FEDERALISM AND TAKEOVER LAW:

THE RACE TO PROTECT MANAGERS FROM TAKEOVERS

Lucian Arye Bebchuk* and Allen Ferrell**

* William J. Friedman & Alicia Townsend Friedman Professor of Law, Economics and Finance, Harvard Law School; Research Associate, National Bureau of Economic Research

** John M. Olin Fellow in Law, Economics and Business, Harvard Law School.

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Abstract

This paper analyzes certain important shortcomings of state competition in corporate law. In particular, we show, with respect to takeovers, states have incentives to produce rules that excessively protect incumbent managers. The development of state takeover law, we argue, is consistent with our theory. States have adopted antitakeover statutes that have little policy basis, and, more importantly, they have provided managers with a wider and more open-ended latitude to engage in defensive tactics than endorsed even by the commentators most favorable to such tactics. Furthermore, states have elected, even though they could have done otherwise, to impose antitakeover protections on shareholders, who did not appear to favor them, in a way that left shareholders with little choice or say. Finally, we conclude by pointing out that proponents of state competition cannot reconcile their views with the evolution of state takeover law---and should therefore reconsider their unqualified support of state competition.

Key words: takeovers; defensive tactics; poison pills; federalism; state competition; Delaware. JEL Classification: G30, G34, G38, H70.

[*] William J. Friedman & Alicia Townsend Friedman Professor of Law, Economics and Finance, Harvard Law School; Research Associate, National Bureau of Economic Research
[**] John M. Olin Fellow in Law, Economics and Business, Harvard Law School.

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INTRODUCTION

Twenty-five years ago Bill Cary published his most lasting contribution to corporate law---his *Yale Law Journal* article entitled "Federalism and Corporate Law: Reflections upon Delaware"[1]---one of the most well-known and widely cited articles in corporate law.[2] In the article, he argued that Delaware's reliance on revenues generated from corporate charters had led it to favor corporate managers in crafting its corporate code. Cary believed that managers, often at the expense of shareholders, enjoyed unjustifiably lax constraints with regard to issues ranging from fiduciary obligations to a parent's treatment of a corporate subsidiary.[3] To stop this harmful "race to the bottom," Cary proposed Congress adopt "federal standards of corporate responsibility."[4]

Cary's skeptical view of state competition has not been widely accepted by corporate law scholars. Indeed, scholars since Cary have largely taken a favorable view of state competition for corporate charters. Ralph Winter, in an influential critique of Cary's position, argued that state competition for corporate charters leads

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1 83 Yale L.J. 663 (1974).

2 Fred R. Shapiro, The Most-Cited Articles From the Yale Law Journal, 100 Yale L.J. 1449, 1462 (1991) (finding that Cary's article was the 14th most cited Yale Law Journal article).

3 See Cary, 83 Yale. L.J. at 673--84.

4 Id. at 701.

to a "race to the top" as a result of market constraints on managers' behavior.[5] Frank Easterbrook and Daniel Fischel have endorsed and developed Winter's contention that state competition benefits shareholders.[6] Roberta Romano has similarly argued that state competition ensures that corporate law maximizes shareholder wealth.[7] Indeed, Professor Romano labels the federalist structure of corporate law "the genius of American Corporate Law."[8]

Several years ago one of us pursued the route suggested by Cary and developed an analysis of the problems produced by state competition.[9] That analysis suggested that, with respect to a set of important corporate issues, state competition is unlikely to serve shareholder wealth maximization.[10] Rather, the analysis suggested that states might have an incentive to provide rules that are preferred by managers and controllers---and that on these issues the rules preferred by managers and controllers may well be different from what's beneficial to shareholders.

Building on that analysis, we continue in this Article to examine the contention, articulated by Cary, that there are serious problems with state competition. Our analysis suggests that state competition suffers from important structural

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5 Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Studies 251 (1977).

6 See Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J.Corp. L 540, 546 (1984); Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L.& Ec. 395, 398 (1983); Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. Rev. 913 (1982); see generally Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 1--40 (1991).

7 See Roberta Romano, Competition for Corporate Charters and the Lesson of Takeover Statutes, 61 Fordham L.Rev. 843, 856 (1993); Roberta Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709, 717 (1987); cf. Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359 (1998).

8 Roberta Romano, The Genius of American Corporate Law 1 (1993).

9 See Lucian A. Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L.Rev. 1435 (1992).

10 Moreover, state competition for corporate charters might lead to inefficiencies when the interests of not only shareholders but also third parties are implicated by a legal rule. See id. at 1485--1495. The present discussion will focus on shareholder wealth.

problems, and that competition among states is therefore likely to produce troubling results with respect to some critical aspects of corporate law. Cary carefully examined several corporate law issues, such as proxy contests, de facto mergers, fairness in parent-subsidiary transactions, and directors' duty of care, all hot issues in the 1960s. We will discuss the issues involved in the state competition debate through the lens of takeover regulation, perhaps the most important issue in corporate law in the last two decades.[11] We use takeover law as a case study of the shortcomings of state competition.

Our analysis is organized as follows. Part I will argue that there are strong theoretical reasons to believe that states will have incentives to produce a body of takeover law that excessively protects incumbent managers and restricts hostile takeovers. Because managers play a key role in incorporation decisions, states (especially ones with a large number of already incorporated companies, such as Delaware) will give substantial weight to satisfying managers' preferences. To be sure, in some areas of corporate law, because managers' and shareholders' interests are sufficiently aligned due to various market forces, the rules that managers would like states to adopt are those that maximize shareholder value. But, we argue, in the area of takeovers, this is unlikely to be the case. Because of the value that managers

[11] A parallel debate has been taking place concerning competition among jurisdictions in the international sphere. Some commentators believe that this form of competition is generally beneficial, see, e.g., Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359 (1998); Stephen Choi & Andrew Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 S.Cal.L.Rev. 903 (1998); Stephen Choi & Andrew Guzman, National Law, International Money: Regulation in a Global Market, 65 Fordham L. Rev. 1855 (1997). Others predict harmful effects resulting from such competition, see, e.g., Merritt Fox, Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment (unpublished paper); Merritt Fox, Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?, 95 Mich. L. Rev. 2498 (1997). While our paper will focus on competition among states, the analysis also has implications for international competition among jurisdictions. For reasons explained in Bebchuk, supra, at 1507-08, international

might place on their independence, managers might prefer rules that excessively restrict takeovers notwithstanding that such rules might somewhat reduce share value and make it somewhat more difficult for them to acquire other companies when they wear the acquirers' hat.

Part II analyzes the development of state takeover law and argues that it is consistent with the above theoretical analysis. States have developed a substantial body of rules, including both antitakeover statutes and judicial decisions permitting the use of defensive tactics, that make takeovers more difficult. We suggest that these rules are quite likely to excessively protect managers. To start with, we show that the extent to which these rules restrict takeovers has little support in the policy literature on takeovers. States' relentless effort to come up with new antitakeover statutes seems to be motivated more by a desire to make takeovers more difficult than by an attempt to address in a cost-effective way some valid policy concerns. And the latitude that states have given to defensive tactics has surpassed what even the strongest supporters of defensive tactics have advocated. Furthermore, states have provided managers with more antitakeover protections than shareholders seemed to have been willing to give them. Finally, and perhaps most importantly, states have elected to proceed in a way that imposed antitakeover protections without giving them much choice or say.

Our analysis of Delaware takeover law highlights the fact that its rules governing defensive tactics seem to be characterized by unnecessary ambiguity and unpredictability resulting in frequent litigation. While this aspect of Delaware law

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competition and state competition have similar structural problems. Thus, the implication of our analysis is that international competition would not work well with regard to rules governing takeovers.

benefits the interests of the Delaware bar, which might be of importance to Delaware, it is difficult to see how shareholders are benefited by the excessive unpredictability and vagueness of its rules. Finally, our analysis of state takeover law ends in a comparison of it to the body of takeover law produced by the British City Code which is the product of self-regulation by a body that might well have stronger incentives to care about shareholder interests than do states. In sharp contrast to what state takeover law does, the British City Code severely restricts defensive tactics by incumbents, restricts bidders only to an extent that seems to serve some valid policy concerns, and overall regulates takeovers through rules that are much clearer and predictable in application.

Part III discusses the inability of state competition advocates to square their position with *their own view* that state takeover law, including Delaware's, excessively protects incumbent managers and excessively discourages bidders. Indeed some of the fiercest critics of impediments to takeovers, which are as much a product of state competition for corporate charters as any other aspect of corporate law, are also the leading state competition advocates. We conclude by expressing our belief that state competition advocates would be well-advised to reconsider their position. Pro-state competition scholars' own criticisms of state takeover law, many of which we share, demand no less.

I. THE THEORY OF TAKEOVER LAW UNDER STATE COMPETITION

As one of us has argued, state competition might have virtues with respect to some corporate law questions but perform badly with respect to others.[12] According to that analysis, the issues with respect to which state competition will work poorly are: (i) issues that are "significantly redistributive" (in that their effect on managers' or controlling shareholders' private interests is not insignificant relative to their effect on shareholder value), (ii) issues that directly affect the strength of market discipline, and (iii) issues that implicate the interests of not only shareholders and managers but also third parties. In this Article, we will focus our attention on one very important area of corporate law: the rules governing takeovers. The argument will be that states have an incentive to design takeover law that is more restrictive on bidders and more protective of managers than is in shareholders' interests.

A. The Importance of Managers

A state's takeover law will apply to companies incorporated in that state who become takeover targets. These companies have, almost by definition, sufficient dispersion of shares such that managers have some measure of "de facto" control.

Let us begin by explaining why states, in particular Delaware, will care about managers' preferences. The reason for this is simple: managers play a pivotal role in determining whether a company reincorporates to another state.[13] If a state wishes to

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[12] *See* Lucian A. Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L.REV. 1435 (1992).

[13] A company cannot reincorporate without the company's managers deciding to bring a reincorporation proposal to a shareholder vote. See Robert C. Clark, Corporate Law s 10.2.4 at 416--17

maximize the number of companies that are incorporated there---the starting assumption of the "race to the top"/"race to the bottom" debate---the state will take an interest in both initial incorporation decisions and subsequent reincorporation decisions.

Consider Delaware, which has a very large number of companies already incorporated there. It is critically important to Delaware's continued success, and any state in a similar situation, that it retain companies already chartered there. The potential loss by Delaware of chartered companies through reincorporation, for any given period of time, is greater than the potential gain from initial incorporations. While the number of initial incorporations in any given year is likely to be fairly limited, the number of companies that Delaware could potentially lose through reincorporation, i.e. the companies already chartered there, is significant. Moreover, Delaware will not only be interested in preventing its companies from reincorporating to another state, but inducing companies chartered elsewhere to move to Delaware.[14] For these reasons, it would not be surprising if Delaware's corporate law catered, to a significant extent, to the preferences, whatever those preferences may be, of managers.

Indeed, the incentive of states, which do not have a large number of chartered companies, to provide shareholder wealth-maximizing rules, when these harm managerial interests, is not nearly as strong as one might think. First of all, by

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(1986). Moreover, managers in companies with widely dispersed ownership of shares can have significant influence over the outcome of a shareholder vote through control of the voting process.

[14] Delaware has been very successful in the market for reincorporations. *See* Roberta Romano, Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225, 265-78 (finding that 82% of all reincorporating companies between 1960 and 1982 switched to Delaware); *see also* Demetrio Kaouris, Is Delaware a Haven for Incorporation?, 20 Del. J.Corp. L. 965, 1011 (1995) (finding that out of 255

providing rules preferred by shareholders the state will place itself at a disadvantage in the market for reincorporations with respect to the companies that are currently chartered there and to those that might otherwise consider reincorporating to that state.

But wouldn't a state that provided rules beneficial to shareholders attract more initial incorporations as a result? Not necessarily. It is questionable the extent to which companies initially incorporating in a state with shareholder wealth-maximizing rules, when those rules differ from the ones preferred by managers, would benefit from them in the form of a higher price for securities sold in an initial public offering. Buyers of securities in a company initially incorporated in such a state might anticipate that if the state did ever enjoy a significant number of chartered companies, the state will then have a powerful incentive, much as Delaware does, to craft its law so as to satisfy managerial preferences. Even if the state were judged unlikely to make such a mid-stream change in its law, a similar shareholder wealth-decreasing result might nevertheless be anticipated due to the ability of managers to reincorporate the company, at a later point in time, in a state that does have rules to the liking of the managers.

But merely concluding that states, and in particular Delaware, care a great deal about managers' preferences does not by itself imply that managers' and shareholders' interests are likely to systematically diverge. This was perhaps the most underdeveloped aspect of Cary's position. Pro-state competition scholars are quick to argue that state competition for corporate charters works well because, due to

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surveyed companies that changed their corporate domicile between 1982 and 1994, 89% reincorporated to Delaware).

market incentives, managers want to do what is in the interests of shareholders.[15] Below we explain why these market incentives may often be insufficient to induce managers to prefer takeover rules that are more restrictive than what would be optimal for shareholders.

B. Managers' Preferred Takeover Law

1. Market Incentives

At first glance one might reason as follows: Since managers want to keep their jobs and independence, they will surely want to prevent any takeover that does not receive their approval. It is not possible to jump to this conclusion, however, because managers also care about share value for several widely noted reasons. And to the extent that restrictive takeover law would reduce shareholder value, they might prefer a state that opts for a more permissive approach.

Among the potential reasons why managers might have a strong interest in maximizing share value, we address two of the main ones. First, unnecessarily low share value can lead to an increased likelihood of takeover. The greater the difference between a share's value and what it could be worth if managers were acting in shareholders' interests, the more profitable, *ceteris paribus*, a takeover will be, and hence, the more likely it is that one will occur. Second, managers' compensation and wealth are often tied, at least to a certain extent, to a share's price through share

[15] See, e.g., Roberto Romano, The Genius of American Corporate Law (1993); Frank H. Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law (1991); Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J.Legal Studies 251 (1977).

options and share holdings. Insofar as managers are shareholders themselves, they will have an incentive to make decisions that reflect the interests of shareholders.

As will be explained, however, these two market constraints are unlikely to be sufficient, in a number of cases, to cause managers to prefer a permissive takeover legal regime.

2. The Effect of Restrictive Takeover Law on Managers' Interests

As noted, pro-state competition theorists argue that the threat of a takeover will cause managers to seek the legal arrangement that would be beneficial to shareholders. The argument is roughly as follows. Suppose there are two legal arrangements and one produces higher shareholder value compared with the other one. In that case, managers will prefer the regime which maximizes shareholder value, because that arrangement also reduces the probability of a takeover. Higher share value makes takeovers more costly and, as a result, less likely.

But let us further suppose that of the two regimes, A is the optimal takeover regime from the perspective of shareholders while B is a somewhat more restrictive arrangement. Since A is the optimal arrangement, share value would be, by definition, lower under regime B. But that does not necessarily mean that the likelihood of a takeover would be increased by B. To be sure, with a lower share value, a takeover at the same price would be more profitable. But if B makes it sufficiently more difficult to do a takeover, then the likelihood of a hostile takeover would be smaller despite the lower share price.

It is important to note that making a hostile takeover overall more difficult can benefit managers in two ways. First, they might be able to use the protective arrangement to prevent a takeover altogether, a valuable option since they could then retain all the private benefits of control that come with independence (including not losing their jobs). Alternatively, they can use their increased ability to resist takeovers so as to benefit themselves in any takeover, perhaps by maximizing the side payments they receive from an acquirer in a negotiated acquisition.

However, one might raise the interest of managers in increasing share value because of their stock options and stock holdings. But the above-mentioned two effects, which are potentially quite important to managers, can easily dominate this interest. Consider managers who now have, say, 3% of the company's stock and enjoy substantial private benefits of control.[16] If a legal arrangement would substantially reduce the likelihood of their losing these private benefits of control, then that might well be more important to them than avoiding some reduction in the value of their existing holdings.[17]

3. Managers' Interests in Acquiring other Companies

Thus far, we have explained why managers of a Delaware company might prefer that, if their company were to become a target, they enjoy the protection of a legal regime that restricted takeovers more than is optimal from the perspective of

[16] The correlation between managerial pay and performance has been found to be weak. See Michael C. Jensen & Kevin J. Murphy, Performance Pay and Top Management Incentives, 98 J. Pol. Econ. 225, 237 (1990); CEO Incentives—It's Not How Much You Pay, But How, Harv. Bus. Rev., May-June 1990, at 138.

shareholders. But it might be said that this does not imply that they would prefer that Delaware have rules that inefficiently restricted takeovers, for such rules would apply to them regardless of whether their company becomes a target. Such rules *may* also apply to companies that they will want to acquire in the future. One might posit that this creates a countervailing consideration.[18] Because managers can be on both sides of a takeover, so to speak, they will not favor a takeover law that is too restrictive.

But this symmetry does not exist. For several reasons, managers of a Delaware company will likely care more about how Delaware's takeover rules would affect them should their company become a target, than they would about the impact of Delaware's takeover law should they wish to acquire other companies.

First of all, while Delaware law would surely affect them if they become an acquisition target, Delaware law may or may not affect them should they want to acquire another company. It will affect them if they want to buy another company that is incorporated in Delaware with dispersed ownership, but it will not affect them if they go after a company with a controlling shareholder, a company that is closely held, or a company with dispersed ownership that is incorporated elsewhere.[19]

Second, even assuming that Delaware takeover law would apply each time they go after a target, there is an asymmetry in the stakes to managers. It very well might be extremely important to them to retain their own positions and private benefits of control---here the personal stakes of managers could be quite substantial.

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17 See Melvin A. Eisenberg, The Structure of Corporation Law, 89 Col. L.Rev. 1461, 1510 (1989) (concluding that managerial interests are strongest when their jobs are implicated, thereby creating an incentive for states to adopt rules that enable managers to keep their positions).

18 See Romano, The Genius of American Corporate Law 59-60 (1993).

19 In other words, a manager's decision of where to (re)incorporate has no effect on the takeover law governing potential acquisitions. Foregoing (re)incorporating in a state with antitakeover defenses does not increase the probability that a potential target will do the same.

In contrast, it is unlikely to be as important to them to weaken the power of the managers of a company with dispersed ownership which they might wish to acquire. Their personal interests are not implicated to anywhere near the same degree; at most they will have to choose different acquisition targets or to pay a higher acquisition price (including any side payments to the target's managers). This asymmetry is evidenced by the fact that corporations are the primary lobby responsible for the passage of antitakeover legislation,[20] even though this legislation will presumably impede their own future acquisitions of corporations falling under the legislation's ambit.

C. Conclusion

The bottom line of the preceding analysis is that states competing for corporate charters---and in particular Delaware which is presumably striving to maintain its dominant role in this market---have an incentive to provide a body of law that makes takeovers more difficult regardless of whether this is in the interests of shareholders. We now turn to take a look at Delaware's takeover law and reflect on whether it's consistent with our theoretical conclusions.

II. REFLECTIONS ON STATE TAKEOVER LAW

We start with a qualification---what we provide in this Part is not a full analysis and evaluation of the development of state takeover law in the last twenty-five years. This would be too large an undertaking. The literature on takeovers is

[20] See William J. Carney, The Production of Corporate Law, 71 S. Cal. L. Rev. 715, 749--50 (1998);

voluminous. What we do is to offer a set of observations on the body of takeover law that Delaware and other states have produced. Our observations are consistent with the preceding theoretical analysis which indicated that state competition is unlikely to produce a body of takeover law that is optimal from the viewpoint of shareholders.

A. The Pro-Management Tilt of State Takeover Law

1. How States Worked To Make Takeovers More Difficult

States have worked hard, and quite successfully, to make takeovers more difficult. State takeover law consists of a substantial body of rules---both statutory and judge-made that significantly impedes hostile takeovers and shields incumbent managers. The fruits of these efforts are reflected in both rules governing bidders and those governing the use of defensive tactics. As we will explain, it is the rules concerning defensive tactics that have erected the most important impediments. But we will also analyze the rules restricting the activity of bidders both for the sake of completeness and because they also reflect, though less dramatically, the tendency of states to substantially restrict takeovers.

(i) Rules Restricting Bidders

One popular way among states of protecting managers from unwanted takeovers is restricting what bidders are able to do. While the Securities Exchange

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Roberta Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111, 121--22 (1987).

Act of 1934[21] and the Securities Act of 1933[22] regulate various aspects of tender offers, the most important source of restrictions on the activities of bidders have come, by and large, from state antitakeover legislation. Over a twenty-five year period, there have been several waves of state antitakeover statutes, easily making passage of antitakeover legislation one of the top priorities of states in the corporate law area. Numerous states over the years have enacted antitakeover statutes imposing a bewildering array of requirements on bidders.

The first state takeover statute was enacted by Virginia in 1968.[23] Over the next thirteen years, thirty-six states followed Virginia's lead.[24] These statutes often imposed disclosure requirements on bidders as well as---more burdensomely---requiring administrative approval for a bid to proceed. After the first wave of statutes' constitutionality was called into serious question,[25] states enacted a new set of antitakeover statutes.

So-called second-generation antitakeover statutes spread rapidly.[26] There were several types of second-generation antitakeover statutes. "Control share acquisition" statutes typically require a shareholder vote approving an "acquisition of control" by a party. Other states adopted "fair price" statutes which prohibit a "second-step"

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21 The Williams Act amendments to the Securities Exchange Act of 1934 impose various disclosure and procedural requirements on cash tender offers.

22 If a portion of the consideration for the target company is securities of the bidder, the Securities Act of 1933 will often be applicable.

23 Takeover Bid Disclosure Act, Va. Code ss 13.1-528. 13.1-541.

24 See Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225, 234 (1985)

25 Edgar v. Mite, 457 U.S. 624 (1981).

26 While we refer to five different types of statutes as second-generation statutes, it is worth pointing out for purposes of clarity that some commentators have divided these statutes into several different generations.

merger[27] between the bidder and the target company unless a supermajority shareholder vote approves the merger or the bidder provides a "fair price," as defined by the statute, for the remaining shares. In a somewhat similar vein, states also adopted "redemption rights" statutes, which provide minority shareholders the right to sell to the bidder shares for their "fair value," again a price determined by statute. Some states, including Delaware, adopted a "business combination" statute prohibiting bidders from engaging in certain business combinations with an acquired company for a specified period of time.[28] Thirty-seven states adopted second-generation antitakeover statutes within a mere eight years of the *MITE* decision.[29] The hard work of states ultimately paid off. They had fashioned antitakeover statutes that were likely to pass constitutional muster.[30]

The states were still not satisfied. Yet another type of antitakeover statute, the so-called "constituency statute," has become popular among states. The focus of these statutes, however, is somewhat different than the others. They are concerned with what target management can legally do in frustrating an unwanted bid, not on what bidders can do. It is to this central issue that we now turn.

(ii) Rules Governing Defensive Tactics

The most important impediment to takeovers today is the wide latitude given to managers to engage in defensive tactics, especially the ability to hide behind a

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[27] A "second-step" merger is a merger between a corporation and a shareholder holding a significant percentage of the corporation's stock.

[28] See generally Jesse Choper, John Coffee, and Ronald Gilson, Cases and Materials on Corporations 1054-1057 (1995) (4th ed.)

[29] Carney, The Production of Corporate Law, 71 S.Cal. L.Rev. at 752-53.

poison pill.[31] Perhaps the most critical development creating this managerial power was the approval by the Delaware courts of poison pills put in place by management.[32] After it became clear that managers had the power to erect poison pill defenses, the key question became (and continues to be): When would managers be forced to dismantle them in a takeover contest? Delaware law has gradually evolved so as to allow directors, consistent with their fiduciary obligations to shareholders, to "just say no" to potential bidders *with* their poison pill defenses in place.

Many states have adopted "constituency statutes" that enable directors to consider the interests of non-shareholder constituencies, such as employees and local communities, in exercising their authority.[33] Arguably this provides managers with an even greater ability to formulate a legally acceptable reason not to dismantle a poison pill or refrain from whatever other defense maneuvers they might wish to engage in. It is worth noting that even though Delaware does not have a

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[30] See CTS Corp. v. Dynamics Corp., 481 U.S. 69 (1987) (upholding Indiana's second generation antitakeover statute against a dormant commerce clause challenge).

[31] The Chief Economist for the Securities and Exchange Commission defined a poison pill as:

> [A]ny financial device that when triggered by a particular action (e.g. merging a target's assets or acquiring more than some specified amount of the target's common stock), results in one or a combination of the following:
>
> (1) the acquirer is forced to purchase securities from the shareholders of the target firm at prices equal to or exceeding their market value
> (2) security holders of the target firm gain rights to exchange stock of the target firm for a combination of cash and securities from the target firm exceeding that of the surrendered stock (acquirer is generally excluded from this exchange)
> (3) the security holders of the target firm gain rights to purchase securities from the target form at prices below market value (acquirer is generally excluded)
> (4) the acquirer must sell securities of the acquiring entity at prices below market value to security holders of the target firm
> (5) the acquirer loses substantial voting power of his or her shares relative to other security holders of the target firm.

Office of the Chief Economist, The Effects of Poison Pills on the Wealth of Target Shareholders 1, 6-7 (Oct. 23, 1986).

[32] The use of the poison pill to ward of a potential bidder was first approved by the Delaware Supreme Court in Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985), a case which we will discuss in Part II(A)(2)(ii).

"constituency statute" its case law has long permitted managers in evaluating and responding to a hostile takeover to consider its "impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)."[34]

(iii) The Corporate Fortress

Considering the cumulative effect of the restrictions states have placed on the activities of bidders as well as managers' ability to erect and maintain antitakeover defenses, especially the poison pill, it is obvious to even the most casual observer that managers have substantial power to block takeovers. Companies are today surrounded by high walls that can be very costly for bidders to breach against a determined target management. As a result of these legal developments, the impact on the operation of the market for corporate control has been far-reaching.

As one would expect, states have varied somewhat in how far they have gone in this direction. As pro-state competition scholars have emphasized, Delaware, despite offering managers substantial protection against unwanted acquisitions, has not fortified the corporate castle as much as other states have. But for our purposes, what is important is not the differences among states, which are, on the whole, small compared to the long road toward restricting takeovers that almost all states have traveled. What is important is the aggregate product of state competition and how that differs from the body of rules that would maximize shareholder wealth.

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[33] Thirty-one states have adopted "constituency statutes" since 1986. See Jesse Choper, John Coffee, and Ronald Gilson, Cases and Materials on Corporations 1057 (1995) (4th ed.).

Accordingly, we now offer some observations on why the impediments to takeovers that states have so vigorously created are excessive.

2. The Weak Policy Basis for State Antitakeover Law

Being academics, we start with the observation that the powerful antitakeover position taken by Delaware does not appear to have a strong basis in the extensive literature examining the desirability of different types of takeover regulation from the perspective of shareholders. Before proceeding, we want to emphasize that this is just one observation and not the basis for our view that Delaware has gone too far. Of course, the best arrangement could, in fact, be one that receives little support in academic circles. Even if powerful antitakeover protections are justified, we will argue in subsections (3) and (4) below that they should have been afforded to managers in a manner much different than they were. But a natural place to begin the analysis is to see how Delaware's antitakeover position has fared in policy debates.

(i) Rules Restricting Bidders

In this Section we will examine the policy basis for the arrangements introduced by state antitakeover statutes. As we have seen, while these statutes have made takeovers more difficult, their impeding effect is likely less than that of the rules governing defensive tactics. Our problem with takeover statutes, however, is not so much with the magnitude of the difficulties they pose for takeovers. Instead, as

[34] Unocal, 493 A.2d at 955; see also Time v. Paramount, 571 A.2d 1140, 1153 (Del. 1990) (stressing this language in Unocal)

explained below, our problem is that these statutes seemed to have been created to a large extent for the purpose of making takeovers more difficult rather than to address legitimate policy concerns.

We start with the observation that states have consistently come up with very different types of antitakeover statutes, focussing on various issues and using different techniques. When a particular type of statute was found to be constitutionally suspect or to provide little impediment to takeovers, they simply went back to the drawing board and adopted another type of statute. The first generation focussed on the tender offer process, a similar focus to that of the Williams Act. When these statutes' constitutionally were called into question in *MITE*, states simply went to the drawing board having in mind that a statute regulating a company's internal affairs would likely be permissible under the decision's rationale. They tried then to use this opening to impede takeovers, without interfering in the takeover process directly, by altering the powers that an acquirer would have following a takeover. When various second-generation statutes---many of which, as explained below, have a plausible policy rationale---were upheld against constitutional challenges but did not seem to pose a substantial impediment to tender offers shareholders would want to accept, states went back to work. They came up with a new and different set of statutes. The one common denominator to all the antitakeover statutes is that they all seek to make takeovers, in one way or another, more difficult.

As has already been mentioned, for some second-generation statutes one could at least find a legitimate policy rationale: the need to address the pressure-to-tender problem that shareholders sometimes confront when considering a tender offer. The

pressure-to-tender problem results from shareholders' incentive to tender their shares to a bidder out of fear of ending up with low-value minority shares in the event that other shareholders tender and the offer succeeds. Shareholders will have this incentive even if they all reach the conclusion that their shares would be worth more if the tender offer did not succeed.[35]

One type of second-generation statute that some states adopted, referred to earlier, is the "control share acquisition" statute. This statute could conceivably be justified as addressing the pressure-to-tender problem as it required shareholders to vote on whether a bidder can acquire control of a company. Such a vote might prevent a coercive offer from proceeding and, thus, benefit shareholders.[36] This type of statute provides shareholders with direct input as to whether an acquisition should proceed. In sharp contrast, many of the more formidable defensive tactics, as we shall see, are so potent precisely because they prevent shareholders from ever deciding for themselves the merits of a tender offer.[37]

Another type of second-generation statute that addressed the pressure to tender problem is the "redemption rights" statute. This statute typically ensures that the post-tender offer value of minority shares will not fall below the offer price. This again would eliminate the pressure to tender. Tender offers that shareholders do not find attractive would not be able to succeed through a bidder exploiting a

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[35] See Lucian A. Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1695 (1985); see also Lucian Bebchuk, The Pressure to Tender: An Analysis and Proposed Remedy, 12 Del. J.Corp. L. 911 (1987); Brudney & Chirlstein, Fair Shares in Corporate Mergers and Takeovers, 88 Harv. L. Rev. 297, 336-37 (1974).

[36] See CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987) ("By allowing [ ] shareholders to vote as a group, [Indiana's control share acquisition statute] protects them from the coercive aspects of some tender offers.")

[37] See infra Part II(A)(3)-(4).

shareholder's pressure to tender for fear of being stuck with less valuable minority shares.

So it is fair to say that many second-generation antitakeover statutes responded to a concern that the literature had identified as important. One might have thought that states would rest content with their "control share acquisition" or "redemption rights" statutes. To the extent that the pressure-to-tender problem was effectively addressed by these statutes, the only tender offers that would be able to succeed are the ones shareholders want. Moreover, while these second-generation statutes would arguably frustrate all offers shareholders would not want to succeed, they probably would not substantially deter offers shareholders would want to take.[38] But states did not stop here. Tellingly, states continued to add more restrictions on bidders which do not seem designed to address specific concerns over the operation of the takeover process.

Take, for example, the "business combination" statutes. Delaware has one,[39] along with thirty other states.[40] These statutes typically restrict a successful bidder's ability to engage in a wide range of transactions with an acquired company, such as mergers, liquidations, sales of assets and stock issuances.[41] These statutes might also prevent some takeovers which shareholders would want. They could conceivably reduce the potential efficiency gains resulting from the bidder acquiring control to the extent that those gains would require, say, effecting a merger between the bidder and the target.

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[38] See Ronald Gilson and Bernard Black, The Law and Finance of Corporate Acquisitions 553-558 (1995) (supplement)

[39] Del. Gen. Corp. Law s 203.

Some observers argue that the costs imposed on bidders by Delaware's "business combination" statute, and similar statutes, are not all that large and thus, by themselves, should not greatly curtail takeovers.[42] But our point does not depend on how large the costs are. Assuming that just having fewer hostile takeovers is not an end in itself, these statutes are not an effective instrument for addressing any valid concern. The only justification that could be given for these statutes is that, by defending minority shares in the aftermath of a takeover, they prevent coercion and unequal treatment of shareholders. A "control share acquisition" statute or a "redemption rights" statute would clearly be superior in accomplishing these goals. A state could fulfill these goals in a complete way without preventing efficient takeovers. In contrast, "business combination" statutes carry the potential cost of preventing some desirable acquisition offers.

Reviewing what states have done legislatively in restricting bidders causes one to suspect that states really care about making takeovers more difficult rather than merely eliminating particular distortions in the takeover process. This impression is powerfully reinforced by looking at state rules governing defensive tactics. We now turn to this subject.

(ii) Rules Governing Defensive Tactics

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[40] See Jesse Choper, John Coffee, and Ronald Gilson, Cases and Materials on Corporations 1055 (1995) (4th ed.)

[41] See, e.g., Del. Gen. Corp. Law s 203(c)(3).

[42] See,. e.g., Ronald Gilson and Bernard Black, The Law and Finance of Corporate Acquisitions 558-573 (1995) (supplement)

The use of defensive tactics by managers raises an obvious conflict of interest problem. There is no question that allowing managerial discretion to use defensive tactics entails costs. This has led some commentators to support a ban on defensive tactics. While other commentators have supported the use of some tactics to address particular threats and distortions, they did not want managers, given the severe conflict of interest problem, to be granted an open-ended license. But this is the direction in which state laws have moved.

The discussion in this Section will focus on the most powerful impediment to takeovers---the ability of managers, at least in a wide range of circumstances, to "just say no" to potential bidders while keeping in place a poison pill defense. There can be no question that the use of defensive tactics by managers presents a serious problem, because of the inherent conflict of interest faced by managers in the takeover context. After all, managers' private interests, including their very jobs, are directly implicated. There is always the danger that managers will oppose a shareholder value-enhancing offer in order to maintain their corporation's independence. As the Delaware Supreme Court has repeatedly emphasized, there is always the "omnipresent specter that a board may be acting primarily in its own interests, in a takeover."[43]

There is a large body of literature that argues that managers should be completely prohibited from engaging in defensive tactics---a literature which includes contributions by leading advocates of state competition.[44] Those who oppose

[43] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954--55 (Del. 1985).

[44] See generally Roberta Romano, A Guide to Takeovers: Theory, Evidence and Regulation, 9 Yale J. on Reg. 119 (1992); Ronald Gilson, A Structural Approach to Corporations: The Case Against Defensive

defensive tactics do not ignore the possibility that abusive takeover tactics might result in a bad takeover outcome. For example, there is the concern, discussed earlier, that shareholders will be pressured-to-tender due to the fear of being left holding minority shares with a value lower than the bid price.[45] But those who oppose defensive tactics can point to legal arrangements that would address such problems. The pressure to tender problem, for example, can often be resolved by having a shareholder vote on a tender offer.[46] There is no need, on this view, to use the costly remedy of giving managers the power to use defensive tactics and, thus, to have some veto power over acquisitions.

While both of us share the above view, some commentators favor giving managers power to use defensive tactics in order to address abusive takeover tactics. For instance, Reinier Kraakman and Ronald Gilson, in trying to explain and rationalize Delaware's early cases applying *Unocal*'s proportionality test, suggested that defensive tactics, including retaining the pill in the face of a hostile tender offer, should pass judicial review insofar as they address two particular threats: so-called structural and substantive coercion.[47] They argued that a pill should be retained only if either: (i) the offer is structured in a coercive way, or (ii) the managers can make some showing (by, say, relying on an investment banker's opinion) that the independent value of the target significantly exceeds the offer consideration. The

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Tactics in Tender Offers, 33 Stan. L. Rev. 819 (1981); 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).

[45] See, e.g., Lucian A. Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1695 (1985).

[46] Id. at 1747-52.

[47] See Ronald Gilson and Reinier Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?, 44 Bus. Law. 247 (1989). Gilson and Kraakman in this article endorsed the approach taken by Chancellor Allen in City Capital Assocs. v. Interco, Inc., 551

point worth emphasizing is that even commentators who endorse the use of defensive tactics to address abusive takeovers do not wish that managers have an open-ended, unlimited power to "just say no."

It is interesting to note that even Martin Lipton, inventor of the pill and champion of takeover defenses, writing in the 1980s did not go so far as to argue that managers should always have the ability to frustrate hostile tender offers. In a 1987 article, Lipton justified defensive tactics by pointing to a list of particular takeover abuses, each of which he discusses at length.[48] He does not at any point argue that managers should be allowed to "just say no" when the identified abuses are not present.

But the Delaware courts have left the reasoning of all these commentators, even those sympathetic to some types of defensive tactics, far behind, instead endorsing a much more expansive license for managerial use of poison pills and "just say no."[49] This was done in stages. Initially, Delaware law seemed to be willing to allow tactics only in response to particular well-defined threats. But later on, without much in terms of providing explicit justification, Delaware went well beyond this.

The first seminal Delaware cases, decided in the mid-1980s, which dealt with managers' ability to use defensive tactics to defeat hostile tender offers, were *Unocal Corp. v. Mesa Petroleum Co.*[50] and *Moran v. Household Int'l, Inc.*[51] In both cases, the Delaware Supreme Court was careful to both examine the particular threat to

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A.2d 787 (Del. Ch. 1988). That approach entails allowing antitakeover devices in the case of coercive behavior by the bidder.

[48] See Martin Lipton, Corporate Governance in the Age of Financial Corporatism, 136 U. PA. L.Rev. 1 (1987).

[49] See, e.g., Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 Stan. L. Rev. 857 (1993).

[50] 493 A.2d 946 (Del. 1985).

shareholders that would have existed without managerial use of the defensive tactic in question and whether the defensive tactic that was used addressed that particular threat. Only then did the court conclude that the use of the defensive tactic was appropriate. In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court reviewed a selective self-tender offer by a target corporation that was being offered as a way of defeating a hostile tender offer. In explaining why the target management had not violated their fiduciary duties to shareholders, the court repeatedly emphasized the fact that the board reasonably believed that the hostile tender offer was a "grossly inadequate two-tier coercive tender offer" and that the self-tender offer was "reasonably related to the threats posed."[52] In *Moran v. Household Int'l, Inc.* , the Delaware Supreme Court approved the use of another defensive tactic by managers: the erection of a poison pill defense. The court relied on the fact that the plan was mild and would therefore not deter bidders. Rather, the poison pill at issue merely provided reasonable protection against a coercive two-tier tender offer.[53] Moreover, the court pointed out that once a bidder did arrive on the scene, a decision not to dismantle the pill at that time would be reviewable by the Delaware judiciary.[54]

After these decisions, the Chancery Court began to develop a jurisprudence limiting the use of defensive tactics so as to protect shareholders not only from coercive hostile tender offers but also from managerial abuse of these tactics. For example, in *AC Acquisitions Corp. v. Anderson, Clayton & Co.*,[55] the Chancery Court concluded that the target board's selective self-tender offer was itself coercive and,

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51 500 A.2d 1346 (Del. 1985).
52 493 A.2d at 956, 958..
53 500 A.2d at 357.
54 See id.

therefore, not reasonable.[56] The Chancery Court followed this up with its decision in *City Capital Associates v. Interco Inc.*[57] There, the court forced a target board to redeem its poison pill in the face of a non-coercive tender offer the board believed was too low.[58] Indeed, in the course of its analysis, the court approvingly cited Gilson and Kraakman's interpretation of the *Unocal* standard.[59] Later that same year, the Delaware Chancery Court in another case forced a target board to redeem its poison pill in the face of a noncoercive tender offer.[60] Unfortunately, this searching inquiry of managerial use of defensive tactics, and whether shareholders were being well-served by them, was not to last.

Perhaps the key turning point in creating a much more expansive license for managerial use of defensive tactics was the Delaware Supreme Court's decision several years later in *Paramount v. Time*,[61] wherein the court went out of its way to explicitly disavow the approach of the Chancery Court in *Interco*.[62] The Delaware Supreme Court stressed that the all-cash, all-shares tender offer for Time by Paramount threatened the target management's business plan (here, merging with Warner)---a threat it found to be legally cognizable.[63] In contrast to what one might have thought from *Unocal* and *Moran*, and the Chancery Court cases building on their

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55 519 A.2d 103 (Del. Ch. 1986).

56 See id. at 113.

57 551 A.2d 787 (Del. Ch. 1988).

58 The Chancery Court forcefully explained that "To acknowledge that directors may employ the recent innovation of 'poison pills' to deprive shareholders of the ability effectively to choose to accept a noncoercive offer . . . would, it seems to me, be so inconsistent with widely shared notions of appropriate corporate governance as to threaten to diminish the legitimacy and authority of our corporation law." Id. at 799-800.

59 See id. at 796 n.8.

60 See Grand Metropolitan Public Limited Co. v. The Pillsbury Co., 1988-1989 Transfer Binder, Fed. Sec. L. Rep. (CCH) 94,104 (Del. Ch. 1988).

61 571 A.2d 1140 (Del. 1990).

62 Id. at 1153.

63 Id.

analysis, the *Time* court made very clear that the use of defensive tactics are not limited to situations where the tender offer is coercive---which Paramount's offer clearly was not---or when management has particular, defensible reasons to believe the offer is inadequate.[64] The potential discretion this line of reasoning provides managers is sweeping.

Until this decision, Delaware was arguably in line with those commentators, such as Professors Kraakman and Gilson, who endorsed defensive tactics in response to particular, well-defined threats.[65] Beginning with *Paramount v. Time*, Delaware courts have, however, increasingly tolerated, although this is not much acknowledged, the open-ended use by managers of defensive tactics far more drastic than the one at issue in *Moran*, without requiring, in any meaningful way, a showing of structural or substantive coercion.[66]

This important leap was made by the Delaware courts without much justification. This development also had little support in the literature, at that time or since. Now it is always possible that Delaware law, notwithstanding the lack of articulated policy justifications, is in fact the legal regime that is beneficial to shareholders and reflects what shareholders want. In the end, what's important is not what some academics believe but what actually serves the interests of shareholders.

And this brings us to our next two critical observations: that Delaware, as well as other states, has adopted stronger antitakeover protections than those shareholders

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64 Id. at 1152-53.

65 See ft. 47 & text.

66 In Unitrin, Inc. v. American Corp., 651 A,2d 1361 (Del. 1995), for instance, the Delaware Supreme Court upheld a target corporation's repurchase of its stock, which was designed to defeat a hostile tender offer. The court pointed out that the bidder could always conduct a proxy contest. This analysis seemed to give short shrift to the interests of shareholders in having the ability to agree to the terms of the competing tender offer and the difficulty of conducting a successful proxy contest.

at the time were willing to voluntarily provide; and that states have imposed these arrangements on shareholders in a way that left them with little choice or say.

3. States Granted to Managers What Shareholders Were Not Willing to Give

It is worthwhile to stress that impediments to takeovers, to the extent that they are favored by shareholders, can be adopted through charter provisions. In the late 1970s and early 1980s managers did indeed push for various antitakeover charter amendments.[67] But it became increasingly clear that informed shareholders were willing to vote only for "mild" antitakeover arrangements---ones aimed at addressing the pressure-to-tender problem but not going much beyond this.[68]

Already in the 1980s, Roberta Romano described how managers were successful in getting antitakeover protections from states more severe than those they could receive from shareholders.[69] If this was true then it has become even more so since. The protections from takeovers which managers have been afforded by states have only grown stronger.[70]

4. States Imposed Antitakeover Rules on Shareholders

States could have taken the approach of making it easier for companies to have takeover protections should shareholders approve. This approach would likely have pleased state competition advocates who often place great emphasis on the

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[67] See Ronald Gilson, The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept, 34 Stan. L. Rev. 775 (1982).

[68] Id. at 826-27.

[69] See Roberta Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev 111, 129--30, 147-48 (1987).

[70] See discussion in Part II(A)(1).

importance of permitting shareholders to choose the legal regime that governs the corporation in which they invest. States, however, have almost universally shunned this approach.

In the takeover context, shareholders did not appear interested or willing to restrict takeovers much beyond arrangements needed for eliminating the pressure to tender. Despite this, Delaware, along with other states, imposed its antitakeover arrangements on shareholders *ex post* in a way that left them little choice.

(i) The Imposition of Legislative Antitakeover Protections

Consider the antitakeover statute adopted by Delaware.[71] Tellingly, Delaware did not do follow its earlier approach concerning limitations on directors' liability. In the aftermath of *Smith v. Von Gorkom*,[72] Delaware changed its corporate code so as to allow companies to adopt charter provisions that limit directors' liability.[73] In contrast, shareholders were not given the option of adopting the antitakeover protections contained in Delaware's "business combination" statute by approving a charter provision to that effect. Instead, the Delaware statute afforded managers these protections unless the corporation opts *out* of it by charter amendment. Why did Delaware adopt opt-in limitations on liability but opt-out limitations on takeovers?

The difference between opt-in and opt-out is of critical significance. This is because a charter amendment must be brought to a shareholder vote. As a result,

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[71] See 8 Del. Code s 203. Delaware's antitakeover statute, with certain exemptions, bars an acquirer from conducting a second-step merger with the target for a period of three years after the target's acquisition.

[72] 488 A.2d 858 (Del. 1985),

shareholders cannot opt out of the Delaware statute unless the directors want this to happen.[74] And since managers generally prefer to have antitakeover protection, there is no reason for them to opt-out. In short, the Delaware takeover statute has followed an enabling approach for the *managers*, not the shareholders---it's the managers who can have an antitakeover arrangement if they want it (which they generally do).[75]

Most states have adopted a similar approach in deciding not to condition legislative antitakeover protections on shareholder consent.[76] Indeed, some states do not even allow for opting-out of their takeover statute (such as Wisconsin's antitakeover statute Judge Easterbrook confronted in *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir)). But practically, the difference between allowing opting-out and not allowing opting-out is usually not all that significant. As long as managers control the opting-out process, we are often going to have the antitakeover arrangement preferred by managers regardless of shareholders' interests.

(ii) The Imposition of Poison Pills

The introduction of more and more potent poison pills, and their approval by Delaware courts and the courts of other states, has changed the landscape of

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[73] See 8 Del. Code s 102(b)(7) permits the certificate of incorporation to contain "a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of . . . [duty of care].".

[74] See 8 Del. Code s 242(b) (shareholders cannot propose charter amendments on their own).

[75] Professor Romano's suggestion that the opting-out structure of Delaware's takeover law saves on the transaction costs that would be incurred by forcing corporations to opt-in, see Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709, 729 (1987), is a fairly insignificant consideration in light of the harm resulting from the increased ability of managers to thwart value-maximizing takeovers at the expense of shareholders.

takeovers. Poison pills have altered fundamentally the allocation of power between managers and shareholders.

What poison pills did was use the formal power that managers have to issue securities. This power was originally given to facilitate the raising of capital.[77] The creators of the poison pill, however, used this power to design securities not with a view to raising capital but rather with the sole purpose of preventing acquisitions managers wish to block.

There is no question that the introduction of poison pills in the 80s could not have been anticipated in the 1970s, 1960s, or 50s. It took huge managerial demand for antitakeover protection, coupled with the creative legal ingenuity of Martin Lipton and his colleagues, for poison pills to be invented and implemented on a widespread basis. Shareholders buying shares in Delaware companies earlier on simply could not have anticipated poison pills and the reallocation of power they would cause.

And a drastic reallocation it is indeed. As long as they are not redeemed by managers, poison pills typically prevent shareholders from having access to an offer. For this reason, they have had a dramatic effect on the takeover picture and the division of power between shareholders and managers.

Our point here is not that this reallocation is necessarily bad. Let's grant for a moment that it might be beneficial to shareholders. The important point is that this

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[76] See Carney, The Production of Corporate Law, 71 S.Cal. L.Rev. at 752 (describing as the very purpose of state antitakeover statutes the provision of "takeover defenses without the necessity of [a shareholder] vote").

[77] 8 Del. Code s 157 states that:

Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

was a major reallocation, which had not been anticipated earlier. If states wanted to ensure that this was in shareholders' interests and not just in managers' interests, they would have required that this reallocation of power first enjoy shareholder consent.

Shareholder consent could have been required in any number of ways. Courts developing the doctrines governing the use of the poison pill could have required, given the inherent conflict of interest, that pills be ratified by the shareholders either right away or within a certain period of time. Or a court could have required managers to redeem a pill when shareholders express a clear preference for them to do so---say, by tendering en masse to a non-coercive bid. Or, at the minimum, courts could, in such circumstances, have required the managers to carry a heavier burden of demonstrating in a meaningful way the benefits of maintaining the pill. Similarly, state corporate statutes could have been amended to condition the use of poison pills on the adoption of a charter provision allowing managers to do so.

But this is not what Delaware and other states have done. Delaware has imposed on the shareholders of Delaware corporations an arrangement whereby managers enjoy a much greater level of protection from takeovers than they had before without requiring shareholders' consent or giving them some practical way of getting out of an undesired arrangement.

This is all consistent with the mid-stream problem discussed in Part I.[78] Delaware cares a great deal not only about new incorporations but also about maintaining the large stock of companies it currently has. Managers play a crucial role in how successful Delaware is in maintaining its current position. The need to

[78] See supra Part I(A).

satisfy the preferences of managers of existing chartered corporations has proved to be an important force in the development of Delaware's law.

B. The Pro-Uncertainty Tilt of Delaware Antitakeover Law

Besides predicting that states will tend to adopt corporate rules whose substantive content benefits shareholders, the pro-state competition position also entails that these rules would likely be formulated in a way that similarly maximizes shareholder wealth. Roberta Romano, one of the strongest supporters of state competition, suggested in her earlier writings that one of the advantages of Delaware law is its certainty and predictability.[79] It is important to realize that this dimension is not the same as where the law stands substantively. For example, a body of law can restrict takeovers greatly in either a predictable or fuzzy way. And, similarly, if the law is permissive, this can again be done in a predictable or fuzzy way. That is, one dimension is roughly where the line is drawn, and the other dimension is how clearly that line is drawn.

Other things being equal, predictability is desirable. It reduces uncertainty and the amount of litigation. It is for these reasons that Romano viewed it as a virtue and suggested that Delaware law's certainty and predictability has enabled it to remain dominant in the competition for corporate charters despite widespread copying of Delaware law by other states.[80] The problem, however, is that Delaware law does not enjoy this virtue of predictability and certainty. Delaware courts have

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[79] See Roberta Romano, Law as Product: Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225, 273--79, 280--81 (1985); Roberta Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709, 720--25 (1987).

[80] See 1 J.L. Econ. & Org. at 226.

consistently filled Delaware jurisprudence with principles that are open-ended and unclear.[81] The principles throughout Delaware law contain terms which call for a case-specific assessment by the court. Moreover, there is always some room for the chancery court's equitable intervention. Any plaintiffs' lawyer knows that it would be difficult to attack successfully a freezeout or to get a derivative suit to pass the test formulated in *Aronson v. Lewis*.[82] But the outcome is never certain.

There are reasons to believe that this is no accident. Delaware might purposely be maintaining a legal regime that encourages litigation.[83] Delaware's corporate lawyers, an important interest group in Delaware, benefit from more, rather than less, litigation. Thus, regardless of where Delaware law stands substantively, Delaware has an incentive and, consequently, the tendency to draw the line in a way that is more fuzzy and litigation-inducing, than what would be good for shareholders.

The pro-uncertainty tilt of Delaware's takeover law is as apparent as it is in other areas. Delaware could have given managers a great deal of power to "just say no" while circumscribing very clearly the boundaries of what managers can and cannot do. But, no, Delaware has chosen to do it in a way that leaves a fair amount of uncertainty as to where exactly the line is drawn.[84] Characteristically of Delaware, the court's requirement of a very case-specific investigation, always keeps the door

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81 See generally Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Col. L.Rev. 1908, 1913-23 (1998); J. Coates, "Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions, 107 U.Penn. L.Rev. ___ (1999) (forthcoming) (describing uncertain nature of Delaware law on discounts in fair value determinations).

82 473 A.2d 805 (Del. 1984).

83 See Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Col. L.Rev. 1908, 1913-23 (1998); Douglas M. Branson, Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law, 43 Vand. L. Rev. 85 (1990); Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Texas L. Rev. 469 (1987).

84 See, e.g., Unocal, 493 A.2d 946, and Revlon, Inc. v. McAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (court emphasized the need to conduct a very case-specific investigation to determine whether a manager acted improperly in rebuffing a takeover attempt).

open, at least a bit, to judicial intervention.[85] It is no coincidence how frequently takeovers result in litigation.

C. Comparison to the British City Code

We would like to end our observations on state takeover law by comparing it to the regulatory arrangement created by Britain's City Code on Takeovers and Mergers.[86] British regulation of takeovers is interesting because it is basically in the hands of the Panel on Takeovers and Mergers, a nongovernmental body, which administers and revises the City Code. The City Code and its implementation is an example of a system of regulation that is not imposed from the outside by a detached governmental body but rather by a group that has strong connections to interested parties. The chair of the panel is chosen by the Bank of England with other members representing such groups as the insurance industry, pension funds, investment banks, clearing houses, British industry and the London Exchange.[87]

The British City Code contains a body of arrangements that is very different from U.S. state takeover law when measured along the two dimensions the earlier discussion has focussed on---the extent to which regulatory arrangements protect managers, and the extent to which they generate confusion and litigation due to a lack of clarity.

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[85] See, e.g., Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1374 (Del. 1995) (describing the *Unocal* test as a "flexible paradigm that jurists can apply to the myriad of 'fact scenarios' that confront corporate boards.")

[86] See generally P. Begg, Corporate Acquisitions and Mergers (1991) (3d ed.).

[87] DeMott, Current Issues in Tender Offer Regulation: Lessons from the British, N.Y.U.L. 945, 954 (1983).

On the first dimension, the City Code differs sharply from U.S. state takeover law on managerial defensive tactics. In particular, the Code contains a sweeping prohibition on defensive tactics unless shareholder consent is obtained. General Principle seven of the City Code states that

> At no time after a bona fide offer has been communicated to the board of the offeree company, or after the board of the offeree company has reason to believe that a bona fide offer might be imminent, may *any action* be taken by the board of the offeree company in relation to the affairs of the company, without the approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits.[88]

This general prohibition is reflected in Rule 21 of the City Code, which specifically prohibits a target board from engaging in a list of certain defensive tactics without shareholder approval[89]---a list which the Panel has made clear is not exhaustive.[90]

It is not the case that the City Code ignores the problems that takeovers might pose. To prevent the possible pressure to tender problem, the Code provides that, if an offer is successful, non-tendering shareholders will get a second opportunity to tender,[91] much like state "redemption rights" statutes. But given that it's possible to enable shareholders to make an undistorted choice by having such an arrangement, the Code does not leave any room for defensive tactics.

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88 P. Begg, Corporate Acquisitions and Mergers at A7.4 (emphasis added).

89 Under Rule 21, a target boards may not unilaterally:
(a) issue any authorized but unissued shares;
(b) issue or grant options in respect of any unissued shares;
(c) create or issue, or permit the creation or issue of, any securities carrying rights of conversion into or subscription for shares;
(d) sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount;
(e) enter into contracts otherwise than in the ordinary course of business.

Id. at A7.22

Turning to the certainty/uncertainty dimension, the British regulatory arrangement seems to provide more certainty and less room for litigation than those under state law. The clear prohibition on the use of defensive tactics contained in the City Code is one such example. It is not a "flexible" balancing test tailor-made for endless litigation.[92] Indeed, a major concern of the Panel on Takeovers and Mergers, as well as others involved in London's financial markets, is that the European Union might pass takeover regulation that will enable targets to engage in strategic takeover litigation so common in the United States and so rare in Great Britain.[93]

The reasons why the Code went in such a different direction might lie in the different incentives its designers had from those who crafted U.S. state takeover law. Presumably those responsible for the City Code gave less weight to managerial interests because of the close connection at least some of them had with the interests of shareholders. Moreover, corporate managers operating in a federal system such as the United States have significantly more influence as they can reward states that cater to their interests and punish those that do not through their incorporation and reincorporation decisions.

The British regulatory system is an example of a national system of regulation that both addresses possible defects in the takeover process and ensures that shareholders, not management, have the ultimate say on whether a takeover proceeds. It accomplishes this without the degree of uncertainty and pervasive

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[90] See, e.g., Consolidated Gold Fields PLC (Takeover Panel, May 9, 1989), at 14 (concluding that the commencement of litigation against the bidder by a target board was "frustrating action" in violation of General Principle 7)

[91] Rules 91.-9.5. See P. Begg, Corporate Acquisitions and Mergers at A7.14-A7.15.

[92] Another example is the Code's rigid timetable for the completion of a tender offer. A takeover bid must be completed in no more than 102 days.

[93] See, e.g., Financial Times, Defending the Code (Nov. 4, 1997), p.12

takeover litigation that characterizes U.S. state takeover regulation. The British experience suggests that the federalist structure of corporate law might not be as powerful a force for desirable corporate rules as some pro-state competition advocates contend.

III. TAKEOVER LAW AND THE SUPPORTERS OF STATE COMPETITION

So far we have argued that state takeover law is consistent with the theory of state competition, outlined in Part I, which views such competition as problematic. We now make our point in another way---by showing how supporters of state competition are unable to square their position on state competition with their views on the type of takeover regulation that maximizes shareholder value.

As will become clear, the leading advocates of state competition are also vigorous supporters of a robust market for corporate control. As a result, there is a deep tension in their views. We begin, in Section A, by analyzing the reasoning of four prominent proponents of state competition and how they try to reconcile their respective positions on state competition and takeovers. In Section B, we will argue that their attempts at reconciling these two positions are unconvincing. We suggest that a more productive path would be for them to reconsider their position on state competition in light of their own arguments concerning the substantial benefits takeovers can create for shareholders.

A. The Dilemma Facing Supporters of State Competition

The most prominent supporters of state competition---Ralph Winter, Frank Easterbrook, Daniel Fischel and Roberta Romano---also simultaneously advocate a legal regime that facilitates, rather than frustrates, takeovers. The hostility of state law to takeovers, therefore, poses a serious problem. What would explain the poor record of states in the takeover area without undermining their general position on state competition? Assessing how successful they are in reconciling their facially inconsistent positions will go a long way in determining how convincing their views are on the desirability of state competition. Accordingly, we will examine these pro-state competition scholars' arguments.

1. Ralph Winter

Ralph Winter formulated the classic response to Cary's contention that state competition results in a "race for the bottom" that harms shareholders.[94] He built his critique on the observation that a corporation chartered in a state with an inefficient corporate code will have a lower rate of return on investment as a result.[95] Companies with sub-par rates of return will have greater difficulty raising capital,[96] have less success in the product market,[97] and be more likely to be the target of a takeover.[98] The consequences of inferior returns created by inefficient corporate rules

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94 Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Studies 251, 256 (1977).

95 See Ralph K. Winter, Jr., The 'Race for the Top' Revisited: A Comment on Eisenberg, 89 Col. L.Rev. 1526, 1526 (1989).

96 Ralph Winter, State Law, Shareholder Protection, and the Theory of the Corporation, at 257.

97 Id. at 264.

98 Id. at 264--266.

reduce managers' private benefits of control, including their job security.[99] Managers, accordingly, have a strong incentive to ensure that the legal regime governing the operations of their corporation result in shareholders receiving the greatest possible return on their investment. In other words, in Winter's view, managers will maximize shareholder value out of self-interest.[100]

At the same time, however, Winter expressed his general belief that a regime that facilitated takeovers maximized corporate profits.[101] Profit-maximization is obviously what shareholders, as residual claimants, typically want. Not surprisingly, he was critical of state antitakeover statutes and, indeed, attributed part of the high cost of takeovers to the comparatively regulatory light-handed federal law (the Williams Act[102]) regulating tender offers. There was much for Winter to object to. Some "first-generation" state antitakeover statutes went so far as to prevent acquisitions of companies, which had their principle place of business in the state, unless a state official approved it.

In explaining how existing state antitakeover law, which he disapproved of based on its effect on shareholder wealth, was consistent with his defense of state competition, Winter made several points---points that, as we shall see, have often been repeated by others. He stressed that Delaware's antitakeover statute, by far the most important state statute on the subject, was relatively innocuous.[103] More importantly, Winter claimed that whether federal regulation was appropriate in the

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99 Id. at 264, 266.

100 Id.

101 Id. at 288.

102 15 U.S.C. s 78m(d)-(e); 78n(d)-(f).

103 Ralph Winter, State Law, Shareholder Protection, and the Theory of the Corporation, at 289.

takeover context was an issue "quite different" from the arguments raised by Cary.[104] Since existing state antitakeover statutes typically had extraterritorial application---they applied to companies even if they were not chartered in the state---these laws, accordingly, implicated a "chartering issue in only a peripheral sense."[105] Indeed, the extraterritorial features of antitakeover statutes, Winter believed, substantiated his basic contention that states competing for corporate charters have strong incentives to provide efficient corporate rules.[106]

This last explanation, based on state antitakeover statutes' extraterritorial application, is obviously inadequate to explain the reaction of states to the Supreme Court's decision in *MITE*,[107] which called into serious question the constitutionality of these statutes. After this decision, the vast majority of states, including Delaware, quickly passed new antitakeover legislation that was confined to companies chartered in the state. State antitakeover law, as a result, can no longer be cabined from the rest of state corporate law in the way that Winter suggested. On the other hand, his other two arguments---that state antitakeover law somehow raised different issues than other aspects of corporate law and the reliance on Delaware's regulatory light-touch---are ones that remain popular to this day with pro-state competition scholars.

2. Frank Easterbrook and Daniel Fischel

Frank Easterbrook and Daniel Fischel are also strong, even passionate, believers in state competition for corporate charters. Thus, in their academic work,

104 Id. at 270.
105 Id. at 289.
106 Id.
107 457 U.S. 627 (1981).

they presume that doctrines produced by state competition are efficient.[108] However, like Winter, they are vigorous supporters of takeovers and, as a result, strongly oppose the use of any and all defensive tactics by target management,[109] because regulation that allows managers to impede takeovers is unjustified and socially wasteful.

The inconsistency in their position is even more obvious than was the case with Winter. Easterbrook and Fischel have consistently argued, over a period of some fifteen years in numerous articles, that state competition generally produces efficient corporate rules.[110] Yet on this important issue state competition produces the opposite of what they strongly believe are desirable legal arrangements. To their credit, they candidly acknowledge the problem state antitakeover legislation creates for their position, describing it as "embarrassing."[111] The dilemma they face is painfully reflected in *Amanda Acquisition Corp. v. Universal Foods Corp.*,[112] where Judge Easterbrook, while considering the constitutionality of a state antitakeover statute, forthrightly acknowledged the tension between his belief in both state competition and the folly of antitakeover regulation.

However, Easterbrook and Fischel, at the end of the day, are only willing to concede that state antitakeover regulation reveals that state competition is not perfect. State competition, they argue, creates efficient rules over a period of time. We must

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[108] See, e.g., Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L.& Ec. 395, 398 (1983).

[109] See, e.g., 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).

[110] See, e.g., Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J.Corp. L 540 (1984); Frank H. Easterbrook & Daniel R. Fischel, Voting in Corporate Law, 26 J.L.& Ec. 395, 398 (1983); Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 NW. U.L. Rev. 913 (1982); see generally Frank H. Easterbrook and Daniel R. Fischel, The Economic Structure of Corporate Law 1--40 (1991).

be patient and recognize that the "long run takes time to arrive."[113] They identify the shortcoming in state competition, at least in the short-run, with respect to takeover legislation as this: states that adopt antitakeover laws are not penalized as much as perhaps they should be by competition from other states as investors will realize that any state can pass antitakeover legislation mid-stream.[114] State antitakeover law, we are assured, is a "special," although important, case.[115]

Like Winter before them, Easterbrook and Fischel point to Delaware's antitakeover statute. They stress that it is relatively mild compared to those of other states.[116] This is used to substantiate the assertion that state competition, even in the takeover context, creates powerful incentives for states to enact efficient regulation.

3. Roberta Romano

Roberta Romano is another leading supporter of state competition. While avoiding taking a stand on the issue in her initial writings, she now characterizes state competition for corporate charters as the "genius of American Corporate Law."[117] Her belief in state competition is as strong as anyone's. Indeed, she has recently argued that securities law should be recast, based on the American corporate law model, so as to allow competition between chartering jurisdictions.[118]

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111 See Frank Easterbrook and Daniel Fischel, The Economic Structure of Corporate Law 221 (1991).
112 877 F.2d 496 (7th Cir), *cert. denied*, 493 U.S. 955 (1989).
113 Id. at 507.
114 Id. at 222.
115 Id. at 212.
116 Id. at 222--223
117 See Roberta Romano, The Genius of American Corporate Law 1 (1993)
118 Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359 (1998).

Also, like Winter, Easterbrook and Fischel, Romano views legal arrangements enabling managers to erect antitakeover defenses as inefficient.[119] She acknowledges the "dismal track records of most states in takeover regulation."[120] Is Romano any more successful in resolving the conflict?

In the course of defending the consistency of her position, Romano emphasizes that Delaware has been slow to adopt antitakeover legislation, even though it typically has been a leader in most major corporate law reforms. Moreover, its antitakeover statute is not as draconian as other states, such as Pennsylvania's disgorgement statute.[121] Furthermore, Romano spends a great deal of time arguing that, whatever the imperfections of state regulation, any federal takeover law is likely to be worse.

This last defense is hardly a ringing endorsement of state competition. Rather than showing the "genius" of American Corporate law, it is rather an argument that we must live in a highly imperfect world. We find it hard to imagine that Romano, or indeed the other pro-state competition scholars we have discussed, would oppose a hypothetical federal statute that sharply limited the ability of states to restrict takeovers. Whether this is a realistic possibility is besides the point. Support for such a statute would underline the fact that state competition suffers from serious shortcomings. What, if anything, should be done about these shortcomings is another analytical question.

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[119] See, e.g., Roberta Romano, A Guide to Takeovers: Theory, Evidence and Regulation, 9 Yale J. on Reg. 119 (1992) (concluding that almost all state antitakeover law is unwarranted and harmful).

[120] Id. at 859.

[121] See Roberta Romano, Competition for Corporate Charters and the Lesson of Takeover Statutes, 61 Fordham L. Rev. 843, 855 (1993).

B. Why Supporters of State Competition Should Reconsider

One type of reaction by state competition supporters, as we have seen, views state takeover law as an anomaly, an exception, or an imperfection. This is most explicit in Easterbrook and Fischel's writings. The sentiment here seems to be that even a process that has strong structural reasons to function well can fail from time to time, and these failures do not imply that the process is not a good one.

But it is not clear that one can brush aside takeover law as an anomaly or an isolated failure, and comfortably continue to believe that state competition is such a great process. To start with, takeovers might well have been the most important issue with respect to which state corporate law has had to develop a position in the last twenty years.

If states have produced bad takeover law, this was not a fluke, a one-time isolated mistake. We are talking about a gradual process developing over quite a few years, in many steps and decisions and with much attention and occupation by state officials along the way. There were several waves of antitakeover statutes,[122] all representing the persistent attempts by states to place impediments in front of takeovers with little or no support in the academic literature. And as for judicial decisions, this involved not one case, but rather an issue that has been visited and revisited over many years. If state competition has persistently produced bad, even indefensible, results concerning the most important corporate issue of recent times, how can we be confident that it performs well elsewhere?

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[122] See supra Part II(A)(1)(i)

All this means is that it is hard to brush this away as an anomalous exception and continue to think state competition can reliably produce good results. Easterbrook and Fischel's explanation of why states have adopted inefficient takeover legislation, the fact that these were mid-stream legislative changes,[123] is in no way limited to takeovers. Mid-stream changes are possible with respect to any legal rule, not just takeover regulation, that managers might wish to change. Moreover, mid-stream changes are not only possible through a state changing its corporate code, due, say, to campaign contributions, but by a corporation reincorporating to another state as well.

Another common reaction by supporters of state competition is to point out that Delaware has not been as extreme as some other states in its antitakeover statute. This is true. But through case law, and in particular the approval of the poison pill, Delaware has erected formidable barriers to takeovers. Delaware's antitakeover position has had, as it typically does, a central and very influential role. The use of poison pills is now very widespread. The debate is over the body of law produced by state competition. And while states differ somewhat in the extent to which they restrict takeovers, they all by and large go much further in that direction than Winter, Easterbrook, Fischel, and Romano would approve of.

While the pro-state competition view has a serious problem accounting for existing state takeover law, needing to rely on excuses and anomalies, the view that Cary held, and that we are advocating, has no problem whatsoever explaining this. Our concern with the possible shortcomings of state competition for corporate charters is not only consistent with the state takeover law that we observe but helps

[123] Supra Part II(A)(4).

explain why state law has evolved in the regrettable direction that it has. By reconsidering their largely unqualified endorsement of state competition, supporters of state competition can gain both a better explanation of why states have adopted restrictive takeover rules and retain their belief in the efficiency of a more permissive legal arrangement.

IV. CONCLUSION

This Article has sought to highlight the problems involved in state competition for corporate charters. On some important issues, states might have incentives to provide rules that are attractive to managers but not shareholders. Takeover law is one important area in which state competition might well have produced a body of law that excessively restricts takeovers. Takeover law is one important area in which state competition is likely to fail. There are strong theoretical reasons to expect that state competition will work to produce a body of corporate law that excessively protects incumbent managers. The development of state takeover law, we have argued, is consistent with this view. It should lead the many who offer unqualified support for state competition to reassess their position.