider a simple quantitative example. Using the assumptions from the baseline case, consider an acquirer which is negotiating with a target board that has complete defenses. In a bilateral monopoly situation, recall that the predicted outcome is \$150. But now assume that the acquirer has an alternative away from the table: a different acquisition of a target T2 which has identical assets.¹⁰⁸ The price of this acquisition would be \$101, either because T2 has no defenses, or because T2's managers prefer a takeover to remaining independent. With the introduction of T2, as soon as the price in the negotiation with T1 goes above \$101, the acquirer will simply buy T2 instead.¹⁰⁹ Knowing this fact, a loyal T1 board will agree to \$101 from the acquirer even if it has complete defenses, an outcome that is the same as the outcome with no defenses. This simple example illustrates the point that the existence of walk-away alternatives caps (and, in extreme cases, eliminates) the effectiveness of takeover defenses as a bargaining tool.

Notice that this argument requires an opportunity cost in buying either T1 or T2: if there were no such cost, then a value-maximizing acquirer should pay \$150 to acquire T1 and \$101 to acquire T2, for a total profit of \$149 (\$50 + \$99). But in the real world, three factors point strongly toward an opportunity cost in buying either T1 or T2.

First, an acquirer typically needs either T1 *or* T2 to fill a particular portfolio need.¹¹⁰ Take the recent example of Proctor & Gamble's acquisition of Wella

¹⁰⁸ See [Banker H] Interview ("A banker may approach the potential target, and say 'I was just with the CEO of [potential acquirer], his business plan is going this way or that way, you certainly are one of the companies that it would make sense for him to combine with, but so are companies B or C.'"); [Banker B] Interview ("A lot of times a client has expressed an interest in developing a business, getting in to a new business, and has asked us to help them in thinking through who the targets may be, the feasibility of these targets, financibility, and also receptivity. So it's a funnel. We start with a lot of companies and start narrowing it down.").

¹⁰⁹ See [Banker H] Interview ("If there are more alternative targets for a potential acquirer, it is certainly going to be the case that you're not going to stretch as far on price, or governance terms, or whatever the issues are. You will have greater conviction to staying closer to what you view as value-enhancing for your own shareholders. . . . And that general thought is going to be the same in the target's analysis for how it treats any particular issue relative to the set of potential alternatives that are available to it."). Cf. [Banker F] Interview ("Weaker defenses may not enable you to pay a lower price, but it probably makes it more likely that you're going to pursue that company rather than another company that has better protections.").

¹¹⁰ See, e.g., [Banker F] Interview ("There certainly have been situations where we've known that a buyer was about to do a deal, that this was our best buyer, and we got wind that they might be talking to the other target, so we would hussle up to get the buyer focused on us.").

AG, a German hair-care company. As reported by the *Wall Street Journal*, P&G bought Wella to “give P&G a leg-up in its growing rivalry with L’Oreal.”¹¹¹ But the *Journal* also reported that “[t]he talks mark P&G’s second attempt at buying a big German beauty firm,” and that Wella was only considered after talks with Beiersdorf had broken down.¹¹² This account suggests that P&G needed to acquire one, and only one, German beauty products company in order to fill a strategic need.¹¹³

Second, acquisitions generally require substantial managerial time and effort in order to ensure a smooth integration. As described by [Banker F], Head of Mergers & Acquisitions at [Bank F]:

I think that particularly these days companies are very cognizant of management time it takes to execute transactions. I don’t mean getting to agreement, I mean buying the company, integrating the company, and managing the new company as part of their company. . . . I think there is a much greater awareness – call it lack of hubris – about how much management time it will take to implement a new acquisition, and hence there is also a sense of how much management depth do we have to be able to do that. And so I think for all of those reasons people are concerned about doing multiple deals at the same time.¹¹⁴

Third, a company that makes an acquisition for cash may have difficulty making further cash acquisitions due to balance sheet constraints. Oracle’s recent (and currently ongoing) effort to buy PeopleSoft illustrates this point: immediately after Oracle announced its cash hostile bid, Moody’s downgraded its outlook to Oracle to “negative,” citing the additional cash that Oracle would need

¹¹¹ See Sarah Ellison & Robin Sidel, *P&G Holds Talks on Buying Wella*, WALL ST. J. (March 3, 2003) at A3.

¹¹² See *id.* (“The Cincinnati consumer-products giant had been trying to woo Beiersdorf AG, maker of Nivea lotions, but those negotiations stalled because of a standoff between the company’s two major shareholders, Allianz AG and the Tchibo family, and disagreements about price.”).

¹¹³ See also Peter Fritsch, *Hercules is Still Hoping for Grace Deal, But is Studying Other Merger Prospects*, WALL ST. J. (Mar. 13, 1996) at B6 (“[Hercules President R. Keith] Elliott quickly added, ‘Grace is just one option, and I can’t tell you more than that.’ He said Hercules continues to maintain a ‘short list’ of possible candidates for a ‘major transaction,’ though he didn’t elaborate.”). After Grace spurned Hercules’ offer, Hercules made unsuccessful bids for four units of Unilever in January 1997 and for Allied Colloids in January 1998. See Susan Warren, *Hercules, Jilted Three Times, Pines for Acquisition*, WALL ST. J. (Feb. 12, 1998) at B4 (“Hercules Inc. has spent much of the decade trimming down and gussying up. Still, the big specialty-chemicals concern can’t get a good date.”). In July 1998, Hercules finally bought BetzDearborn for \$2.4 billion. See Steven Lipin & Susan Warren, *Hercules Agrees to Acquire BetzDearborn*, WALL ST. J. (July 30, 1998) at A3.

¹¹⁴ [Banker F] Interview.

to complete its deal.¹¹⁵ If its PeopleSoft bid is successful, Oracle will have difficulty making further acquisitions for cash until it reduces its leverage.

In short, strategic need, management attention, and financing constraints all suggest that acquisitions impose an opportunity cost that often crowds out further acquisitions. The fact that the Delaware Supreme Court has upheld a breakup fee of \$450 million on the grounds of opportunity cost also supports the view that managerial attention can only be focused on one acquisition at a time.¹¹⁶ Because of this fact, buy-side alternatives might constrain the bargaining range in the negotiations with any particular target.

2. Sell-side alternatives

Sell-side alternatives away from the table might constrain the bargaining range as well. A recent empirical study, examining sale processes initiated by fifty publicly-traded companies during the 1990s, finds that sell-side bankers contacted 63.2 buyers, on average, for each selling company; from those contacted, 28.7 buyers on average indicated interest by signing confidentiality agreements; among these firms, 6.3 buyers continued further due diligence and/or submitted preliminary proposals; and among these, 2.6 buyers submitted binding written offers.¹¹⁷ And to the extent that this kind of a process is not successful in generating adequate competition among buyers, the corporate law of all states requires target shareholder approval for fundamental transactions such as mergers.¹¹⁸ If a higher-value bidder exists, this bidder can use the window between the initial deal announcement and the target shareholder vote to make a higher bid for the target.¹¹⁹ Although deal protection terms such as stock lockup agreements and breakup fees might protect the initial deal to some extent from being “jumped” by a third-party, as a legal matter these deal protection devices

¹¹⁵ See David Bank, *Moody's Downgrades Oracle's Outlook, Citing Peoplesoft Bid*, WALL ST. J. (June 12, 2003) at B4.

¹¹⁶ See *Brazen v. Bell Atlantic*, 695 A.2d 43, 49 (Del. 1997) (“Is the liquidated damages provision here within the range of reasonableness? We believe that it is, given the undisputed record showing the size of the transaction, *the analysis of the parties concerning lost opportunity costs*, other expenses and the arms-length negotiations.”) (emphasis added).

¹¹⁷ See AUDRA L. BOONE & J. HAROLD MULHERIN, CORPORATE RESTRUCTURING AND CORPORATE AUCTIONS (working paper, Nov. 2002) (on file with author).

¹¹⁸ See DEL. GEN. CORP. LAW § 251; REV. MODEL BUS. CORP. ACT §11.04(b).

¹¹⁹ See, e.g., Interview with Blaine V. Fogg, Skadden, Arps, Slate, Meagher & Flom, in New York, NY, transcript at 3 (June 15, 2000) (“I had a situation recently . . . in which the buyer was foreign, and needed the U.S. management. Now there was another company out there who was probably likely to pay a higher price, but the target didn't want to talk to them. So what do you do? They announced their deal; the other bidder came in and bid a high price and they won.”), cited in Guhan Subramanian, *The Drivers of Market Efficiency in Revlon Transactions*, manuscript at 15 n.74, forthcoming J. CORP. L. (2003).

cannot completely eliminate the possibility of an overbid.¹²⁰ Finally, certain transactions are subject to so-called *Revlon* duties, in which the initial bidder and target must leave the deal relatively unprotected in the event that a higher-value bidder should appear.¹²¹

To summarize, once a target has decided to sell itself, the typical process involved in “shopping the company,” the shareholder vote requirement, or the additional constraints imposed by *Revlon* (or all three) make sell-side alternatives away from the table important in many if not most negotiated acquisitions.¹²² These features of a sell-side process have implications for the bargaining power hypothesis. Consider a situation in which the target has no defenses, and in the baseline case would agree to be acquired for \$101. However, if another bidder would pay \$130, for example, then the bidder at the table might be forced to offer more in the initial negotiation with the target regardless of the target’s defenses.¹²³ As with buy-side alternatives, sell-side alternatives rather than the defenses of the target become the binding constraint in the negotiation, and therefore determine the terms of the final offer.

3. Application to the 1990s M&A marketplace

The extent to which alternatives away from the table impose constraints on the bargaining range depends on the “thickness” of the market for corporate control. If the market is thin, then the bilateral monopoly assumption is plausible and defenses might provide bargaining power in the takeover negotiation. But if the market is thick, then the bilateral monopoly assumption becomes more problematic because other potential buyers and sellers constrain the bargaining range. In this environment, defenses are less effective in influencing the outcome.

¹²⁰ See Interview with Robert E. Spatt, Simpson, Thacher & Bartlett, transcript at 2 (“It tends to be the lawyers [negotiating lockups], being able to tell the bankers, ‘Hey, when you get into the board room, you’re going to have to make sure you tell the board that you don’t think that whatever it is that’s been agreed to would be an undue impediment.’ And that’s something I try to get investment bankers to tell boards, because that is the underpinning under the case law of what it should be.”), cited in Coates & Subramanian, *supra* note 102, at 390 n.240. An exception used to be so-called “pooling-killing” lockups, which are no longer relevant with the elimination of pooling accounting in June 2002.

¹²¹ See *Revlon v. MacAndrews & Forbes, Inc.*, 506 A.2d 173 (Del. 1986); Subramanian, *supra* note 119.

¹²² See, e.g., JAMES C. FREUND, FROM THERE TO HERE: REFLECTIONS ON THE PAST TWO DECADES OF M&A PRACTICE (1996) (unpublished manuscript, on file with author), at 14 (“A raider was assumed to be lurking out there, but hadn’t yet surfaced.”); JAMES C. FREUND, THE ACQUISITION MATING DANCE AND OTHER ESSAYS ON NEGOTIATING at 157 (1987) (noting negotiation situation in which the acquirer asked the target’s representatives whether there were other potential buyers).

¹²³ See [Banker I] Interview (“If there is a third party that is interested in acquiring that target, the value opportunity potential created by that third party clearly must be factored in to the original acquirer’s pricing.”).

Which description better characterizes the 1990s M&A marketplace? Clearly, the 1990s market was the thickest in U.S. corporate history, with an unprecedented level of deal activity in terms of both number of deals and total deal volume.¹²⁴ Moreover, the fact that deal activity clustered by industry during the 1990s wave¹²⁵ suggests an amplification of bargaining range constraints: when one acquirer/target pair was engaged in takeover negotiations, other players in the same industry were also more alert to takeover possibilities. Practitioner interviews indicate that buyers and sellers in most situations were considering several alternatives in the 1990s marketplace. [Banker E], Global Co-Head of Mergers & Acquisitions at [Bank E], describes the way he approaches a buy-side process:

The way we conduct our business is pretty continuous daily contact with our strategic clients about a range of alternatives, and how the comparative risks and benefits of those different alternatives change over time. . . . Alternatives assessment is important for two reasons. First, it means you're not missing anything. And second, these are complicated judgments you're making, and I've often found that figuring out the right thing to do is easy if you're comparing two things. It's like deciding what art you like – you put two pictures side-by-side and you decide which one you like better. Or an eye test – which is sharper? You don't have to sit there and analyze the sharpness of the individual thing, you just compare. So comparing alternatives is a very efficient way to get everyone's head around what is the best thing for us to do.¹²⁶

And [Banker B], Co-Head of U.S. Mergers & Acquisitions at [Bank B], describes the competition that typically ensues on the sell-side:

It's very common to talk to multiple buyers to 'shop the company' in order to get the highest price. You want to balance the number of buyers against the desire to keep things quiet. . . . The more people you talk to, the greater the chance of leaks. . . . But there is nothing like a competitor to push the price up.¹²⁷

¹²⁴ See Joseph H. Flom, *Mergers & Acquisitions: The Decade in Review*, 54 U. MIAMI L. REV. 753 (2000).

¹²⁵ See Mark L. Mitchell & J. Harold Mulherin, *The Impact of Industry Shocks on Takeover and Restructuring Activity*, 41 J. FIN. ECON. 193 (1996).

¹²⁶ [Banker E] Interview.

¹²⁷ [Banker B] Interview. Cf. [Banker F] Interview (“Walk-away alternatives are more prevalent on the sell-side than on the buy-side, because it's somehow more believable than I've talked to another person and they are ready to buy my company. It's less typical that there is the exact comparable thing to buy. But that is definitely a factor in some decision-making, particularly if there is a scarcity of acquirers.”).

If alternatives away from the table are significant, then these alternatives rather than takeover defenses might dictate the bargaining range.¹²⁸ According to [Banker I], Head of Mergers & Acquisitions at [Bank I]:

The overwhelming factor that influences price is third-party alternatives, to the extent that third-party alternatives exist. . . . If you've got three well-heeled bidders competing for a company, the fact that the target had a staggered board or a poison pill became unimportant well before that bidding process ensued.¹²⁹

This thickness in the 1990s marketplace suggests that alternatives away from the table might make the influence of takeover defenses smaller than defense proponents have suggested.¹³⁰

C. Hostile Bid Costs

The prior Part makes the following basic point: in any negotiation, bargaining power affects the distribution of the surplus *within the constraints imposed by the bargaining range*. As these constraints become more severe, the potential for bargaining power to influence the negotiated outcome becomes smaller. Of course, the fact that alternatives away from the table might narrow the bargaining range does not mean that the bargaining power hypothesis might not be working within this narrower range. However, the introduction of hostile bid costs further reduces the influence of defenses. If these costs are sufficiently large, then a hostile bid may be precluded as a structural matter, which would make the actual target defenses irrelevant (not just less important) in determining the final deal price. In this Part I explain these points in more detail.

¹²⁸ See, e.g., [Banker F] Interview, (“In order for defenses to be materially relevant in some meaningful number of cases you have to have a board which is really prepared to use them as a lever in the negotiation, and I think that boards have a lot of other mechanisms for creating a competitive process or a lever to enhance the value that shareholders are receiving.”).

¹²⁹ [Banker I] Interview. See also [Banker H] Interview (“I think that a more meaningful influence on price [than defenses] is just the presence of actual or potential competitive bidders.”); [Banker F] Interview (“In how many situations do defenses provide my principal negotiating leverage? In most situations, if it's a strategic acquirer, there is a decent chance that there is another strategic acquirer, and your price tension is created by your competitive process, not by hiding behind your shark repellents.”)

¹³⁰ It might nevertheless be argued that defenses allow the target to improve its alternative away from the table. This argument only applies once a hostile bid has been announced, because until that point the buyer has not brought pressure to bear on the target in a way that would make time critical. (Or put differently, until the buyer goes hostile, the target does not face time pressure in finding a higher-value bidder.) However, Bebchuk, Coates, and I find that hostile bid targets with strong defenses are slightly *less* likely (not more likely) to sell to a white knight than targets with weaker defenses. See Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*, *supra* note 7, at 930. Instead of using potent defenses to find a higher-value buyer, it seems that the typical ESB target uses defenses to resist the hostile bidder and to remain independent. See *id.* at 934.

1. Fixed costs, independent of defenses

Consider again a baseline scenario in which the target has no takeover defenses, and assume that alternatives away from the table have narrowed the bargaining range to [\$130, \$150]. So, for example, the target board must get at least \$130 in order to prevent being jumped by an outside bidder, and at \$150 the acquirer has a better alternative in buying some other company. Against no defenses, the expected outcome is \$131; against complete defenses, the expected outcome is \$140.¹³¹

Now assume that the acquirer would need to spend \$10 in order to launch a hostile bid, regardless of what the target's defenses are, and that this new assumption is also common knowledge. The \$10 cost of making a hostile bid changes the expected outcome against a no-defenses target, because the bidder should be willing to pay as much as \$140 in order to avoid hostile bid costs of \$10. Again modeling the negotiation as a Nash bargaining game, the expected outcome is at the midpoint of the bargaining range, at \$135, even in the absence of takeover defenses. In effect, the target gains bargaining power from the introduction of hostile bid costs because the bidder is no longer indifferent between a negotiated acquisition and a hostile bid, holding deal price constant.

If hostile bid costs are increased to \$20, analogous logic indicates that the bidder should be willing to pay \$150 in order to avoid hostile bid costs, and the expected outcome is therefore \$140 against a no-defenses target. This predicted outcome is the same as the outcome with complete defenses. In fact, with hostile bid costs greater than or equal to \$20 (the size of the bargaining range), there is no price at which the acquirer would prefer to make a hostile bid. If the target does not agree to a deal, the acquirer prefers to simply go to its walk-away alternative.

These two numerical examples indicate that the introduction of fixed hostile bid costs pushes the predicted outcome against a target with no defenses toward the outcome against a target with complete defenses. In the extreme, if hostile bid costs are greater than or equal to the width of the bargaining range, then a hostile bid is structurally precluded, and the expected outcome against no defenses is the same as the expected outcome against complete defenses. The intuition for this result is that if hostile bid costs are sufficiently large, then alternatives away from the table rather than takeover defenses are the binding constraint in the takeover negotiation. And if takeover defenses are not a binding constraint, then they cannot influence the final outcome.

Whether and to what extent hostile bid costs reduce the influence of takeover defenses in negotiated acquisitions thus turns on the magnitude of these costs. While I do not attempt to answer this question directly (and its answer is no doubt highly context-specific), in the remainder of this Part I put forward three

¹³¹ See *supra* Part III.A.

categories of hostile bid costs: bidder out-of-pocket costs, bidder reputational costs, and costs imposed on the target. Taken together, these three costs suggest that a hostile bid may be precluded in many if not most negotiated acquisitions.

a. Bidder out-of-pocket costs

The clearest costs of launching a hostile bid are the bidder's additional out-of-pocket expenses, such as additional financing costs (because hostile bidders typically offer cash) and additional lawyer and banker fees. On the latter element, although the market for law firms capable of advising in a hostile context is deeper than it was in the 1980s fights (dominated by Skadden, Arps on the acquirer side and Wachtell, Lipton on the target side), a hostile bid usually involves the involvement of one among an elite group of high-priced New York City law firms, typically in addition to local and in-house counsel.¹³² And finally, though not strictly an out-of-pocket cost, diversion of managerial focus on the acquirer side may be an important element of the overall cost of making a hostile takeover bid.

b. Bidder reputational costs

Second, making a hostile bid imposes reputational costs on the bidder, because future targets may be less willing to initiate negotiations with a bidder that has previously made a hostile takeover bid.¹³³ Even if a future target were willing to negotiate with such a bidder, it may be more cautious, less forthcoming, and less willing to explore value-creating opportunities than with a bidder that has never made a hostile bid or has explicitly relinquished the hostile bid weapon.¹³⁴

¹³² I find that five firms, all headquartered in New York City, accounted for 85% of the market for acquirer-side outside counsel in hostile takeover situations between 1996 and 2002: Skadden, Arps, Slate, Meagher & Flom (35% share); Simpson, Thacher & Bartlett (15%); Sullivan & Cromwell (13%); Cleary, Gottlieb & Stein (12%); and Fried, Frank, Shriver, Harris & Jacobson (10%). See BEBCHUK, COATES & SUBRAMANIAN HOSTILE BIDS DATABASE, *supra* note 95.

¹³³ See, e.g., [Banker I] Interview (“Some buyers will say regardless of the importance I am not interested in pursuing an unfriendly transaction even if I want to do so here, because it will preclude me if I’ve done so from having a whole series of other conversations with other partners who may be concerned about my willingness to go unfriendly.”); [Banker A] Interview (“No one wants to enter into a negotiated acquisition with a guy holding a club.”). Cf. [Banker J] Interview (“It cuts both ways. With some companies that have done hostiles before, you could argue that they may have the baggage of folks not wanting to talk to them. In other cases, other competitors might say, ‘Those guys at XYZ are aggressive, so if they want this I’m not going to compete because even if I won I wouldn’t be happy with the price.’”).

¹³⁴ See, e.g., [Banker E] Interview (“If you create a sense of risk on their part to even be talking to you, it’s a tougher thing to deal with in getting something done. . . . It’s been my observation that working with a target is usually a better way to get a deal done than assuming a more threatening posture.”). Cf. [Banker D] Interview, (“If you knew that you had somebody locked up with a standstill for three years, they aren’t going to do a darn thing, sure, you might be a lot more open

[Banker J], Head of Mergers & Acquisitions at [Bank J], describes the importance of trust and relationship in achieving productive negotiations:

Practically speaking, the hostile bid is not a particularly useful card to try to play. It's more amateurish than anything else. It's bad mood music if you want people to romance each other, to have that kind of a threat hanging back there, and I think it would in most cases diminish the likelihood of serious discussions.¹³⁵

Perhaps as a result, many companies in the 1990s publicly committed to not making a hostile bid.¹³⁶ Tyco, for example, had such a policy, and followed it to such a degree as to withdraw a hostile bid that had already been made by a company (U.S. Surgical) that Tyco acquired.¹³⁷ In a statement to analysts after the announcement of Tyco's acquisition of U.S. Surgical, now infamous Tyco CEO L. Dennis Kozlowski stated with respect to the outstanding bid for Circon: "We're not big on hostile bids. In fact, we don't do them."¹³⁸ Companies such as Tyco might make a categorical concession if the reputational benefits of disavowing the hostile bid weapon *ex ante* exceed any benefits of retaining the hostile bid weapon in particular negotiations.¹³⁹

c. Costs imposed on target

Finally, making a hostile bid often imposes costs on the target that make it less attractive for the bidder to acquire, in two respects. First, and well-understood, a hostile bid causes operational disruption. Target management and board time is diverted from managing the business,¹⁴⁰ any difficulties that

sharing information, walking them through the business, than if they signed a one-month standstill.").

¹³⁵ [Banker J] Interview. Others use the "romance" analogy as well. *See, e.g.*, [Banker A] Interview ("We actually recommend that managers 'date' before we get to price or anything else. We'll say, 'You need to get together a number of times, have dinner off-site, go have some chats, go talk about the companies, make sure that you all think this will work. Then come back to us and we'll talk to you about structure and price and the rest of it, but we really need to know that you are comfortable with where you are headed with all this.'").

¹³⁶ *See, e.g.*, [Banker I] Interview ("There are clearly clients who say that they are not interested in hostiles.").

¹³⁷ *See* BRIAN J. HALL, CHRISTOPHER ROSE & GUHAN SUBRAMANIAN, CIRCON (A), Harvard Business School Case 9-801-403 (Dec. 5, 2001) at 14.

¹³⁸ *See id.*

¹³⁹ One question is why a bidder would categorically dismiss the hostile bid possibility when it can do so in individual transactions through contract. *See infra* Part III.D. One reason might be that a reputation for not making hostile bids increases the likelihood of being approached by a potential seller. That is, a seller might be more likely to initiate a transaction with a buyer who has publicly and categorically disavowed the hostile bid weapon. I thank Louis Kaplow for this point.

¹⁴⁰ *See, e.g.*, HALL, ROSE & SUBRAMANIAN, *supra* note 137, at 12-13 (quoting Circon CEO Richard Auhll describing the process of "managing under siege" from U.S. Surgical: "The

motivated the hostile bid receive greater publicity and scrutiny,¹⁴¹ and key employees may leave to competitors, even if their jobs are not explicitly at risk.¹⁴² Even if the bidder is not successful and *ex post* this cost is borne by the target, *ex ante* it increases the acquirer's willingness-to-pay in a friendly transaction by the magnitude of the cost multiplied by the acquirer's estimated likelihood of success.¹⁴³

A second cost, less well-understood, is that making a hostile bid may make post-deal integration more difficult (assuming that the deal is successful) because of the animosity generated by the process itself.¹⁴⁴ As described by [Banker C], Head of Mergers & Acquisitions at [Bank C]:

Hostile deals get fought out in the public realm. When you're announcing a deal, you don't want your investors and the public seeing sausage being made. You want to be able to go out and say, "Here's the deal." Everybody smiles, shakes hands, says it's a great deal, here's what the synergies are, etc. Present it to all of your constituencies – your investors, your employees, your regulator, the communities you do

workload during this hostile takeover attempt was the highest of my professional career. Of course, we had all the normal tasks of running a corporation, but on top of this [we were] managing outside consultants, . . . building morale among employees, . . . giving white knight and white squire presentations, . . . and beginning a major cost-cutting program.”)

¹⁴¹ See, e.g., *Alltel Presses Offer for CenturyTel, Disparaging Sale of Wireless Unit*, WALL ST. J. (Aug. 28, 2001) at B4.

¹⁴² See [Banker F] Interview (“Just because something is a public company doesn't mean you can buy it on an unfriendly basis. If management is going to walk out the door the moment you're closed, you've got a lot of vulnerability there. Certainly for companies where the assets walk out the door every night – companies where intellectual property is very important – it's generally viewed as being very difficult to buy those companies on an unfriendly basis.”). *But cf.* Mylene Mandalindan, Don Clark & Robin Sidel, *Oracle's Bid for PeopleSoft Offers Possible Taste for the Future*, WALL ST. J. (June 9, 2003) at A10 (“Hostile takeovers are rare in technology because tech companies' most valuable assets – their employees – historically have been able to jump to rivals if they are unhappy with any corporate turmoil. But the pinched tech job market may make engineers think twice about walking out the door.”).

¹⁴³ Importantly, operational disruption costs do not reduce the target's reserve price because alternatives away from the table or (in the absence of such alternatives) the target's share price in the marketplace sets a floor on what the target's board will accept. For example, if a target has an alternative offer of \$130, then the target board will not accept \$125 in order to avoid operational disruption costs of \$10; rather, the acquirer must offer \$131, regardless of the costs a hostile bid might impose, in order to prevent the target from selling to the alternative bidder. Therefore, operational disruption costs imposed on the target operate unambiguously to increase the acquirer's reservation price without changing the target's reservation price. This effect, in turn, pushes the predicted outcome against a target with no defenses toward the predicted outcome against a target with complete defenses.

¹⁴⁴ See, e.g., [Banker I] Interview (citing the ability “to do a better job integrating post-acquisition” as an important reason that “in almost every instance” acquirers prefer to do a deal on a friendly basis).

business in – and deliver it wrapped up in a bow. When you do a hostile deal, you’re making sausage in front of people, and it’s ugly sausage, because the other guy is trying to fight you off by saying all the reasons why the deal is bad.¹⁴⁵

To summarize, these three categories of cost – out-of-pocket costs, bidder reputational costs, and costs imposed on the target – reduce the influence of takeover defenses on the negotiated outcome.¹⁴⁶ And if these costs are greater than the bargaining range in a particular negotiation, then a hostile bid is structurally precluded, and the target’s defenses are irrelevant for the outcome of the negotiation. Manifesting this point, practitioners uniformly confirm that the vast majority of bidders do not consider the hostile bid to be a meaningful weapon in a negotiated acquisition.¹⁴⁷

2. Monotonically increasing in defenses

The previous analysis identified three costs of making a hostile bid that are independent of the target’s particular defenses. I argued that these costs reduce and may eliminate the influence of takeover defenses on negotiated acquisitions. But even if hostile bid costs do not eliminate the influence of takeover defenses, the bargaining power hypothesis in its current manifestation still requires that hostile bid costs are increasing in the target’s defenses over the particular range of defenses that is currently at issue. No academic commentator today (including myself) questions the Williams Act or the right of a target board to maintain a pill for a limited period of time, in order to identify a higher-value buyer or to inform shareholders about the bid.¹⁴⁸ The policy debate today focuses within a relatively

¹⁴⁵ [Banker C] Interview.

¹⁴⁶ There is also a hostile bid cost in the form of a benefit foregone, in that an acquirer in a negotiated acquisition can receive deal protection. The stock option lockups and breakup fees significantly increase the likelihood that the bidder will be able to close its deal. See Coates & Subramanian, *supra* note 102, at 332-34, 347-52.

¹⁴⁷ See, e.g., [Banker E] Interview (“The vast majority of the time, you get a client who says, ‘Look, I’m not interested in going hostile with this thing. Let’s just put that off the table. . . . Fundamentally, I don’t want all the management fallout issues, etc. of a hostile. It’s a relatively rare thing to say the hostile weapon is our primary option or even something we want to explore deeply.”); [Banker D] Interview (“Most people will only do friendly deals. . . . And in a friendly, if it’s truly friendly, I don’t really care about the defenses, except perhaps for some value in keeping an interloper from trumping a deal post-announcement such as a poison pill.”).

¹⁴⁸ This consensus did not exist twenty years ago. Compare Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target’s Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing that target managers should be required to remain passive against a hostile tender offer) with Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982) (arguing that target managers should be allowed to use defensive tactics in order to facilitate an auction) and Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982) (same).

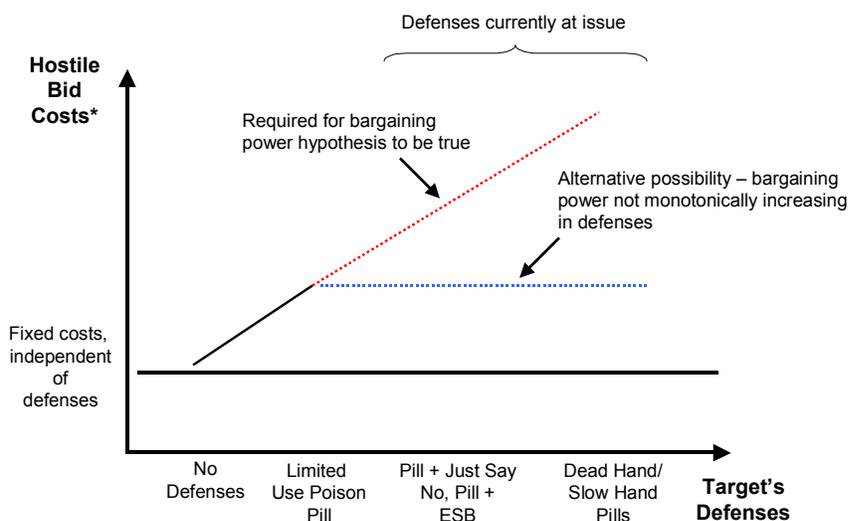
narrow range, on the prolonged use of more potent pills such as Just Say No pills, ESB pills, and dead hand/slow hand pills. That is, today's debate focuses not on *whether* a target board can maintain defenses, but rather *for how long*.¹⁴⁹

If the bargaining power hypothesis is meant to advance the position of defense proponents within this debate, the general claim that defenses yield higher premiums becomes a more specific claim that the more potent pills yield higher premiums beyond the well-accepted baseline defenses. Implicit in this more specific claim is the assumption that if some defenses provide some bargaining power, then strong defenses must provide greater bargaining power – that is, bargaining power is monotonically increasing in defenses.

To illustrate this point quantitatively, consider again a bargaining range of [\$130, \$150]. Further assume that hostile bid costs independent of the target's defenses are \$10, so that a hostile bid is not structurally precluded. In this scenario the acquirer should be willing to pay up to \$140: at \$141, it prefers to make a hostile bid of \$130 and incur hostile bid costs of \$10. A Nash bargaining game predicts a negotiated outcome of \$135.

Now consider the influence of a potent defense such as an ESB. If an ESB would impose an additional \$10 of cost on the bidder, then using similar logic the acquirer should be willing to pay up to \$150 in a negotiated acquisition, yielding a predicted negotiated outcome of \$140. This analysis is consistent with the bargaining power hypothesis, in that stronger defenses lead to a higher predicted outcome (\$140 versus \$135). But it appears only in the set of circumstances in which hostile bid costs (independent of the target's defenses) are smaller with the width of the bargaining range, *and* increasing over the range of defenses that is at issue in the current debate. Figure 3 illustrates this point graphically:

¹⁴⁹ See Bebchuk, Coates & Subramanian, *Reply to Commentators*, *supra* note 7, at Figure 2.

Figure 3: Bargaining Power Monotonically Increasing in Target's Defenses

* Assumed proportional to target's bargaining power

To summarize: If fixed hostile bid costs, independent of the target's defenses, are larger than the width of the bargaining range, then a hostile bid is structurally precluded, and the target's defenses are irrelevant for the takeover negotiation. If hostile bid costs are not monotonically increasing in the potency of the target's defenses, then baseline defenses may (or may not) give bargaining power, but more potent defenses do not necessarily give additional bargaining power. Only if both of these conditions are not true is the bargaining power hypothesis valid at a theoretical level. The analysis therefore suggests that the bargaining power hypothesis operates in a far smaller set of negotiated acquisitions than its proponents have argued to date.

D. Asymmetric Information

Even in situations where a hostile bid is not structurally precluded and hostile bid costs are increasing in a target's defenses, virtually all acquirers put away the hostile bid threat in negotiated acquisitions in order to gain access to the target's books and records. As described by [Banker F] of [Bank F]:

I'm representing the buyer, and I look at it and say: "Am I really prepared to buy this company without due diligence?" And many times the answer is no. . . Well, the price of getting due diligence is going to be

the standstill agreement. And that standstill is going to provide as much or more protection than any of the normal defense mechanisms.¹⁵⁰

In general, a “blind” bid, without the ability to conduct due diligence, is subject to the well-known “lemons problem,” in which the bidder has likely overpaid when the target accepts the offer.¹⁵¹ While one could imagine several potential solutions to this problem,¹⁵² the solution that has developed in the context of negotiated acquisitions is the standstill agreement. Surprisingly, despite their important implications for the interplay between negotiated and hostile acquisitions, standstill agreements have not received attention from academic commentators to date.¹⁵³ Under the terms of the standstill, the potential acquirer agrees to not increase its stake in the target, conduct a proxy contest to replace the target’s board, or make a tender offer for the target’s stock without the approval of the target board, for a specified period of time, typically between 6 and 12 months.¹⁵⁴ In exchange, the acquirer gains access to the target’s internal documents that allow it to conduct due diligence. [Banker A], Head of Mergers & Acquisitions at [Bank A], describes the reasoning that leads to a standstill:

One of the key issues is that we’re going to share a lot of information with you. It’s inside, non-public information. A lot of it may be very detailed, line-by-line. . . . Why should we have all of these discussions, and you just turn around and make a hostile tender for me? If you do, I feel like a real chump, because I’ve given you all this information, and then you say, “Never mind, I’ll just take my offer directly to your

¹⁵⁰ [Banker F] Interview. See also [Banker C] Interview (“The other side, before they will give you access to do the due diligence, or typically before they will even agree to negotiate with you, will have you sign a confidentiality agreement that will include a standstill agreement.”); [Banker H] Interview (“The confidentiality agreement that exists in its standard form at every firm on the Street has a standstill paragraph in it.”).

¹⁵¹ See George Akerlof, *The Market for Lemons: Quality, Uncertainty, and the Market Mechanism*, 84 Q. J. ECON. 488 (1970). See also [Banker B] Interview (“You’d much prefer getting confidential information, being able to kick the tires a bit, than having to do it from the outside.”).

¹⁵² See, e.g., ROBERT H. MNOOKIN, SCOTT R. PEPPET & ANDREW S. TULUMELLO, BEYOND WINNING 25-26 (2000) (discussing methods for overcoming information asymmetries in negotiations).

¹⁵³ A Westlaw search over the past five years revealed several discussions of standstill agreements in practitioner-oriented publications such as the Practising Law Institute and the American Bar Institute journals, but none in academic journals such as law reviews. One recent working paper from the financial economics arena notes the existence of standstill agreements but does not identify the connection to the takeover defenses debate. See BOONE & MULHERIN, *supra* note 117, manuscript at 13-14.

¹⁵⁴ See [Banker C] Interview (“Six months would be a common shorter standstill.”); [Banker A] Interview (“Most of the standstill are for twelve months. We’ll resist a standstill that is more than twelve months. A lot of that is on the theory that the information grows old.”).

shareholders.” So on the target side you say, “If you want to talk about a real merger, then sign a standstill and tell me you’re not going to do anything unfriendly.” That’s the cost of entry. Otherwise, you’re telling me you’re not friendly.¹⁵⁵

The exceptions demonstrate how ubiquitous standstills are, as described by [Banker E] of [Bank E]:

There are a few companies that say, “Look, we don’t sign these things, period. We just don’t do it.” And the seller’s banker sits there and says, “That’s actually true – I’ve never seen these guys sign one.” But only a handful of companies take that posture, and obviously you can only do it if you’ve historically had that posture. As you might expect, the companies that can get away with that are the bigger gorillas in the jungle.¹⁵⁶

The ubiquity of the standstill agreement in negotiated acquisitions suggests two different tracks for acquiring a company. The first track is based on publicly-available information, does not involve discussions with target management beyond an initial check (frequently in the form of a bear hug letter), and goes directly to shareholders.¹⁵⁷ The second track requires confidential information,

¹⁵⁵ See [Banker A] Interview. See also [Banker B] Interview (“I approach you and want to buy your company. The first thing you are going to say is that you want a proper confidentiality agreement and a standstill. . . . Any big M&A law firm is going to put a standstill in. It’s sort of odd to call up and then not be willing to sign a standstill. It’s good corporate practice on the sell-side to demand it.”); [Banker E] Interview (“Often what a target will do is say, ‘Well, you want due diligence, the only way you’re going to get it is if you sign this piece of paper saying you’re not going to jump ugly with us.’”).

¹⁵⁶ See [Banker E] Interview. See also Marla A. Hoehn, *Letters of Intent, Confidentiality and Standstill Agreements*, 1349 PLI/CORP 69, 76 (2002) (“[S]tandstill agreements are often included as provisions in a LOI [letter of intent].”); *Alliance Gaming Corp. v. Bally Gaming Int’l, Inc.* (Del. Ch. 1995) (unpublished opinion, text available at 21 DEL. J. CORP. L. 143) (“The practice of requiring a bidder to sign a confidentiality and standstill agreement as a condition to allowing ‘due diligence’ access to confidential information is well recognized and accepted.”); *In re J.P. Stevens & Co., Inc.*, 542 A.2d 770 (Del. Ch. 1988) (rejecting claim that target board’s insistence on a particular form of standstill agreement constituted breach of fiduciary duty). Because standstill agreements are not usually disclosed in the merger agreement it is difficult to determine more systematically how common they are. See, e.g., *Pennaco Energy/Marathon Oil Merger Agreement*, Schedule 14C (filed Feb. 26, 2001), Background of the Offer and Merger at 3 (describing confidentiality agreement signed by Marathon Oil on Nov. 15, 2000); *In re Pennaco Energy, Inc.*, 787 A.2d 691, 697 (Del. Ch. 2001) (describing two-year standstill agreement included as part of Marathon Oil confidentiality agreement).

¹⁵⁷ See, e.g., [Banker D] Interview (“If you’re talking hostile, there really isn’t negotiation as you would think of arms-length negotiation. Ninety-something percent of the time, there is no negotiation in a hostile. . . . By definition, if there is going to be serious negotiation, you’ve taken the hostility out of it.”). For examples of this point, see, e.g., HALL, ROSE & SUBRAMANIAN, *supra* note 137, at 4 (“‘I was rather stunned,’ said [Circon CEO Richard] Auhll. ‘I guess it

invariably includes a standstill agreement, and involves intense negotiations between target and acquirer.¹⁵⁸ Practitioners indicate that the decision as to which track to pursue is typically made early on, usually before even initiating contact with a potential target.¹⁵⁹ [Banker H], Head of Mergers & Acquisitions at [Bank H], states:

When a potential seller puts forward a standstill agreement, then as a potential acquirer you have one of two choices. Either you preserve your flexibility to do a hostile deal, in which case you don't move forward with the bilateral discussions because the target isn't willing to share confidential information with you unless you agree to the standstill, or you try to modify it as much as you can but fundamentally give up the basic ability to launch an unsolicited offer. . . . If the target is insisting on it, you're going to make the decision right away, so you're not going to be able to hold it in reserve for a later threat.¹⁶⁰

The asymmetric information problem is independent of the target's takeover defenses. This problem, and hence the need for due diligence, has become only more acute in the Sarbanes-Oxley era: with the certification requirements imposed by the Act, buying assets without access to confidential information could expose the CEO to personal liability for any surprises that might lurk beneath the surface.¹⁶¹ Therefore, if the standstill agreement is the standard *quid pro quo* for access to confidential books and records, and virtually all acquirers in negotiated acquisitions agree to a standstill as standard business practice, then takeover

became clear that it was going to be a hostile attempt. He didn't make any friendly overtures at all.”); Mandalindan, Clark & Sidel, *supra* note 142 at A1 (“Craig Conway, the [Peoplesoft] chief executive, says he was caught completely unaware during a business trip to Amsterdam when he was told of press reports about a \$5.1 billion hostile takeover offer from Oracle Corp.”).

¹⁵⁸ The existence of standstill agreements and two tracks for acquiring a company call into question earlier work describing a continuum between negotiated acquisitions and hostile takeovers. See G. William Schwert, *Hostile in Takeovers: In the Eyes of the Beholder?*, 40 J. FIN. 2599 (2000).

¹⁵⁹ See [Banker F] Interview (“You frequently need to make the decision that affects whether you are going to be able to go unsolicited relatively early on in the process. . . . Essentially you end up with a friendly path and an unfriendly path, and a fork in the road relatively early on.”).

¹⁶⁰ [Banker H] Interview.

¹⁶¹ See Sarbanes-Oxley Act of 2002 §§ 906, 302, Pub. L. No. 107-204, 116 Stat. 745 (requiring CEOs and CFOs of public companies to certify periodic reports containing financial statements filed with the SEC). While the certification requirements require knowledge of the misstatement before liability will attach, *see id.* at §§ 906(a), 302(a)(2)-(3), informal conversations with practitioners indicate substantial uncertainty and concern about how this knowledge requirement will be implemented.

defenses are irrelevant in determining the final price received by target shareholders in most negotiated acquisitions.¹⁶²

E. Agency Costs

Finally, consider a situation in which the bargaining range is large (i.e., alternatives away from the table are weak), fixed hostile bid costs are smaller than the width of the bargaining range, and the acquirer has not relinquished the hostile bid threat through a standstill agreement. Even in this case, it is not clear that takeover defenses will increase premiums for shareholders once the possibility of agency costs is introduced. If the target board is not a loyal agent for its shareholders, then it might use bargaining power provided by takeover defenses not to improve the premium that the target shareholders receive, but rather to extract private benefits for themselves.¹⁶³

A simple quantitative example illustrates the point. Starting with the same assumptions as in the baseline model, consider a situation with complete defenses, in which two possible deals emerge from the negotiations between the target board and the acquirer: Deal A is a straightforward \$110 for the company; Deal B is \$101 for the company and \$5 in value to target managers (e.g., through additional parachute provisions, or positions in the continuing company). Because of the complete defenses assumption, the acquirer must get the target board's approval and cannot take either Deal A or Deal B directly to shareholders. A loyal target board would choose Deal A because it yields higher value for its shareholders. But of course, with the introduction of agency costs a target board might prefer Deal B. From the shareholders' perspective, Deal B is no different from the no-defenses scenario – in both cases the target shareholders receive \$101. The only difference is that Deal B provides private benefits to target managers. More value has in fact been extracted from the acquirer (consistent with the bargaining power hypothesis) but this value has not accrued to the benefit of shareholders (inconsistent with the hypothesis).¹⁶⁴

Making matters worse is the fact that the acquirer also prefers Deal B because the total cost is lower: \$106 total cost in Deal B (\$101 to the shareholders and \$5 in private benefits) compared to \$110 in Deal A. In fact, any deal that provides value exclusively to the target shareholders can be improved for both the acquirer and target managers with a deal that provides less value to the shareholders and some value to the target managers. The constituency that loses in this diversion

¹⁶² See [Banker B] Interview (“In a negotiated deal I don’t believe that a staggered board and a pill really come in to play, because most of the time there is going to be some kind of standstill arrangement.”).

¹⁶³ See Bebchuk, *supra* note 8, at 991.

¹⁶⁴ See *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787, 798 (Del. Ch. 1988) (“[A]n active negotiator with power, in effect, to refuse the proposal may be able to extract a higher *or otherwise more valuable* proposal.”) (emphasis added).

of value is the target's shareholders, but in the regime of complete defenses posited above, these shareholders are not at the negotiating table. Thus there are strong theoretical reasons to believe that agency costs might exist in the negotiation between the acquirer and the target board in a world of complete defenses.

Of course, fiduciary duty might limit the extent to which the target board can extract private benefits in the negotiation with the acquirer. But empirical evidence suggests that the agency cost problem is present in many negotiated acquisitions. One study examines 252 friendly acquisitions from 1995 to 1997 and finds that CEO's who own less-than-average equity in their company (and thus might have reduced incentives to maximize share price) are more likely to negotiate a lower premium for their shareholders if they receive an augmented golden parachute, additional merger-related payments (such as consulting contracts or special bonuses), a high position in the acquiring company, and/or a seat on the acquiring company's board.¹⁶⁵ Another study finds that CEO's of target companies in mergers-of-equals are more likely to negotiate a lower premium for their shareholders.¹⁶⁶ Both of these studies are consistent with the view that takeover defenses may result in private benefits for managers rather than higher premiums for shareholders.¹⁶⁷

These studies and the quantitative example developed in this Part suggest that buyers may make use of the agency problem in crafting a deal with the target's managers. As described by [Banker A] of [Bank A]:

The defenses say how you have to deal with them. . . . If there is no role for the other CEO, you may have to pay a little more, because you're

¹⁶⁵ See JAY HARTZELL, ELI OFEK & DAVID YERMACK, WHAT'S IN IT FOR ME? PERSONAL BENEFITS OBTAINED BY CEOs WHOSE FIRMS ARE ACQUIRED, manuscript at 20 (working paper March 2000).

¹⁶⁶ See JULIE WULF, DO CEOs IN MERGERS TRADE POWER FOR PREMIUM? EVIDENCE FROM "MERGERS OF EQUALS", manuscript at 29-30 (working paper June 2002).

¹⁶⁷ Another, more obvious, agency cost might be management simply refusing to negotiate with the acquirer. See, e.g., HALL, ROSE & SUBRAMANIAN, *supra* note 137, at 6 ("[Circon CEO] Auhll was instructed by legal counsel not to communicate with [U.S. Surgical CEO] Hirsch or other Surgical representatives, despite several attempts by Surgical to do so."); Steven Lipin, Allanna Sullivan & Terzah Ewing, *In Fight for Pennzoil, Old Suitor Becomes the Pursued*, WALL ST. J. (June 24, 1997) at B4 (quoting letter from Pennzoil CEO James L. Pate to Union Pacific Resources CEO Jack Messman stating "I thought I had made it clear that Pennzoil fully intends to remain independent and is not interested in any process that could put Pennzoil into play."); *Barbarians in the Valley*, THE ECONOMIST (June 28, 2003) at 61 (quoting PeopleSoft CEO Craig Conway as stating that he "could imagine no price nor combination of price and other conditions to recommend accepting [Oracle's] offer."). Although this phenomenon is inconsistent with the view that takeover defenses increase shareholder value, see *supra* Part II.C.2, it is not necessarily inconsistent with the bargaining power hypothesis, which is based on the premise that negotiations have already been initiated between acquirer and target.

telling him that he has to disappear. If management has roles, you might be able to get a slightly cheaper price, because they will see the benefits of getting together.¹⁶⁸

This reasoning suggests that the agency problem is fueled from the buy-side. Another possibility is that buyers simply react to the incentives put in place by the target's managers and board:

If I see a company where the management is not under contract and they have no severance arrangements or no change in control payments, I envision a tougher battle because they are fighting for their lives. If I've seen that the board has actually given them a decent severance package, then the typical thing that happens is if you cut a reasonable deal, where they make enough money not to worry about their futures, they will make a deal. And I actually feel more comfortable when that exists than less in terms of being able to get to a deal.¹⁶⁹

In either case, defenses might allow target managers to extract private benefits for themselves rather than a higher premium for shareholders.

F. Synthesis

In the *Stanford Law Review* symposium commenting on the article by Bebchuk, Coates and myself, Mark Gordon states that:

[I]t seems an impossible feat of logic to argue, on one hand, that ESB's present a 'serious impediment to a hostile bidder seeking to gain control over the [incumbent directors'] objections' and are 'extremely potent as an antitakeover device,' while at the same time arguing that, on the other hand, boards are unable to use this extremely potent force to extract a better price from any genuinely interested suitor. . . . Even a [trivially small] benefit applied over thousands of friendly deals amounts to a massive net benefit to stockholders of companies that employ an ESB.¹⁷⁰

In fact, it is entirely consistent to argue that takeover defenses are a potent weapon against a hostile takeover bid,¹⁷¹ but are irrelevant in most negotiated acquisitions. Far from being an "impossible feat of logic," I demonstrate that it is quite easy to hold this view once alternatives away from the table, hostile bid costs, asymmetric information, and agency costs are introduced in to the standard bargaining model.

¹⁶⁸ See [Banker A] Interview.

¹⁶⁹ See *id.*

¹⁷⁰ Gordon, *supra* note 3, at 824 (citing Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*, *supra* note 7, at 890, 903)

¹⁷¹ See Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*, *supra* note 7, at 937.

Practitioner interviews confirm this conclusion. The M&A heads that I interviewed (who actually negotiate price¹⁷²) uniformly state that takeover defenses are relevant only in a subset of negotiated acquisitions, if at all; conversely, no one believed that takeover defenses influence all negotiated acquisitions, as Gordon and Kahan & Rock argue.¹⁷³ Among practitioners the differences of opinion existed only at the margin: while the majority believed that defenses were irrelevant most of the time,¹⁷⁴ some believed that they mattered in some non-trivial fraction of deals.¹⁷⁵ [Banker J] of [Bank J] represented the majority view:

In a negotiated deal, the existence or non-existence of shark repellent stuff is generally not a big factor. Most of the time, the kind of deals that we are talking about aren't being done with some kind of veiled threat. . . . The assumption is that we like each other and are friendly to each other. There is often some sort of standstill provision in place, which generally takes you out of the land of worrying tremendously about what the structural defenses are.¹⁷⁶

¹⁷² See, e.g., [Banker F] Interview (“Typically the commercial terms of the deal – meaning price, meaning what assets are we buying, what liabilities are we taking – that’s usually a subject for the financial people to sort out.”); [Banker A] Interview (“The bankers will hash out the price and yell and scream at each other, and then very often the two CEO’s will have a meeting and bridge the final gap, but that’s always at the point where the CEO’s can be the guys who make the deal, not the guys who break it. So a key part of the bankers’ role is to make sure the hard negotiations are kept away from the key principals. . . . On a public-to-public deal, we will always advise that the advisors do the bulk of those kinds of negotiations.”). See also JAMES C. FREUND, *ANATOMY OF A MERGER* (1975) at 56 (“No legal mystique surrounds the subject of price, and the majority of businessmen are generally quite able to handle the matter on their own, without any intervention from the legal profession.”).

¹⁷³ See Gordon, *supra* note 3, at 823-24; Kahan & Rock, *supra* note 3, manuscript at 23-24.

¹⁷⁴ See, e.g., [Banker F] Interview (“I would say that in certain situations defenses matter, but probably not in most situations.”); [Banker E] Interview (“Defenses are part of the picture, but probably a little bit to the side of the picture.”); [Banker I] Interview (“Defenses are on one branch of the decision tree, but it’s not a material branch of the decision-making process.”).

¹⁷⁵ For example, one interviewee stated: “The go-in hostile bid for a company with defenses is much higher than for a company without defenses. Almost by definition it would follow that friendly deals would have to be priced higher as well.” However, in prior work Bebchuk, Coates and I find no evidence that hostile bids against companies with defenses are priced higher than hostile bids against companies without defenses. See Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*, *supra* note 7, at 935-36.

¹⁷⁶ [Banker J] Interview. See also *id.* (“We tend to look at a defenses profile on a ‘pro forma’ basis, just to see what they have, trying to anticipate whether there will be issues arising from some of these things, even if they are purely mechanical issues about having to get a board waiver so a pill won’t trigger – some of the things that fall in to the ‘Good Housekeeping’ side of the transaction. You might put a summary of that sort of stuff in to the file, just because you’ve done it, but generally in this context you don’t see that stuff circulated to the board. People just aren’t focused on it.”).

And on the more specific question of whether defenses increase the price paid to target shareholders, [Banker D], Head of Mergers & Acquisitions at [Bank D], states:

I have never told a company that they should think that they should pay more [because of defenses]. I think some studies over the years have empirically said that that might be the case, but I don't think that thought has ever entered my mind – that I changed my view of fundamental economic value based on the defenses.¹⁷⁷

At the very least, the real-world factors identified here suggest that the bargaining power hypothesis cannot be accepted at the level of theory, but rather is an empirical question that must be tested against the available empirical evidence. The next Part does so.

IV. Econometric Evidence

This Part tests the hypothesis that more potent takeover defenses increase premiums for target shareholders. Part IV.A presents results from an inter-state test, using differences in the background corporate law among states. Part IV.B presents results from an intra-state test, using the Maryland Unsolicited Takeover Act of 1999 as the basis for a natural experiment. Part IV.C discusses implications of these results for the current and long-standing debate about whether takeover defenses increase or decrease overall shareholder value.

A. Inter-State Test

I use the background corporate law of California, Delaware, Pennsylvania, Maryland, Georgia, and Virginia, as described in Part II.A, to test the hypothesis that stronger defenses increase premiums for target shareholders in negotiated acquisitions. The null hypothesis is that premiums are the same for targets incorporated in these different states. If the bargaining power hypothesis is correct, then premiums should be higher in states that authorize the most potent pills (Pennsylvania, Georgia, Virginia, and Maryland¹⁷⁸) and lower in the state

¹⁷⁷ [Banker D] Interview. *See also* [Banker I] Interview (“At the margin structural defenses don't carry the day when you have a compelling economic offer. You have to think about economics – is it a good economic decision to go a dollar higher – not, does a dollar more overcome the shareholder rights plan.”); [Banker E] Interview (“My own personal view is that any effect of takeover defenses on aggregate shareholder wealth . . . is within the noise of all the other variables that are out there. I think in terms of corporate governance, and confidence that the system is working properly, and a set of rules that people can understand and therefore can be efficient in the way they undertake things, takeover defenses are extremely important and have a different sort of impact.”).

¹⁷⁸ I group Maryland, which authorizes “slow hand” pills, with Pennsylvania, Georgia, and Virginia, which authorize the more potent “dead hand” pills, because the Maryland Unsolicited

that provides the least statutory validation for pills (California) relative to Delaware which takes a middle ground on the pill question.¹⁷⁹

The test is well-specified for two reasons. First, because pills do not require a shareholder vote, all targets in dead-hand/slow-hand states have the ability to put in a complete defense at any point. While in theory a company could waive this right in its charter, to my knowledge no company has done so. Conversely, all California companies have a far more limited right to put in a pill during takeover negotiations, and no California board can unilaterally bolster its pill through charter or bylaws provisions.¹⁸⁰ Thus the background corporate law is applicable to all companies in the relevant jurisdictions.

Second, because reincorporations require a shareholder vote, and because reincorporations, as an empirical matter were relatively rare during the 1990s, the background corporate law for most public companies is relatively independent of firm-level characteristics that might also influence deal premiums.¹⁸¹ For example, the pill studies suffer from potentially serious endogeneity problems because poorer-performing companies may be more likely to put in pills.¹⁸² In contrast, state-level antitakeover statutes can be taken as relatively exogenous to firm-level characteristics.

1. Methodology

I begin with a sample of all negotiated acquisitions of U.S. public company targets, as reported in Thompson Financial Corporation's mergers & acquisitions database, announced and completed between January 1990 and December 2002. I exclude unsolicited and hostile tender offers, mergers of equals, stock repurchases, and purchases of less than a controlling interest in order to focus on the kinds of takeover negotiations to which the bargaining power hypothesis most clearly applies. I exclude transactions in which the target company has a controlling shareholder because a controlling shareholder is a complete takeover defense against a hostile bid. I exclude freeze-out transactions because the Delaware courts have imposed an additional set of procedural requirements on

Takeover Act of 1999, unlike any other state statute, allows Maryland boards to adopt an effective staggered board (ESB) without shareholder authorization, and even if contrary to the corporation's charter. *See* MD. CODE ANN., CORPS. & ASS'NS §3-803 (1999 & Supp. 2001). This provision goes further than any other state statute and arguably makes Maryland the most antitakeover jurisdiction in the country. *See infra* Part IV.B.1. In unreported regressions I exclude Maryland and obtain similar results.

¹⁷⁹ *See supra* Figure 1 and accompanying text.

¹⁸⁰ *See supra* text accompanying note 39-40.

¹⁸¹ *See* Subramanian, *supra* note 15, at 1821 (Table 1) (reporting 373 reincorporations among a sample of 7,820 U.S. public companies during the 1990s). Moreover, reincorporations during the 1990s do not seem to be predicted by observable firm financial performance measures such as Tobin's Q or return on assets (ROA). *See id.* at 1850 (Table 7).

¹⁸² *See supra* text accompanying note 83.

these negotiations that are not present in arms-length negotiations between outside acquirers and the target board.¹⁸³ I exclude transactions in which the acquirer held more than a 5% stake at the time the deal was announced, because such toehold positions may give the acquirer bargaining power unrelated to the defenses of the target. I exclude spin-off transactions and acquisitions out of bankruptcy for similar reasons. I exclude deals less than \$50 million in value because targets that are smaller than this size often have illiquid stock, thus making premium data unreliable. The final sample includes 1,692 negotiated acquisitions.

Following the convention among pill premium studies, I calculate the premium received by target shareholders relative to one day prior to deal announcement, one week prior to announcement, and four weeks prior to announcement. Unlike many of the pill studies, I adjust the premium received for market movements between the three baseline dates and the announcement date, using the value-weighted index from the University of Chicago's Center for Securities Pricing (CRSP) database.¹⁸⁴

2. Overall results

I calculate the average (mean) premium, adjusted for market movements during the period between the baseline date and the announcement date, according to potency of the target's pill as provided by the background state corporate law.¹⁸⁵ Figure 4 shows the results:

¹⁸³ See *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994); *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

¹⁸⁴ Results are qualitatively the same if I do not make this adjustment.

¹⁸⁵ More specifically, Virginia targets are classified as having potent defenses after April 2, 1990, and Maryland targets are classified as having potent defenses after June 1, 1999, when their respective pill validation statutes became effective. Pennsylvania and Georgia targets are considered to have potent defenses throughout the sample period, because their pill validation statutes became effective on March 23, 1988 and February 7, 1989 respectively. See MARIA CARMEN S. PINNELL, *STATE TAKEOVER LAWS*. The one potentially problematic state is Georgia, where the validity of dead hand pills may have become clear only after the *Invacare* decision in 1997. See *Invacare Corp. v. Healthdyne Technologies, Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997). Results are qualitatively the same if I classify Georgia targets as having potent defenses only after *Invacare* was decided, in July 1997.

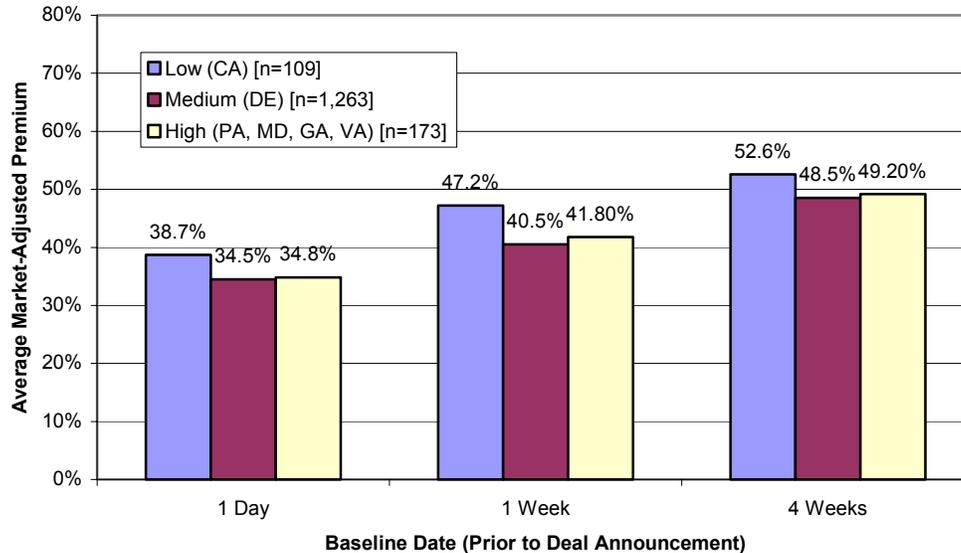
Figure 4: Effect of Pill Potency on Premiums

Figure 4 shows no statistically significant differences in the premiums received across these three different types of jurisdictions. Target companies in states with the most potent defenses extract slightly higher premiums, relative to Delaware, but the difference is not statistically significant or economically meaningful. In fact, the economically significant difference occurs between California and states with more potent pills, in a direction opposite to what the bargaining power hypothesis would predict: California targets, armed with the weakest pills, extracted premiums that were roughly 5% higher (not lower) than targets with more potent pills.

Of course, these univariate statistics may mask important differences across states that should be controlled for, to the extent possible, in order to isolate the effect of takeover defenses on premiums received. I run a multivariate regression to control for other factors that might influence the premium received by target shareholders.

First, I control for the size of the deal by including in all models the standard control of log of deal size. Because the actual relationship between premium and deal size may not necessarily follow this particular functional form, I also include seven size dummy variables, with cut-offs at \$100 million, \$250 million, \$500 million, \$1 billion, \$5 billion, and \$10 billion, and interactions between these dummy variables and log of deal size.

Second, I control for whether the acquirer provides a collar provision to the target,¹⁸⁶ and whether the target provides the bidder with deal protection in the form of a break-up fee, stock option lockup, or topping fee.¹⁸⁷ To the extent that these provisions are traded off against the deal price, one would expect to see a negative correlation between a collar agreement and deal premiums (because the target should pay to receive this insurance), and a positive correlation between deal protection and deal premiums (because the acquirer should pay to receive this insurance).

Third, I control for the consideration received by target shareholders. Cash deals generally trigger tax recognition for target shareholders, while stock-for-stock deals are generally tax-free. Therefore the acquirer may be expected to pay more in a cash deal than in a stock deal to partially offset the negative tax consequences for the target's shareholders, unless the target shareholders have losses rather than gains in their stock, or if a significant fraction of the shares are held in tax-exempt pension funds.

Fourth, I include two dummy variables that attempt to control for potentially important elements of deal structure: whether a tender offer was made, and whether the deal was structured as a pooling-of-interests. A tender offer in particular may provide important deal insurance to the acquirer. In prior work, John Coates and I show that friendly deals executed through a first-stage tender offer are far more likely to close than deals that are executed through a merger agreement, perhaps due to the faster execution of a tender offer that reduces the possibility of other bidders.¹⁸⁸ The acquirer should therefore be willing to pay for this additional insurance that a tender offer provides.¹⁸⁹

Finally, I include industry dummy variables at the 2-digit SIC code level, to control for industry effects, and year dummy variables, to control for potential time trends in premiums paid.

The dependent variable in all models is the market-adjusted premium received. The independent variable of interest is a categorical variable *PILL*, set to 0 if the target is incorporated in California (baseline), 1 if the target is incorporated in Delaware, and 2 if the target is incorporated in Pennsylvania,

¹⁸⁶ A collar provision adjusts the exchange ratio or the price received by target shareholders in the event that the acquirer's stock price goes outside specified boundaries during the period between announcement and closing.

¹⁸⁷ A breakup fee requires the target to pay the bidder a cash settlement in the event that the deal is not consummated due to one or more "trigger conditions." A stock option lockup gives the bidder the right to buy a specified percentage of the target's shares (typically 19.9%) at a specified price (typically the deal price). A topping fee has the same payoff structure as a stock option lockup but involves cash rather than the issuance of additional shares. See generally Coates & Subramanian, *supra* note 102, at 314; 365 n.164.

¹⁸⁸ See *id.* at 351-53.

¹⁸⁹ I thank John Coates for helpful conversations on this point.

Georgia, Virginia, or Maryland. All models are run as robust regressions, which minimizes the influence of outliers relative to an ordinary least squares (OLS) regression model.¹⁹⁰ Overall results are reported in Table 2:

Table 2: Effect of Pill Potency on Deal Premiums

| | Premium Over 1 Day Prior to Deal Announcement | Premium Over 1 Week Prior to Deal Announcement | Premium Over 4 Weeks Prior to Deal Announcement |
|---|---|---|--|
| <u>Pill Potency:</u> | | | |
| Medium (Delaware) | -3.05 (2.72) | -6.15 (2.95)** | -4.40 (3.46) |
| High (Pennsylvania, Maryland, Georgia, Virginia) | -0.80 (3.35) | -2.42 (3.64) | -3.47 (4.26) |
| <u>Deal Characteristics:</u> | | | |
| Log (market capitalization) | -0.76 (7.61) | 1.26 (8.26) | 2.38 (9.69) |
| All-cash | -0.10 (2.69) | 0.20 (2.92) | -1.12 (3.44) |
| All-stock | -0.06 (2.70) | -1.47 (2.92) | 0.71 (3.43) |
| Pooling-of-interests | 1.29 (2.16) | 4.15 (2.34)* | 0.61 (2.74) |
| Tender offer | 6.52 (1.97)*** | 10.27 (2.13)*** | 9.84 (2.51)*** |
| <u>Deal Protection:</u> | | | |
| Collar provision | -0.93 (2.31) | -0.80 (2.50) | 1.57 (2.94) |
| Breakup fee | 1.69 (1.71) | 1.47 (1.86) | 1.35 (2.17) |
| Stock option lockup | 2.50 (2.03) | 2.49 (2.21) | 1.17 (2.58) |
| Number of Observations | 1,544 | 1,545 | 1,548 |

Notes: All models are run as robust regressions. Standard errors are reported in parentheses. All models include a constant term, industry controls (2-digit SIC code level), year controls, and interactions between size dummy variables and log of firm size (not reported). * = statistically significant at 90% confidence; ** = statistically significant at 95% confidence; *** = statistically significant at 99% confidence.

Table 2 shows that most of the coefficients on the pill potency variables are statistically insignificant. The one coefficient that is statistically significant is in a direction opposite to what the bargaining power hypothesis would predict: using premiums calculated over one week prior to deal announcement, Delaware targets, armed with moderate pills, achieve approximately 6% lower premiums than California targets, armed with weaker pills, even after controlling for industry differences that no doubt exist across these two states. While I can think of no reason why takeover defenses should reduce premiums in negotiated

¹⁹⁰ Results are the same if I run the model as an OLS regression, using both premium and natural log of premium as the dependent variable.

acquisitions, the results presented in Table 2, at the very least, do not support the predictions of the bargaining power hypothesis.

Examining the control variables, Table 2 provides some mild support for the deal insurance hypothesis. Tender offers are highly correlated with higher deal premiums, consistent with the theory that buyers pay for the fast execution that a tender offer provides. The coefficients for breakup fees and stock option lockups (though not collar provisions) are also consistently positive across models, consistent with the deal insurance hypothesis, but these coefficients are not statistically significant.

3. Focused samples

Thus far I have tested the hypothesis that defenses provide a premium benefit across all deals, as argued by defense proponents,¹⁹¹ and find no evidence to support this strong form of the bargaining power hypothesis. I now test the hypothesis that defenses increase premiums in particular kinds of deals. As suggested by the theoretical model put forward in this Article, I test two possibilities.

First, I test the hypothesis that defenses are effective in extracting higher premiums for targets with fixed assets, i.e., targets for which property, plant & equipment (PP&E) rather than human capital are critical. The argument is twofold: first, that a hostile bid is more feasible against a target with hard assets, because the assets cannot readily exit,¹⁹² and second, the bidder is less likely to relinquish the hostile bid threat against a hard-assets target because the assets are easier to value without confidential information. I test this theory by running the baseline model only on targets in four SIC divisions: Agriculture, Forestry & Fishing (SIC codes 01-09); Mining (10-14); Construction (15-17); and Manufacturing (20-39).

Second, the model presented in this Article predicts that takeover defenses are more likely to be a binding constraint in a takeover negotiation if there are fewer alternatives away from the table for the bidder and/or the target. I test this theory by running the model on deals announced after December 2000, when the M&A slow-down began.¹⁹³ A thinner M&A marketplace suggests fewer walk-away alternatives, which in turn may increase the likelihood that defenses would give targets bargaining power against potential acquirers.

¹⁹¹ See *supra* text accompanying note 43.

¹⁹² See [Banker A] Interview (“[A hostile bid is viable] only in situations where hard assets are key, and where for whatever reason you think you can actually keep the employees. . . . Otherwise you may lose more value than you can possibly gain.”).

¹⁹³ See Nikil Deogun & Kara Scannell, *Market Swoon Stifles M&A’s Red-Hot Start, But Old Economy Supplies a Surprise Bounty*, WALL ST. J. (Jan. 2, 2001) at R4; Robin Sidel, *Cash is More Popular Amid Drop in Mergers*, WALL ST. J. (April 2, 2001) at C18.

As in Table 2, I run both model extensions using baseline dates one day prior, one week prior, and four weeks prior to bid announcement. I use deal premium and log of deal premium as the dependent variable, run as both a robust regression and an OLS regression. The results are substantively the same as reported in Table 2: (1) tender offers are highly correlated with higher deal premiums, and statistically significant in most models; (2) no other features of the target or the deal are statistically significant at 95% confidence in predicting deal premiums; and (3) importantly, the pill potency variables are not statistically significant at 95% confidence in any of the regressions.¹⁹⁴

B. Intra-State Test

One concern with the econometric results presented in the previous Part is that there may be differences among firms incorporated in these different states that are not adequately captured by industry and size controls. In order to provide a partial response to this objection, I now present results from an intra-state test, using the Maryland Unsolicited Takeover Act (“MUTA”) of 1999 as the basis for a natural experiment. MUTA was signed into law on June 1, 1999 and contains a broad array of potent takeover defenses: in addition to endorsing slow-hand pills, as discussed in Part II.A, it provides a broad constituency provision, allowing directors to reject a takeover bid because of the effect that the acquisition would have on non-shareholder constituencies,¹⁹⁵ it rejects Delaware’s heightened scrutiny for director conduct in sale of control situations and instead provides that directors’ actions will be assessed under the business judgment rule,¹⁹⁶ and it allows Maryland corporations to adopt a staggered board without shareholder approval, and even if contrary to the firm’s charter.¹⁹⁷ These provisions make the Maryland statute by far the most potent antitakeover statute in the United States, effectively giving Maryland companies the “complete defense” that was theorized in Part III. If the bargaining power hypothesis is correct, then premiums for Maryland targets in negotiated acquisitions should increase after June 1, 1999.

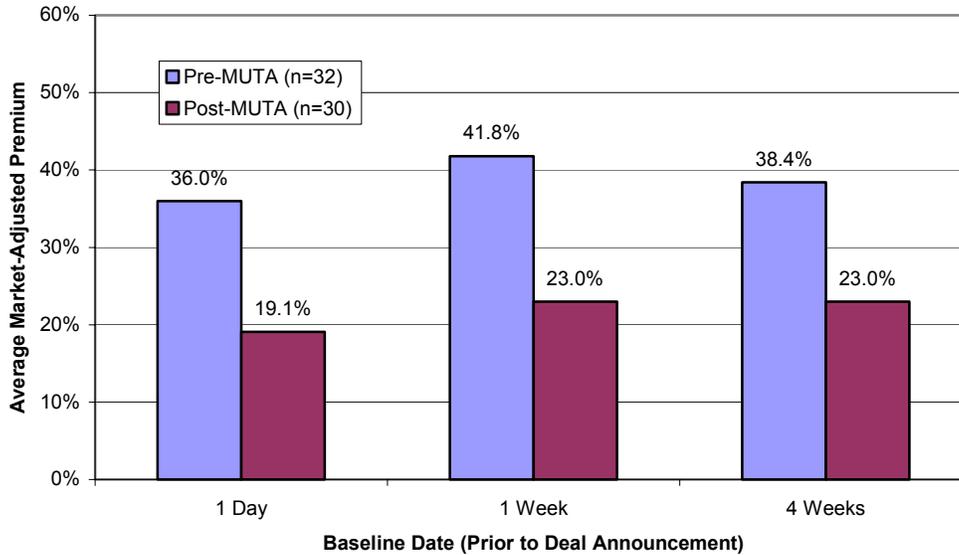
Figure 5 presents average premiums for Maryland targets in negotiated acquisitions before and after MUTA went into effect.

¹⁹⁴ Cf. ELEANOR E. MACCOBY & ROBERT H. MNOOKIN, *DIVIDING THE CHILD: SOCIAL AND LEGAL DILEMMAS OF CUSTODY* 143-57 (putting forward the hypothesis that custody is used as a bargaining chip for the father to provide less financial support, but finding no evidence to support this hypothesis) (1992).

¹⁹⁵ MD. CODE ANN. at § 2-104(b)(9), 2-405.1(d)(5)(ii) (1997).

¹⁹⁶ See *id.* at §2-405.1(f) (1999). In effect this provision extends the “Just Say No” defense that Delaware courts have permitted for strategic, stock-for-stock mergers to all sale of control situations in Maryland.

¹⁹⁷ See *id.* at §3-803 (1999 & Supp. 2001). Collateral provisions make the staggered board automatically effective. See *id.* at §3-804(a)-(c), §3-805(1).

Figure 5: Pre- and Post-MUTA Premiums

Although the sample size is small, Figure 5 shows a statistically significant *decrease* in premiums, at 90% confidence, after MUTA went into effect. This finding is consistent with the only statistically significant finding reported in Table 2, showing a negative coefficient for the pill potency variable in one particular specification.

As in the previous Part, I also run a multivariate regression model to control for other factors that might influence deal premiums. Because of the small number of observations, I use a subset of the controls included in Table 2. To control for a potential downward time trend in premiums during the sample period (and even though examination of the data does not reveal such a trend), I use as the dependent variable in each model the market-adjusted premium minus the average deal premium in the month that the deal is announced.¹⁹⁸ Results are reported in Table 3.

¹⁹⁸ Results are the same if I use the market-adjusted premium without any time trend adjustment.

Table 3: Effect of Maryland Unsolicited Takeover Act on Deal Premiums

| | Premium Over 1 Day Prior to Deal Announcement | Premium Over 1 Week Prior to Deal Announcement | Premium Over 4 Weeks Prior to Deal Announcement |
|-------------------------------------|---|---|--|
| <u>MUTA</u> | -12.18 (5.44)** | -14.68 (4.97)*** | -19.28 (6.20)*** |
| <u>Deal Characteristics:</u> | | | |
| Log (market capitalization) | 0.22 (1.80) | 0.07 (1.65) | 0.54 (2.05) |
| All-cash | 1.22 (5.78) | 6.71 (5.27) | 2.74 (6.58) |
| Tender offer | 9.24 (6.55) | 17.64 (5.98)*** | 17.76 (7.46)** |
| <u>Deal Protection:</u> | | | |
| Breakup fee | -5.35 (5.18) | -3.68 (4.73) | -9.63 (5.90) |
| Stock option lockup | -4.16 (7.24) | 6.64 (6.61) | 13.54 (8.24) |
| Number of Observations | 62 | 62 | 62 |

Notes: All models are run as robust regressions. Standard errors are reported in parentheses. * = statistically significant at 90% confidence; ** = statistically significant at 95% confidence; *** = statistically significant at 99% confidence.

Table 3 shows that the differences reported in Figure 5 continue to hold up in a statistically and economically significant way after controls for other factors are introduced. Specifically, deal premiums in negotiated acquisitions were 12-19% lower after MUTA became effective, at 95% confidence. The results are the same when I eliminate premium outliers, which may have an undue impact in a small sample even though the model is run as a robust regression. The results are weaker but directionally similar when I eliminate real estate investment trusts (REIT's) from the sample,¹⁹⁹ which had uncertain vulnerability to a hostile takeover during the period under consideration.²⁰⁰ These findings generally reject the hypothesis that MUTA led to higher premiums in negotiated acquisitions for Maryland companies.

¹⁹⁹ When I eliminate REIT's, the MUTA coefficient continues to be negative in all regressions, but is only statistically significant at 95% confidence when I use deal premium four weeks prior to announcement as the dependent variable. The weaker results may be due, at least in part, to the smaller number of observations in these models.

²⁰⁰ While there have been several hostile bids against REIT's in the modern era of takeovers, the vulnerability of REIT's to hostile takeover bids became considerably clearer after Simon's hostile takeover bid for Taubman Centers Inc. (a REIT) in December 2002. See Dean Starkman & Robin Sidel, *Mall Brawl: Bid Marks REIT Turning Point*, WALL ST. J. (Apr. 28, 2003) at C1.

C. Assessment

The empirical evidence presented in this is consistent with the theoretical model and practitioner evidence presented in Part III demonstrating that takeover defenses do not increase premiums in most negotiated acquisitions. This conclusion is consistent with several other empirical studies that also do not find evidence to support the bargaining power hypothesis. For example, Robert Daines and Michael Klausner find that the presence of takeover defenses at the IPO stage cannot be explained by the desire of IPO entrepreneurs to extract more in an eventual negotiated sale of the company.²⁰¹ In follow-on work to our initial study of ESB's in the hostile takeover context, Bebchuk, Coates, and I report no statistically significant difference in the premiums received by shareholders of 39 ESB targets and 34 non-ESB targets.²⁰² More generally, the evidence presented here is consistent with robust econometric evidence, reported in several studies over the past twenty years, demonstrating that share prices decrease when states pass antitakeover statutes.²⁰³ If the bargaining power hypothesis were correct, one would expect share prices to increase to reflect the greater premiums that would be extracted in future negotiated acquisitions.²⁰⁴

Finally, my theoretical model, practitioner interviews, and econometric evidence are consistent with revealed preference among shareholders in the 1990s, who overwhelmingly voted to rescind takeover defenses such as poison pills and staggered boards.²⁰⁵ If these defenses gave target boards bargaining power to extract higher premiums, one would expect shareholders to bestow these powerful weapons on their boards of directors rather than trying to take them away. Or put differently, if the findings from the pill studies were correct, then shareholders in the 1990s attempted to destroy billions of dollars of (their own) value by passing precatory resolutions urging rescission of pills and staggered boards. Whatever rational apathy arguments might apply to shareholder decision-making on many corporate governance issues, the magnitude of the dollars at stake makes these arguments less likely to be valid with respect to the bargaining power hypothesis.

²⁰¹ See Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J. LAW, ECON., & ORG. 83, 86 (2001).

²⁰² See Bebchuk, Coates & Subramanian, *Reply to Commentators*, *supra* note 7, at 906.

²⁰³ For a review of studies from the 1980s and early 1990s, see ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 62-66 (Table 4-1) (1993). For a review of more recent studies, see PINNELL, *supra* note 185, at Appendix C (2000).

²⁰⁴ For this reason the Maryland result reported in the previous Part is unlikely to be explained by bargaining power already impounded into the stock price of Maryland companies.

²⁰⁵ See Michael Klausner, *Institutional Shareholders' Split Personality on Corporate Governance: Active in Proxies, Passive in IPOs*, U. PENN. L. REV. (forthcoming 2003).

However, despite the consistency of the econometric and real-world evidence, the nature of the bargaining power hypothesis makes it difficult, as an econometric matter, to definitively disprove.²⁰⁶ This Article nevertheless advances the debate by demonstrating that the bargaining power hypothesis cannot be accepted at the level of theory. The specific econometric question is whether the bargaining power benefit in some (potentially small) subset of negotiated acquisitions is sufficient to offset the cost of strong defenses in the hostile deal context. Because the bargaining power hypothesis is not universally applicable to all negotiated acquisitions, it is not necessarily the case that “even a miniscule benefit”²⁰⁷ in negotiated acquisitions is sufficient to offset the cost in the hostile bid context. In order to make the case that the net wealth effect of strong defenses is positive, one must examine both the benefit achieved and the scope of deals to which the benefit applies.

Even if future work were to find that stronger defenses were correlated with higher premiums, it would be unclear how to interpret the results. Because of the real-world factors introduced in Part III – most importantly, hostile bid costs and standstill agreements – there are strong theoretical reasons to not necessarily attribute higher premiums for strong-defense targets to the bargaining power hypothesis. Indeed, such an inference may be implausible in view of the practitioner authority documented in this Article claiming that defenses are irrelevant in most negotiated acquisitions.²⁰⁸ Instead, two alternative explanations might provide a better explanation for such results.

First, there is the possibility that strong defenses deter low-premium bids (the “bid deterrence hypothesis”). Rather than simply shifting the distribution of deal premiums for strong-defense targets to the right (as the bargaining power hypothesis suggests) the distribution of deal premiums might be truncated at some number greater than zero because low-premium bids are unlikely to succeed.²⁰⁹ The two hypotheses are observationally equivalent – both would appear in the data as higher premiums for strong-defense targets – yet they have opposite social welfare implications: if the bargaining power hypothesis is at work, then strong defenses increase target shareholder value, while if the bid deterrence hypothesis

²⁰⁶ Much in the same way as it would be difficult to disprove the hypothesis that the Red Sox are more likely to win when I wear a blue shirt. We nevertheless reject this hypothesis at the level of theory. As Einstein noted, “It is the theory which decides what we can observe.”

²⁰⁷ Kahan & Rock, *supra* note 3, manuscript at 23. See also Gordon, *supra* note 3, at 824.

²⁰⁸ See *supra* Part III.F.

²⁰⁹ See, e.g., [Banker C] Interview (“In more cases people walk away and they don’t make the offer, because they think the offer will be rejected [when a target has strong defenses].”). See also Bebchuk, Coates & Subramanian, *Reply to Commentators*, *supra* note 7, at 907 n.70. I thank Richard Zeckhauser for helpful conversations on this point.

is at work, then strong defenses reduce target shareholder value because value-creating deals are deterred.²¹⁰

A second possibility is that strong-defense targets are weaker companies than weaker-defense targets (the “operational improvement hypothesis”).²¹¹ The causation might run in one of two ways: either weaker companies put in strong defenses, because the likelihood of a hostile takeover bid is greater; or strong defenses permit larger managerial agency costs which then reduces firm value. Regardless of which way the causation might run, one would expect higher premiums for strong-defense companies not because of greater bargaining power, but rather because of greater opportunity for operational improvements at these companies.²¹² This conclusion would be consistent with recent evidence offered by Gompers, Ishii & Metrick, showing that a portfolio of companies with few defenses outperformed a portfolio of companies with many defenses over the period 1990 to 1999.²¹³

A methodology that would distinguish the bargaining power hypothesis from the operational improvement hypothesis (though not from the bid deterrence hypothesis) would involve examining the effect of the deal announcement on the acquirer’s stock price in deals involving strong-defense targets and weak-defense targets. If strong-defense targets are able to achieve higher premiums solely because of enhanced bargaining power, then acquirers should suffer a negative wealth effect, on average, in buying such targets relative to buying weaker-defense targets, because the greater value being extracted by the target will be taken out of the acquirer’s stock price. Clearly this approach introduces challenges of its own; perhaps because of these challenges, such an approach has not been attempted to date. But because it is the only test that I know of which would rule out the operational improvement hypothesis in favor of bargaining power, it would seem to be an essential piece of the empirical evidence for the pro-defenses position.

²¹⁰ This analysis takes the perspective of target shareholders, which is the perspective that is most relevant for Delaware corporate law. From a social welfare perspective, however, bid deterrence unambiguously reduces shareholder value: higher premiums only transfer value from acquirer to target, and therefore can be ignored, leaving only the social cost of deterred deals. See ROBERT CHARLES CLARK, *CORPORATE LAW* 590 (“Shareholders as a group may be better off in the long run if the cost of takeovers is kept low and the number of takeovers high.”) (1986); Easterbrook & Fischel, *supra* note 148.

²¹¹ This argument is more applicable to analyses of firm-level defenses than the state-level analyses presented here. See *supra* text accompanying note 181-182.

²¹² Cf. Coates, *supra* note 14 (making an analogous argument to explain the results of the pill studies).

²¹³ See Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107 (2003).

V. Discussion

A. The Trajectory of the Post-Enron Delaware Case Law

The Delaware Supreme Court has made dramatic pro-shareholder moves over the past year: in *every case* involving directors' fiduciary duties since June 2002, when the Sarbanes-Oxley Act was passed by Congress, the Court has held against management and in favor of shareholders, often expanding existing corporate law doctrines in important ways.²¹⁴ In *MM Companies, Inc. v. Liquid Audio, Inc.*,²¹⁵ for example, the Delaware Supreme Court extended the stringent "compelling justification" standard articulated in *Blasius Industries, Inc. v. Atlas Corp.*²¹⁶ beyond actions that thwart the ability of a bidder to take control of the board, to include defensive measures that merely dilute the "substantial presence" of insurgent directors.²¹⁷ Similarly, in a rare 3-2 decision, the Court in *Omnicare, Inc. v. NCS Healthcare, Inc.*²¹⁸ invalidated a shareholder lock-up agreement as impermissibly "preclusive and coercive," thus giving the first glimpses of what might run afoul of *Unitrin's* deferential restatement of *Unocal's* intermediate standard of review. One commentator described the *OmniCare* decision as "the most controversial corporate law decision of the past twenty years."²¹⁹

This trend in the Delaware jurisprudence is unlikely to be coincidental. As the SEC begins implementing the various provisions of the Sarbanes-Oxley Act, Delaware courts may have moved in a pro-shareholder, anti-managerial direction in order to avoid further federal preemption on (historically) state corporate law issues.²²⁰ Examining forty years of U.S. corporate law history, Mark Roe finds a correlation between the threat of federal preemption and Delaware's corporate

²¹⁴ See *Director Liability Warnings*, BUSINESS & SECURITIES LITIGATOR (Feb. 2003) at 12 (citing *Telxon Corp. v. Meyerson*, 802 A.2d 257 (Del. June 2, 2002), *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113 (Del. June 11, 2002), *Levco Alternative Fund Ltd. V. Reader's Digest Ass'n, Inc.*, 2002 WL 1859064 (Del. Aug. 13, 1002), *OmniCare, Inc. v. NCS HealthCare, Inc.*, 2002 WL 31767892 (Del. Dec. 10, 2002), *MM Cos. V. Liquid Audio, Inc.*, 2003 WL 58969 (Del. Jan. 7, 2003)).

²¹⁵ 813 A.2d 1118 (Del. 2003).

²¹⁶ 564 A.2d 651 (Del. Ch. 1988).

²¹⁷ See *Liquid Audio*, 813 A.2d at 1132 ("As this case illustrates, such defensive action need not actually prevent the shareholders from attaining any success in seating one or more nominees in a contested election for directors, and the election need not involve outright control of the board of directors.").

²¹⁸ No. 659, 2002 (Del. Apr. 4, 2003).

²¹⁹ See Robin Sidel, *Merger Business Has New Order With Court Ruling on 'Lockups'*, WALL ST. J. (April 7, 2003) at C4 (quoting Professor Eric A. Chiappinelli of the Seattle University School of Law).

²²⁰ See Mark Roe, *Delaware's Competition*, HARV. L. REV., manuscript at 45 (forthcoming 2003).

law jurisprudence.²²¹ If this theory is correct, then Delaware may continue on this path at least until the threat of federal preemption recedes.

B. The Costs and Benefits of a Meaningful Hostile Takeover Weapon

This prediction is important for what it might mean for Delaware's takeover jurisprudence. If future takeover cases follow the general trend of the recent director fiduciary duty cases, then the Delaware courts may begin to replace what amounts to business judgment review of defensive tactics under *Unitrin* with a return to meaningful intermediate scrutiny review as originally articulated in *Unocal* – in effect, a return to *Interco* and the line of Delaware cases from the late-1980s in which courts engaged in substantive review of defensive tactics taken to thwart hostile takeover offers.²²² Proponents of the status quo warn that this kind of doctrinal movement would weaken target boards' bargaining power in negotiated acquisitions, which would in turn reduce overall returns to target shareholders. But once the "black box" of negotiated acquisitions is unpacked, it becomes clear that the ability of takeover defenses to improve premiums for target shareholders in negotiated acquisitions is substantially limited. Therefore the hypothesized downside of pro-takeover moves in Delaware is minimal at most.

Moreover, while the downside is minimal, the upside of a revitalized takeover marketplace is potentially enormous. The experience of the past two years indicates there is no adequate substitute for a meaningful hostile takeover threat. Apologists for the antitakeover movement of the 1980s and 1990s argued that the dramatic growth of stock option compensation²²³ and the increased representation of independent directors on corporate boards during the 1990s²²⁴ effectively offset the negative effects of entrenchment and higher agency costs.²²⁵ However, putting aside the important question of whether stock options and independent directors were "adaptive devices"²²⁶ responding to the shut-down of hostile

²²¹ See *id.* at 44-45.

²²² See note 16 and accompanying text. One such case that would permit this opportunity is *Oracle v. PeopleSoft*, involving virtually identical facts to the *Time Warner* case in 1989, which is pending before the Delaware Chancery Court. See *Oracle Corp.: Hearing Delayed in Suits to Curb Poison Pill in Bid for PeopleSoft*, WALL ST. J. (July 2, 2003) (parties scheduled to next meet with the Court on July 23, 2003).

²²³ See Brian J. Hall & Jeffrey Liebman, *Are CEO's Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653, 654-55 (1998); Brian J. Hall & Kevin J. Murphy, *Stock Options for Undiversified Executives*, 33 J. ACCTNG & ECON. 3, 4 (2002).

²²⁴ See Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 945 (1999) (reporting a decline in the number of inside directors at the median firm in their sample "due to changes since 1991 in the composition of a typical board.").

²²⁵ See Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871, 896-897 (2002).

²²⁶ See *id.* at 872.

takeovers or merely coincidental, this story is unsatisfying in two respects. First, the threat of a hostile takeover performs a unique disciplinary function in the market for corporate control that negotiated acquisitions do not. There is no reason to believe that the types of acquisitions that are motivated by stock option compensation, for example, will provide the same disciplinary benefit that hostile takeovers do.²²⁷

Second, the failures at Enron and other U.S. public companies illustrate the “dark side” of relying on stock option compensation to motivate managers and reduce agency costs.²²⁸ While stock options can certainly be structured in ways that promote a long-term outlook among managers,²²⁹ the stock options that were prevalent in the 1990s are now well-understood to have promoted short-term behavior that took advantage of market speculation to the detriment of long-term shareholder interests. Thus the irony of our experience over the 1990s is that we are now back to where we started from: hostile takeovers promoted a short-term outlook, argued the defense proponents, so defenses were justified as a way of allowing managers to adopt a longer-term perspective,²³⁰ takeover defenses gave rise to stock options, argued the new school defense proponents,²³¹ which (it turns out) promoted the same short-term perspective that we were concerned about in the first place.

In short, stock options and independent directors do not provide an adequate substitute for the hostile takeover threat as a disciplinary device against disloyal or incompetent managers. While this argument was difficult for some to accept during the roaring 1990s, the connection between the hostile takeover threat and well-managed companies is becoming more widely acknowledged after the corporate governance failures of the past two years.²³² In fact, some commentators have argued that the recent failures can be attributed directly to the shut-down of the hostile takeover marketplace.²³³ While I do not go so far, I do

²²⁷ See Reinier Kraakman, *The Best of All Possible Worlds (or Pretty Darn Close)*, 69 U. CHI. L. REV. 933, 936 (2002).

²²⁸ See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1327-28 (2002).

²²⁹ See Brian Hall, *What You Need to Know About Stock Options*, HARV. BUS. REV. (March 2000).

²³⁰ See, e.g., Stout, *supra* note 61, at 853.

²³¹ See, e.g., Kahan & Rock, *supra* note 225, at 896.

²³² See, e.g., *Barbarians in the Valley*, THE ECONOMIST at 61 (June 28, 2003) (“The business culture of the 1990s – defined, above all, by the consensual business matings that spawned the greatest merger boom in history – now looks too cozy.”).

²³³ See, e.g., Henry G. Manne, *Bring Back the Hostile Takeover*, WALL ST. J. (June 26, 2002) at A18 (“New scandals will continue until we bring back the most powerful market mechanism for displacing bad managers: hostile takeovers.”); Herbert Grubel, *Regulators vs. Adam Smith*, WALL ST. J. (Oct. 3, 2002) at A14 (“Throughout history . . . hostile takeovers were profitable because the board of directors installed by new owners would eliminate practices that caused share prices to be

believe that the Sarbanes-Oxley Act and other reforms must be complemented by a meaningful market for corporate control. In other work, Bebchuk, Coates and I put forward a specific proposal that would move in this direction.²³⁴

VI. Conclusion

This Article identifies a disconnect between conventional wisdom among academic commentators and standard practice among M&A practitioners. For decades, academics have claimed that friendly acquisitions are negotiated in the “shadow” of a hostile takeover bid. However, interviews with senior M&A practitioners indicate that this is not the case in most negotiated acquisitions. This Article constructs a model of “bargaining in the shadow of takeover defenses” that bridges this gap. The model begins with a specification of the bargaining process involving a bilateral monopoly between buyer and seller, no hostile bid costs, symmetric information, and loyal sell-side agents. In this stylized model, the academic conventional wisdom clearly holds.

This Article then goes on to introduce four real-world factors: alternatives away from the table, hostile bid costs, asymmetric information, and agency costs. No one doubts that these factors exist. And once these factors are introduced, it becomes clear that only a small fraction of friendly acquisitions are in fact negotiated in the shadow of a hostile takeover threat. This conclusion is consistent with the basic claim among M&A practitioners as well as the econometric evidence presented in this Article.

The model has implications for the bargaining power hypothesis, which many commentators have put forward to support takeover defenses. If all acquisitions are negotiated against a background hostile threat, then Delaware courts should give target boards broad discretion to install and maintain takeover defenses, in order to achieve bargaining power against potential acquirers. But this Article investigates the micro-level underpinnings of negotiated acquisitions to find that the hostile bid threat is in the distant background in many if not most of these deals. As a result, the bargaining power benefits of takeover defenses in negotiated acquisitions recede, and the costs of takeover defenses in the hostile bid context come to the fore.

These costs may be greater in today’s global economy than they ever have been in the past. In the new millennium, activist European Union regulators are seeking to impose what amounts to an open market for corporate control in the

depressed. Thus, executives with excessive compensation are replaced, bonus and option plans adjusted, and shady accounting and self-dealing eliminated.”).

²³⁴ See Bebchuk, Coates & Subramanian, *Powerful Antitakeover Force*, *supra* note 7 (proposing that, absent explicit shareholder authorization to the contrary, incumbents protected by an ESB who lose one election over an outstanding bid should generally not be allowed by courts to further block the bid by maintaining a pill).

EU.²³⁵ If these efforts prove successful (and after more than twenty years of efforts they are looking increasingly likely to be),²³⁶ then U.S. competitiveness will hinge on its willingness to expose American managers to the same disciplinary forces. Doctrinally, the Delaware courts will need to determine whether and to what extent to roll back the sweeping deference that they have given corporate boards during the 1990s, in favor of *Unocal*'s original promise of intermediate scrutiny. This Article provides a theoretical model, practitioner interviews, and econometric evidence suggesting that such a move would not create a countervailing cost for target shareholders in the form of reduced bargaining power in negotiated acquisitions.

²³⁵ See John C. Coates IV, *The Integration of Capital Markets by Fallible Regulators: Should the EU Disperse Ownership of Public Companies* (working paper June 2003).

²³⁶ See *id.*