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THE POWERFUL ANTITAKEOVER
FORCE OF STAGGERED BOARDS:
THEORY, EVIDENCE, AND POLICY

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The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy

Lucian Arye Bebchuk, John C. Coates** IV &
Guhan Subramanian****

Staggered boards, which a majority of public companies now have, provide a powerful antitakeover defense, stronger than is commonly recognized. They provide antitakeover protection both by (i) forcing any hostile bidder, no matter when it emerges, to wait at least one year to gain control of the board, and (ii) requiring such a bidder to win two elections far apart in time rather than a one-time referendum on its offer. Using a new data set that includes all hostile bids in the five-year period 1996-2000, we find that not a single hostile bid came close to winning a ballot box victory against an “effective” staggered board (ESB). We also find that an ESB nearly doubles the odds that the average target in our data set will remain independent, from 34% to 61%, halves the odds that a first bidder will be successful, from 34% to 14%, and reduces the odds that our average target will be forced to sell to a white knight, from 32% to 25%. Furthermore, we find that the shareholders of targets that remain independent in our data set are made substantially worse off compared with accepting the bid, and that ESB’s do not provide sufficient countervailing benefits in terms of increased premia to offset the increased costs of remaining independent. Overall, our estimates indicate that, in the period that we study, ESB’s reduced the expected returns of the shareholders of hostile bid targets by 8-10%. Finally, we show that most staggered boards were adopted before the developments in takeover doctrine that make ESB’s such a potent defense. Our findings call for a reconsideration of the rules governing takeover defenses. In particular, we argue that, at least in the absence of explicit shareholder authorization, managers who lose one election over an outstanding bid should not be allowed to further block the bid with a pill-ESB combination.

JEL classification: G30, G34, K22

Key words: Takeovers, Defensive tactics, boards, mergers and acquisitions

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I. INTRODUCTION

Staggered boards (SB's) are an important part of the modern U.S. corporate landscape. In a large sample of major U.S. public companies, 58% had a staggered board in 1998,¹ and among firms going public in the 1990s, the incidence of staggered boards increased from 34% in 1990 to over 70% in 2001.² Despite this large and growing importance in practice, the impact of staggered boards on the market for corporate control has not been adequately recognized by courts, academics, or practitioners.

This article demonstrates that staggered boards play a key role in the antitakeover protection that U.S. public companies now enjoy. A staggered board, we argue, offers a more powerful antitakeover defense than has previously been recognized. Whereas conventional wisdom holds that once a company becomes a takeover target it is unlikely to remain independent, the managers of targets with staggered boards can—and most of the time do—maintain the target's independence. We argue that staggered boards have a special antitakeover power that makes it extremely difficult for a hostile bidder to gain control. Using a new database of all hostile bids against U.S. targets in the five year period 1996-2000, we also provide evidence that staggered boards indeed have the powerful antitakeover effect suggested by our theory. Finally, we show that the effectiveness of staggered boards substantially reduces target shareholder wealth. The theory and evidence that we put forward have important implications for takeover regulation, and we examine the changes in takeover law that they warrant.

Staggered boards have increased in importance with the appearance and proliferation of poison pills. Takeover law allows managers to maintain a pill as long as they are in office, and thereby impede a hostile bid. As a result, as long as

1. See Database constructed from VIRGINIA K. ROSENBAUM, CORPORATE TAKEOVER DEFENSES (1998 volume), Investor Responsibility Research Center (n=2447). This figure is up from 53% in 1993. See *id.* (1993 volume). IRRC includes all firms in the S&P 1500 plus an additional 1000 firms "selected primarily on the basis of market capitalization and high institutional ownership levels." See ROSENBAUM, *supra*, at ix.

2. See John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1353, 1376 (2001) (finding 34% staggered board incidence in a sample of 160 IPO firms from the period 1991-92, 66% incidence in a sample of 160 IPO firms from the first nine months of 1998, and 82% incidence in a sample of 33 IPOs from 1999); Takeover Defenses of Recent U.S. IPOs (chart showing 73% of IPOs had staggered boards in 2001), available at <http://www.sharkrepellent.net> (visited Jan. 16, 2002). See also Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L. ECON. & ORG. 83, 96 tbl. 2 (finding 44% staggered board incidence among a sample of 310 firms that went public between 1994 and 1997).

managers maintain their opposition to a hostile bid, the bidder can obtain control only if it wins control of the board via a proxy contest and replaces the directors with ones that will redeem the pill. This route of winning control of the board is the safety valve on which takeover law has relied to protect shareholder interests. However, we show that when a target has an effective staggered board (ESB)—a staggered board that is appropriately designed to prevent circumvention—this safety valve is illusory.

There are two reasons why an ESB presents an exceedingly difficult impediment to gaining control of the board via the ballot box. First, an ESB substantially increases the delay involved in gaining control of the board and, importantly, establishes a minimum delay. No matter when a hostile bidder might emerge, gaining control of the board takes at least one year, a very long time indeed in the dynamic world of corporate acquisitions. Second, beyond the costs imposed by delay, to overcome an ESB a bidder must win two elections, far apart in time, rather than an up-or-down referendum at a single point in time. We show that the two-election problem is a serious one for bidders. In combination with the delay problem it makes an ESB a powerful if not insurmountable antitakeover device. Indeed, we show that an ESB provides managers with stronger protection from a hostile takeover than would an arrangement (not permitted under current law) providing directors with guaranteed three-year terms.

After developing our theory of staggered boards, we test it against a new database of all hostile bids made against U.S. targets in the five-year period from 1996 to 2000. We find that during this period not a single hostile bidder gained control of an ESB target's board through a ballot box victory. The inability of hostile bidders to gain control of the board of a target with an ESB significantly reduces the credibility of the threat to do so, which in turn has a major impact on the outcome of hostile bids. Specifically, we find that an ESB *nearly doubles* the likelihood that the average target in our data set will remain independent, from 34% to 61%; *halves* the likelihood that the first bidder will be successful, from 34% to 14%; and reduces the likelihood that a target will be forced to sell to a white knight or other subsequent bidder, from 32% to 25%.

We also find that the substantial increase in the likelihood of remaining independent produced by ESB's is rather costly for target shareholders. Remaining independent makes shareholders substantially worse off, evaluated either in the short-run or the long-run, compared with the scenario in which the hostile bid would have been accepted. Furthermore, we find that ESB's do not provide sufficient countervailing benefits in terms of increased premia, and may even provide no such benefits at all. Overall, we find that ESB's produced losses on the order of eight to ten percent of value for shareholders of hostile bid targets in the latter half of the 1990s.

These findings lend new significance to shareholder proposals demanding declassification of SB's, proposals which have become far more numerous and

popular (with shareholders) in recent years.³ More generally, these findings have important implications for the U.S. market for corporate control and the broader business landscape. For companies with dispersed ownership, takeover bids can be a key mechanism for replacing poorly performing managers. Staggered boards, in turn, largely determine the extent to which managers of such companies are vulnerable to a takeover threat. The theoretical arguments and empirical evidence presented here suggest that ESB's increase the risk of managerial entrenchment, weaken the disciplinary effect of the market for corporate control, and reduce shareholder wealth.

After analyzing the antitakeover consequences of staggered boards, we examine how we got to this state of affairs. We compare the evolution of the Delaware case law with the timing of staggered board incidence, and show that most companies that now have staggered boards adopted them before shareholders could have been aware of their entrenching power that was accorded to them by subsequent developments in takeover law. Specifically, shareholders who approved staggered boards prior to 1990 found themselves in the 1990s stuck with an arrangement whose full antitakeover power they could not have anticipated when buying shares in the company or when voting to approve the staggered board. In the 1990s, shareholders began to comprehend the full antitakeover potential of staggered boards, and, led by activist institutional investors, began voting against proposals to adopt new staggered boards and for proposals to rescind existing ones.⁴ For most companies, however, this shareholder activism has amounted to "too little, too late," because the majority of large companies had already adopted staggered boards. Today, shareholder appeals for declassification take the form of precatory (non-binding) shareholder resolutions.

Our conclusions concerning the special antitakeover power of staggered boards call for a reconsideration of existing takeover law. Courts have sought to strike a balance between the goals of protecting shareholders against threats that some hostile offers might present and preventing managers from entrenching themselves. Under the well-known *Unocal* standard, managers can use defensive

3. See Jason D. Montgomery, *Classified Boards*, Corporate Governance Services, Investor Responsibility Research Center (Mar. 3, 1998); *Record Support for Destaggered Boards Highlights Shareholder Proposal Results*, Corporate Governance Highlights, Investor Responsibility Research Center (June 18, 1998), at 97.

4. New staggered boards have been emerging through the 1990s, however, in IPO's. See Coates, *supra* note 2, at 1377; Daines & Klausner, *supra* note 2, at 96 tbl. 2. Shareholders have been willing to buy shares from companies that have staggered boards in their initial charter. In those cases, the initial price could reflect the costs to shareholders of staggered boards, although it is also possible that investors in IPOs are still not fully aware of the antitakeover potential of staggered boards. See *infra* Part II.D.

tactics but only to an extent that is “reasonable in relation to the threat posed.”⁵ Allowing managers to maintain a pill as long as they are in office, courts have believed, is a proportionate measure because of the availability of the proxy contest safety valve. Our analysis shows, however, that this safety valve on which courts have relied is largely illusory against companies with an ESB.

Accordingly, when a target has an ESB (which is approximately half the time), we propose that managers should not be allowed to maintain a pill after they lose one election. Allowing managers to maintain a pill after what was essentially a referendum on the offer would be, we believe, a disproportionate and substantially entrenching measure. Therefore, we argue, preventing the use of a pill-ESB combination following defeat in one election would be consistent with the basic principles of *Unocal* and *Moran*. In addition, our approach would preserve the business benefits that are often cited to justify staggered boards—board stability and board independence—while ensuring that staggered boards are not used for managerial entrenchment.

At a minimum, our approach should be followed by courts for all targets whose staggered boards were not adopted or ratified after 1990, when staggered boards obtained their antitakeover force due to developments in the law governing poison pills. This minimal approach would at least ensure that the antitakeover protection provided by a staggered board does not exceed the one that has been authorized by informed shareholder consent.

The remainder of this article proceeds as follows. Part II provides the necessary background: an account of the widespread use of staggered boards, the justifications offered for them, and the rising shareholder resistance against them. Part III offers our theory of staggered boards and demonstrates why, at a theoretical level, ESB’s are far more potent against hostile takeover bids than prior commentators have realized. Part IV provides empirical evidence that supports this theory. Part V examines how this state of affairs came about and documents that the large majority of ESB’s were adopted before shareholders could have recognized the antitakeover significance that ESB’s would obtain by subsequent judicial developments. Part VI discusses the implications of our analysis and makes recommendations that would improve the efficiency and legitimacy of takeover law. Part VII concludes.

5. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

II. BACKGROUND

A. *The Law of Staggered Boards*

The default law in all states requires that all directors stand for election at each annual shareholder meeting.⁶ However, all states provide an exemption from this requirement if the board is staggered.⁷ A company with a staggered board groups directors into classes (typically three), with each class elected at successive annual meetings. For example, a board with twelve directors might be grouped into three classes, with four directors standing at the 2001 annual meeting, four more directors standing for reelection in 2002, and the remaining four directors standing for reelection in 2003.⁸ With three classes, directors in each class would be elected to three-year terms. Thirty-nine jurisdictions, including Delaware and California, permit a maximum of three classes.⁹ New York permits as many as four classes of directors¹⁰ and Arizona allows three “or to the extent not inconsistent with cumulative voting rights, more.”¹¹ Ten other states have not addressed this issue.¹²

6. *See, e.g.*, DEL. CODE ANN. tit. 8, § 211(b) (2000); MODEL BUS. CORP. ACT § 8.03(d) (1999). Moreover, if the corporation does not hold an annual shareholder meeting within thirteen months (in Delaware) or fifteen months (under the RMBCA) of the last meeting, a court may order an annual meeting on the petition of any stockholder or directors. *See* DEL. CODE ANN. tit. 8, § 211(c) (2000); MODEL BUS. CORP. ACT § 7.03(a)(1) (1999).

7. *See* GRANT A. GARTMAN & JACK D. ISAACS, CORPORATE GOVERNANCE STATE BY STATE: A GUIDE TO SELECTED STATUTES (Investor Responsibility Research Center, 1998).

8. While Delaware does not require the classes to be roughly equal in number, *see* DEL. CODE ANN. tit. 8, § 141(d) (2000), the RMBCA does, *see* MODEL BUS. CORP. ACT § 8.06 (1999). However, regardless of whether required or not by statute, most companies that install a staggered board impose this requirement on themselves, perhaps because by doing so they maximize the antitakeover protection of the CB. *See, e.g.*, Bestfoods Restated Certificate of Incorporation § 11(8) (requiring the same number of directors in each class, “as nearly as may be possible”). *But see* ARV Assisted Living Bylaws § 3.3 (allowing the board to determine without restriction the number of directors in each class).

9. *See* Richard H. Koppes, Lyle G. Ganske & Charles T. Haag, *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 BUS. LAW. 1023, 1029 n.21 (1999).

10. N.Y. BUS. CORP. LAW § 704(a) (McKinney 2001).

11. ARIZ. REV. STAT. ANN. § 10-806 (West 1996).

12. *See* Koppes, Ganske & Haag, *supra* note 9, at 1029 n.21.

Delaware allows a SB to be specified either in the charter or in the bylaws,¹³ while the Revised Model Business Corporation Act (RMBCA) only provides for a SB to be specified in the charter.¹⁴ In all states, installing a SB through charter amendment requires both shareholder approval *and* board approval,¹⁵ while installing a SB in the bylaws requires either shareholder approval *or* board approval.¹⁶ Conversely, dismantling a SB that is in the charter requires both a shareholder vote and a board vote, while dismantling an SB in the bylaws can be done either through shareholder vote or through board vote. Thus while SB's have the same (direct) effect whether installed through the charter or through the bylaws, SB's in the bylaws are generally much easier to dismantle.¹⁷

If an SB is installed in the charter, directors may only be removed for cause, and shareholders may not “pack the board” by increasing the number of directors and filling the vacancies created, we characterize the SB as an “effective staggered board” (ESB)—one that cannot be dismantled by a hostile bidder without first winning control of the board.¹⁸ As we shall see below, the distinction between a SB and an ESB is irrelevant for two of the arguments put forward to explain SB's—board stability and board independence—but it becomes highly relevant for the

13. See DEL. CODE ANN. tit. 8, § 141(d) (2000).

14. See MODEL BUS. CORP. ACT § 8.06 (1999).

15. See, e.g., DEL. CODE ANN. tit. 8, § 242(b)(1)-(2); MODEL BUS. CORP. ACT § 10.03 (1999) (requiring board approval and shareholder approval for all but minor changes to the charter).

16. Delaware requires that the charter expressly provide for board authority to amend the bylaws, see DEL. CODE ANN. tit. 8, § 109(a) (2000), while the RMBCA reverses this default rule, allowing the board to amend the bylaws unless otherwise specified in the charter, see MODEL BUS. CORP. ACT § 10.20 (1999). Both corporate codes, and all states, allow shareholders to amend the bylaws. See DEL. CODE ANN. tit. 8, § 109(a) (2000), MODEL BUS. CORP. ACT § 10.20(b) (1999).

17. A staggered board in the bylaws might be as difficult to dismantle as a staggered board specified in the charter if the charter specifies that the board must approve any modifications to board structure, effectively making the staggered board provision in the bylaws equivalent to a charter provision. See, e.g., Articles of Incorporation and By-Laws of Quality Dining, Inc. (requiring board approval for “any elimination or modification of the groups or terms of office of the Directors as the By-Laws then in effect may provide.”). In addition, a supermajority voting requirement for shareholder bylaw amendments may make a staggered board in the bylaws equivalent to a charter provision, which can be a hurdle to dismantling that can be practically akin to an outright ban. See, e.g., Circon By-Laws (requiring a two-thirds vote for any shareholder amendments to the bylaws). See also *infra* note 99 and accompanying text (discussing the effect of a supermajority amendment requirement in preserving a staggered board installed in the bylaws in the takeover bid for Circon).

18. See Coates, *supra* note 2.

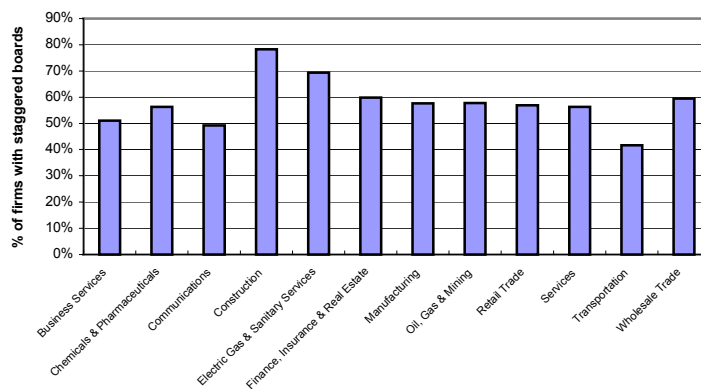
third (and we believe, most important) reason for SB's, to make hostile takeovers more difficult. We therefore make this important distinction between SB's and ESB's throughout the remainder of this article.

B. *The Proliferation of Staggered Boards*

Though staggered boards have been a part of the corporate law landscape for decades,¹⁹ they gained popularity during the 1980s takeover wave. Today, among a sample of 2,421 large public U.S. companies, 58% have staggered boards, up from 53% in 1993.²⁰ In addition to this moderate growth among large companies, there has been a dramatic increase in staggered board incidence among companies going public in 1991-92 (34%) versus 1999-2000 (82%).²¹ The IPO statistics suggest that, barring any major shifts in the legal or political environment, staggered board incidence will only increase further among major U.S. corporations in the years to come.

Figure 1 shows that SB's are represented broadly across industries:²²

Figure 1: SB Incidence by Industry



19. Among the approximately 2500 companies in the IRRC database, the first staggered board appeared in the company now known as Equifax in 1920.

20. The sample comes from the 1993 and 1998 volumes of the Investor Responsibility Research Center (IRRC) Corporate Takeover Defenses databooks, which include all firms in the S&P 1500 plus an additional 1000 firms "selected primarily on the basis of market capitalization and high institutional ownership." See ROSENBAUM, *supra* note 1, at ix.

21. See Coates, *supra* note 2.

22. For a description of the construction of these industry classifications see George P. Baker & Guhan Subramanian, *The Global Market for Corporate Control* (work in progress, on file with the authors).

Figure 1 shows no pronounced industry effect for staggered board incidence. In all industries except Transportation and Communications, staggered boards appear at the majority of firms, and in two industries—Construction and Electric, Gas and Sanitary Services—staggered board incidence is at 70% and higher.

Figure 2 shows staggered board incidence by firm size:

Figure 2: SB Incidence by Firm Size

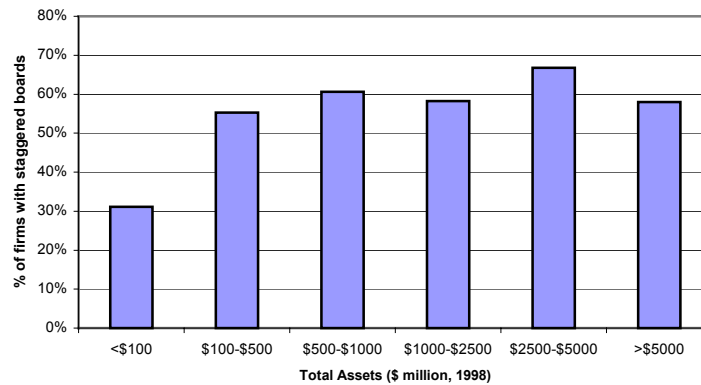


Figure 2 shows that staggered boards are well represented across companies of varying sizes, with only slight differences between the asset distribution of firms with staggered boards and the asset distribution of firms without staggered boards. The only statistically significant difference occurs at the low-end of the spectrum, where staggered boards are slightly under-represented. This finding is consistent with evidence from one of us that staggered boards are less common at smaller IPO firms in the 1990s, controlling for insider ownership.²³ One possible explanation is that smaller firms may be advised by lawyers with less takeover experience, who are less likely to install staggered boards.²⁴

C. *Justifications for Staggered Boards*

1. *Nontakeover justifications.*

Two nontakeover-related justifications have been put forward to justify staggered boards. First, they facilitate the independence of outside directors.²⁵ Independent directors, goes this argument, will be less influenced by executives if

23. See Coates, *supra* note 2, at 61.

24. See *id.* at 30 (finding that outside counsel are often responsible for choosing takeover defenses).

25. See, e.g., Koppes, Ganske & Haag, *supra* note 9, at 1053-54.

they have a term of three years rather than one year. Second, they reduce annual turnover on the board, thereby promoting board stability.²⁶ It is generally good, goes the argument, to always have some experienced and seasoned directors, who have the perspective that only time on the board can provide. If the board were not staggered, there is in theory some chance that all board members in a given year will be rookies. A staggered board prevents this outcome by ensuring that at most one-third of the board members will be new.²⁷

However, a staggered board imposed through the charter is an unnecessarily blunt instrument to achieve these two benefits. On board independence, a bylaw establishing a staggered board would be sufficient to provide independent directors autonomy from management so that they could effectively monitor. Because officers cannot amend the bylaws without approval of a majority of the whole board, a majority-independent board would not be destaggered against the will of the independent directors.²⁸ A bylaw would thus accomplish the independence goal without, as will be made clear below, in any way impeding a hostile bidder.²⁹

26. *See id.* at 1051-2.

27. *See, e.g.,* Avant Corporation Proxy Statement, Proposal No. 2 (April 7, 1998) (advocating a staggered board because classification “will help lend continuity and stability to the management of the Company”); Cornell Corrections Proxy Statement (March 9, 1998) (advocating staggered board “to promote continuity and stability”); Rental Service Corp. Proxy Statement, Proposal No. 2 (March 30, 1998) (same).

28. Even at the minority of public companies that lack a majority of independent directors, it would be controversial and reputationally costly for officers to declassify the board against the will of independent directors. An independent director would not expect that, if he or she were to display independence, insiders would amend the bylaws to cut short the term of the independent director.

29. Although the RMBCA requires a staggered board to be in the charter, most states do not seem to follow the RMBCA on this point. In addition, 50% of all public companies are incorporated in Delaware (*see* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice in the 1990s: Evidence on the “Race” Debate and Antitakeover Overreaching*, manuscript at 17 fig. 2, forthcoming U. PENN. L. REV. (2002), Lucian Arye Bebchuk & Alma Cohen, *Firms’ Decisions Where to Incorporate*, (working paper, 2002), available on www.ssrn.com), which allows a staggered board to be specified in either the charter or the bylaws. In the small number of states which require a staggered board to be specified in the charter, we believe that both board stability and board independence could be achieved through a convention or policy (e.g., that the slate should be two-thirds incumbent directors), which would avoid the antitakeover consequences of a staggered board specified in the charter. Alternatively, a staggered board could be installed in the charter but shareholders could specifically be given the power to remove directors without cause, as suggested by Koppes, Ganske & Haag, *supra* note 9. *See infra* Part III.C (discussing ways to avoid the antitakeover power of CB’s).

Similarly, on board stability, a staggered board bylaw would achieve the goal of preventing excessive turnover, and even a company without a staggered board could have a convention or policy requiring that annual slates include at least two-thirds incumbent directors in the ordinary course of business. Such a policy or bylaw would be followed in the normal course of events.³⁰ As an empirical matter, even in companies that do not have any policy or rule against replacing more than one third of the board in any given year, such high turnover rarely, if ever, happens outside the change of control context.³¹ In the normal course of business, most of the candidates running on the insiders' slate are usually those who are already serving on the board. Thus a convention, policy, or bylaw should provide the desired board independence and board stability in the normal course of events, in a more focused way than a staggered board.

Of course, in one situation a convention, policy, or bylaw would be insufficient—in the case of a hostile change of control. When a buyer acquires a controlling interest, it would be natural for it to replace the directors with a new slate of directors, assuming that it were not stopped by the charter. Thus, alternatives that stop short of a charter amendment would not likely prevail in the case of a hostile takeover.

But a desire for board stability no longer makes sense in the case of a hostile change of control. The argument for continuity presupposes that there is some team working largely in harmony, and that such a team would benefit from retaining a majority of experienced members from whom new members could and would be willing to learn. But in the case of a hostile takeover, old and new directors are not going to form a harmonious team.³² In such a case, board stability indeed might be quite harmful. In fact, arguments for board stability, through “dead hand” and “no hand” pills, have already been rejected by the

30. Observe, for example, that many companies (such as Boeing and GE) follow policies mandating a certain retirement age for the CEO, even in companies with successful and powerful CEO's. It would seem that to retire a CEO at 65 would require a stronger commitment device than is needed to retire only part of the directors, yet we know of no such policies that are written in to the bylaws or charter.

31. See, e.g., Rental Services Corp. Proxy Statement, Proposal No. 2 (March 30, 1998) (acknowledging that “the Company has not yet experienced problems with respect to continuity,” but nevertheless advocating a staggered board “to provide continuity and stability to the Company's management”).

32. For a somewhat humorous illustration of this point, see Brian Hall, Christopher J. Rose & Guhan Subramanian, Circon (A) (Harvard Business School Case Study N9-801-403) (describing how dissident director General Victor Krulak reportedly asks fellow dissident Charles Elson to call him by his nickname, Brute, but then introduces himself to the incumbent directors with: “This is General Krulak.”).

Delaware Chancery Court³³ and the Delaware Supreme Court.³⁴ Thus charter-based staggered boards are over-encompassing because they provide board stability when business justification and support in the Delaware case law are both at their weakest.³⁵

2. *Antitakeover justifications.*

The third reason often given to explain staggered boards is that they make hostile takeovers more difficult.³⁶ For reasons we discuss in Part V, this justification may have been unintended when staggered boards first appeared, but the key point is that the interaction between a staggered board and a poison pill puts up a potent defense against a hostile bidder. A pill provides relatively weak takeover protection if the target is vulnerable to a rapid proxy fight, because the target's board can redeem the pill at any time; a staggered board without a pill is likewise ineffective against a bid, given the unlikelihood that target directors will continue to resist if a bidder has acquired a majority of the target's stock. In combination, however, an effective staggered board and a pill provide enormous protection: the pill blocks any stock acquisition beyond the trigger level, and the staggered board forces the bidder to go through two proxy contests in order to

33. *See Carmody v. Toll Bros., Inc.* 723 A.2d 1180 (Del. 1998) (ruling that claim challenging dead hand pill survives motion to dismiss).

34. *See Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998) (invalidating slow hand pill). *See also Bank of New York v. Irving Bank*, 528 N.Y.S.2d 482, 485-86 (N.Y. Sup. Ct. 1988) (invalidating dead hand pill under New York law).

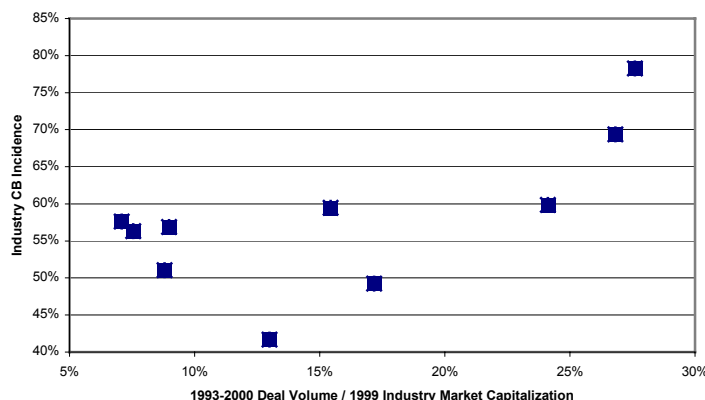
35. *See, e.g., Topps Co. Proxy Statement, Proposal No. 4* (May 28, 1998) (proposing, on the part of a shareholder, to remove a staggered board because "in the unlikely event that stockholders vote to replace all directors, this decision would express stockholder dissatisfaction with the incumbent directors and reflect the need for change."); *Bausch & Lomb Proxy Statement, Shareholder Proposal No. 2* (Mar. 19, 1998) (same).

36. *See, e.g., Eastman Kodak Proxy Statement* (Mar. 19, 1998) (arguing, in the fifth of five points in favor of a staggered board, that it "inhibits unfriendly take-over attempts"); *Rental Service Corp. Proxy Statement, Proposal No. 2* (Mar. 30, 1998) (acknowledging that the installation of a staggered board "may have potential antitakeover effects."). Many management statements against staggered board rescission, or in favor of new staggered boards, argue that this antitakeover effect gives management greater bargaining power. *See, e.g., Bausch & Lomb Proxy Statement, Shareholder Proposal No. 2* (Mar. 19, 1998) ("The classified board does not preclude unsolicited acquisition proposals but, by eliminating the threat of imminent removal, puts the incumbent Board in a position to act to maximize value to all shareholders."); *Bristol Myers Squibb Proxy Statement, Proposal No. 3* (Mar. 16, 1998) ("One benefit derived from that situation is an enhancement of management's ability to negotiate in the best interest of all stockholders with a person seeking to gain control of the corporation.").

gain control of the board.³⁷

Statistics on staggered board incidence support the view that staggered boards are primarily antitakeover devices. First, as noted in Part II.B, staggered boards are relatively less common among smaller firms, where ownership is typically more concentrated and hostile takeovers may be more difficult or impossible (if insiders own a controlling stake). Second, staggered boards were far less common before the 1980s takeover wave,³⁸ even though the board stability and board independence arguments (presumably) applied with equal force before 1980 as after.³⁹ Third, if *ex post* total deal activity can be used as a rough proxy for the *ex ante* likelihood of hostile deal activity, Figure 3 shows a reasonable correlation between deal volume and staggered board incidence:

Figure 3: Staggered Board Incidence by Industry Deal Activity



The x-axis of Figure 3 shows industry deal volume during the “fifth takeover wave,” normalized against total industry market capitalization at the end of the wave.⁴⁰ Thus the x-axis provides a rough proxy for industry deal activity. The y-

37. See, e.g., Federated Department Stores Proxy Statement, Proposal No. 3 (Apr. 16, 1998) (“The Company’s outside advisors have informed the Company that they continue to believe that classified directorate terms are important to ensure the efficacy of stockholder rights plans.”).

38. See *infra* Figure 7.

39. Note also that staggered boards are much less common in the United Kingdom, which has less use for them as antitakeover devices without the accompanying jurisprudence in support of the poison pill that the United States has. Again, the board stability and board independence arguments would seem to apply with equal force in the United Kingdom as in the United States, yet staggered board incidence in the United Kingdom is much lower.

40. This data comes from Baker & Subramanian, *supra* note 22.

axis plots staggered board incidence by industry. Figure 3 shows a reasonable correlation between industry deal activity and staggered board incidence, providing additional indirect evidence that staggered boards are largely installed for antitakeover reasons.⁴¹

D. *The Growing Opposition to Staggered Boards*

While SB's are commonplace among all types of U.S. public companies, as described in Parts II.B. and II.C. above, very few SB's have been proposed by management and approved by shareholders since 1990. The reason is simple: shareholders have stopped voting in favor of new staggered boards. The emergence of shareholder activism in the early 1990s, combined with important changes in the Delaware case law around the same time,⁴² made institutional investors acutely aware of the potential for managerial entrenchment behind a SB/pill combination. As a result, their support for staggered boards vanished, and companies that did not already have their staggered boards in place by 1990 had missed the party. Among companies covered by the IRRC, management proposals to classify boards dropped from 88 proposals in 1986 to just ten proposals in 2000.⁴³ Of these ten, only four involved companies in which management did not own a controlling stake; among these four, only one was successful.⁴⁴

In fact, activist shareholders began trying to turn back the tide by proposing resolutions to declassify boards. These proposals, along with proposals to redeem pills, have been increasingly popular with shareholders during the 1990s,⁴⁵

41. Two industries are not plotted – Oil and Gas, and Business Services – because they have deal activity greater than 50% in the 1990s takeover wave. These two industries have staggered board incidence in line with other industries (Figure 1) but lower than the simple correlation in Figure 3 would suggest. Both of these industries might have other “natural” defenses that would make staggered boards less necessary. Oil and Gas companies are often extremely large, and may deter hostile takeover bids through bulk. Business Services companies are generally less vulnerable to hostile takeover because the critical assets are often human capital, which can readily exit in the aftermath of a successful hostile takeover.

42. See *infra* Part V.

43. See Michael Klausner, *Institutional Shareholders' Split Personality on Corporate Governance: Active in Proxies, Passive in IPOs*, manuscript at 3 (Table 1) (Stanford Law School Working Paper #255, November 2001).

44. See *id.*, manuscript at 4.

45. See John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 861 tbl. 5 (1999) (measuring the steady increase in shareholder votes for precatory resolutions to redeem the poison pill and declassify the board).

although they have no binding effect and therefore have been routinely ignored by managers. The average shareholder vote in favor of proposals to declassify the board increased from 16.4% in 1987 to 52.7% in 2000.⁴⁶ One of us in other work has speculated that these proposals would garner even greater support were they binding on boards.⁴⁷

The experience at Bausch & Lomb is typical. In 1997, shareholder activist William Steiner from the Investor Rights Association of America sponsored a proposal urging the board to declassify itself:

[T]he Company's classified Board of Directors maintains the incumbency of the current Board and therefore of current management, which in turn limits management's accountability to stockholders. . . . I believe that [destaggering the board] is one of the best methods available to the stockholder to insure that the Company will be managed in a manner that is in the best interests of the stockholders.⁴⁸

The Bausch & Lomb board of directors argued against the proposal:

The Board stated in the proxy statement relating to that meeting [approving the staggered board] its belief that the amendment would reduce the vulnerability of the Company to certain potentially abusive takeover tactics and encourage potential acquirers to negotiate with the Board. The Board also stated its belief that the amendment assures continuity and stability of the Company's management and policies, since a majority of the directors at any given time have prior experience as directors of the Company.

In the opinion of the Board, the above reasons continue to be valid and the staggered Board remains in the best interests of the shareholders. . . . The staggered board does not preclude unsolicited acquisition proposals but, by eliminating the threat of imminent removal, puts the incumbent Board in a position to act to maximize value to all shareholders. In addition, the Board does not believe that directors elected for staggered terms are any less accountable to shareholders than they would be if elected annually, since the same standards of performance apply regardless of the term of service.⁴⁹

The Steiner proposal received 62% approval from Bausch & Lomb

46. See Klausner, *supra* note 43, manuscript at 3 (Table 1).

47. See Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 127-128 (2001).

48. Written Statement of William Steiner, Bausch & Lomb Proxy Statement, Shareholder Proposal No. 2 (Dec. 28, 1996).

49. See Written Statement of Bausch & Lomb Board of Directors, Bausch & Lomb Proxy Statement, Shareholder Proposal No. 2 (Dec. 28, 1996).

shareholders, yet the company continued to maintain a staggered board.⁵⁰

E. *Conventional Wisdom on Staggered Boards*

Thus far in this Part we have argued that the motivation for installing staggered boards, as well as the motivation for shareholder activism against them, comes from their potential antitakeover consequences. These antitakeover consequences are the focus of this article; our thesis is that they are greater than has been previously recognized. Although most scholars and practitioners recognize that staggered boards have some antitakeover effect, the conventional wisdom is that the magnitude of this effect is not very large.

We interviewed fifteen senior partners from major law firms in New York City and Wilmington, Delaware and found consensus around the view that targets, once in play, will generally trade to either the initial bidder or to a white knight.⁵¹ When presenting drafts of this article, we also surveyed M&A practitioners and corporate law academics to get their quantitative assessment of the impact of staggered boards on bid outcomes.⁵² Among M&A lawyers, the mean estimate for likelihood of remaining independent increased by only 5% when the target had an effective staggered board.⁵³ Among corporate law academics, the mean estimate

50. See *Bausch & Lomb Votes By Shareholders Go Against Management*, WALL ST. J. (April 30, 1997) at B7 (reporting 28 million shares voted in favor of one-year terms, 17 million shares voted opposed, and 0.3 million abstentions).

51. Selected comments are illustrative: “Once somebody starts, and commits to the deal, the ego of the CEO, etc., generally drive it to completion. . . . Like everything else, it’s the price that determines whether or not the deal is successful.” “Given that the target is put into play, it’s likely to go. If a bidder is willing to pay, it will succeed. If it is not willing to pay, someone else will come along.” This conventional wisdom seems to hold among bankers (“Bankers will come to you and say, ‘Life will now change for you—either you will be bought by [the hostile bidder] or you will be bought by someone else.’”) and gets transmitted to clients (“Our investment bankers and everybody told us that once a hostile bid is made, 80% are successful. So we assumed . . . that we were going to be taken over one way or another.”).

52. Before the presentation, each participant was asked to answer two questions: (1) what is the overall likelihood of a target remaining independent once a hostile bid has been made; and (2) what is the likelihood of a target remaining independent once a hostile bid has been made, if the target has an effective (non-evadable) staggered board? Each respondent individually wrote his or her response on a note card without discussion. Respondents only identified whether they were an academic or a practitioner. Responses were tabulated anonymously and reported back to the group. Respondents did not know they would be asked to answer these questions when they arrived at the seminar.

53. The mean estimate among practitioners increased from 12% (independence rate against bids for targets overall) to 17%.

for the likelihood of remaining independent increased by 9%.⁵⁴ As we will show in Part IV, the actual effect is several times larger than these estimates. The business press also holds the view that the presence or absence of a staggered board is relatively unimportant.⁵⁵

However, it is important to note that our argument does not depend on this characterization of the conventional view. In separate work, we plan to study more rigorously the extent to which this view exists, and, if widespread, what are the sources of the misperception that sophisticated parties seem to have adopted.⁵⁶ In this article, we show only that staggered boards have a substantial and powerful antitakeover effect. Whether market participants have fully understand this point is not important, though our evidence compiled to date suggests that they have not.

III. THE SPECIAL ANTITAKEOVER POWER OF STAGGERED BOARDS

In Part II we showed that staggered boards are an important part of the corporate landscape today. We also argued that the standard non-takeover related justifications for staggered boards (board independence and board stability) are relatively unconvincing, and that the empirical evidence on staggered board incidence is most consistent with the view that staggered boards are motivated primarily by antitakeover reasons. In this Part we develop a theory demonstrating that staggered boards are in fact extremely potent as an antitakeover device. In the next Part we provide large-sample empirical evidence in support of this theory.

Parts III.A and III.B provide a brief chronology of the important Delaware case law, noting the dramatic changes brought about by the arrival of the poison pill in 1984. Part III.C summarizes the existing regime and identifies the three types of targets that now exist. Part III.D analyzes the “delay problem,” and demonstrates that ESB’s impose even more delay on bidders than alternative regimes, currently

54. The mean estimate among corporate law academics increased from 38% to 47%.

55. See, e.g., Avrum D. Lank, *Hostile Takeover Attempts Force Investors to Make Tough Decisions*, MILWAUKEE J. SENTINEL, Jan 11, 1998, at Business 2 (“Only infrequently does a company put in play by a hostile takeover offer emerge intact.”); Anita Raghavan, *In Europe, a New Storm Over Takeover Rules*, WALL ST. J., Dec. 5, 2000, at A21 (“In the case of unsolicited, hostile offers, most boards ultimately cave in to shareholder pressure and dismantle their antitakeover defenses.”).

56. The existence of such misperception among sophisticated parties would suggest an arbitrage opportunity based on the empirical evidence compiled here. Others have identified an arbitrage opportunity in a similar context. See Paul A. Gompers, Joy L. Ishii & Andrew Metrick, *Corporate Governance and Equity Prices* (NBER working paper 8449) (August 2001) (finding lower shareholder returns for companies with more takeover defenses among a large sample of U.S. public companies).

not permitted, which would allow biennial or triennial election of a single class of directors. Part III.E focuses on the “two-election problem” to show that the potency of an ESB against a hostile bid goes beyond delay. We conclude from this analysis that the ballot box safety valve, which Delaware courts relied on so heavily in the development of their takeover jurisprudence over the past two decades, is rendered virtually ineffective against an ESB target.

A. *Before the Pill*

Even before the pill, a staggered board was considered to be a defense, though a rather weak one.⁵⁷ Basically a staggered board would delay a bidder’s ability to take control over the board until two annual elections were over, even if the bidder owned a majority of the shares through a successful tender offer. This outcome would make the hostile acquisition of a control block less desirable, because capturing the benefits of control would be delayed for as long as two years.

The pre-pill staggered board was nevertheless weak, for several reasons. First, a staggered board did not prevent a bidder from acquiring a controlling block and creating a situation in which, albeit with some delay, it would definitely gain control. Thus the staggered board did not impede the acquisition of a controlling block; it only delayed the ability of the buyer to exercise its voting power. Put differently, a bidder who needed to know (say, for strategic planning purposes) whether it would be able to gain control of Company X could find out the answer without delay. At most, the realization of that control would be delayed, but it would be inevitable.

Second, it was generally believed that, if a bidder were to acquire a majority of the shares of a company with a staggered board, it would not in fact take the buyer two elections to gain control of the board because the board could be expected to resign.⁵⁸ There were two reasons for this prediction. First, the board would have little legitimacy continuing to serve when a majority of the shareholders clearly did not wish it to stay. Staying would likely hurt the personal reputations of the board members. Second, this reputational cost would come with little benefit, because eventually losing independence was a certainty, and because an incumbent board could accomplish little against the will of a controlling shareholder. At best, incumbent directors could hang on for a bit

57. See ROBERT CHARLES CLARK, *CORPORATE LAW* 576 (1986) (listing SB’s as takeover defenses but characterizing them as fairly weak); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 *STAN. L. REV.* 819 (1981).

58. See Gilson, *supra* note 57; CLARK, *supra* note 57, at 576 (“In practice, of course, the incumbent directors would often find it in their interest to come to terms with the new controlling shareholder.”).

longer, delaying the ability of a majority shareholder to use freely its impending control position. All of this made mass resignation a highly likely scenario.

B. *Enter the Pill*

The pill dramatically changed how quickly a board could be replaced by shareholders. In the era of the pill, a potential buyer would need an election not to use the voting power of the block it had already acquired, but rather to buy the block in the first place. Pills made staggered boards important.

1. *The pill and the power to keep it.*

Poison pills⁵⁹ consist of stock warrants or rights that allow the holder to buy an acquirer's stock (a so-called "flip over" provision), or the target's stock (a "flip in" provision), or both, at a substantial discount from the market price. These rights only become exercisable in the event that a shareholder (the "acquiring person") buys more than a certain percentage of the target's stock (typically 10 or 15%) without the target board's approval.⁶⁰ These rights are explicitly *not* exercisable by the acquiring person, so the resulting dilution in his voting power and economic stake may make the acquisition of the target through market purchases too expensive to pursue. Although in theory a hostile bidder could "break through" a poison pill by triggering it, suffering the resulting dilution, and continuing to buy shares, no bidder has ever done so in our fifteen-plus years of experience with the pill.⁶¹ In practice, then, the pill provides an impenetrable barrier to control acquisitions. As long as the pill remains in place, no other

59. Throughout, "pill" and "poison pill" means a standard poison pill, which permits redemption by the target board, however constituted, at any time. We treat separately pills that attempt to interfere with proxy fights and/or a target board's ability to redeem the pill (so-called "dead hand" or "slow hand" pills).

60. For a description of the common features of a poison pill, see Wachtell, Lipton, Rosen & Katz, *The Share Purchase Rights Plan*, reprinted in RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 10-18 (2d ed. Supp. 1999). For a description of how a pill is implemented, see John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 287 n.62 (2000).

61. Sir James Goldsmith threatened to trigger Crown Zellerbach's pill in his hostile bid for that company. The threat was sufficiently credible that Crown Zellerbach negotiated a friendly deal with Goldsmith. See Mike Tharp, *Goldsmith Wins Fight for Crown Zellerbach Corp.*, WALL ST. J., July 26, 1985, at 3. This bid was cited in *Moran* as evidence that the pill was not impermeable. However, both the Crown Zellerbach pill and the Moran pill only had "flip over" triggers, not the more potent "flip in" triggers that soon became commonplace.

defensive measures are necessary because the bid is completely blocked. Defensive measures might be needed, at most, to protect the pill itself.

Protecting the pill, however, is not as easy as it might seem, since at any time a pill can be redeemed by the target's board. This provision allows the target board to permit a friendly bidder to proceed, but it also allows a hostile bidder to redeem the pill and proceed with its own bid if it can gain control of the target's board. Efforts to cut off this line of attack by making pills nonredeemable ("no hand" provisions), allowing only continuing directors to redeem the pill ("dead hand" provisions), or delaying redemption for a specified time after a change in board composition ("slow hand" provisions) were invalidated by a New York court in the 1980s and by the Delaware courts in the late 1990s,⁶² although dead hand pills have been legalized in Pennsylvania, Maryland, and Georgia.⁶³ Thus, at the turn of the millennium, the pill remains vulnerable to a successful proxy attack at the vast majority of public companies.

Moran v. Household International (1985)⁶⁴ was the seminal case upholding the poison pill. The Delaware Supreme Court ruled that the business judgment rule applied to Household's decision to adopt a poison pill, but was careful to state that the right to use a pill was not "absolute": "When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, they will not be able to arbitrarily reject the offer."⁶⁵ The court went on to explain that managerial decisions to redeem the pill when faced with a tender offer would be subject to judicial scrutiny under *Unocal*.

Two years later, in *City Capital Associates v. Interco Inc.* (1988),⁶⁶ Chancellor William Allen held that a pill being used by the incumbent board to resist a noncoercive tender offer had to be redeemed. The use of the pill to defeat the offer, Chancellor Allen concluded, was not proportionate to any legitimate threat posed by the tender offer. Another two years later, in *Paramount Communications*

62. See cases cited at *supra* notes 33-34.

63. See MD. CODE ANN., CORPS. & ASS'NS § 2-201(c)(2)(ii) (2000) (allowing directors to limit the power of future directors to vote for redemption, modification, or termination of shareholder rights plans for up to 180 days); *Invacare Corp. v. Healthdyne Tech.*, 968 F. Supp. 1578, (N.D. Ga. 1997) (upholding dead hand pill under Georgia law); *AMP v. Allied Signal*, No. 98-4405, 1998 U.S. Dist. LEXIS 15617 at *34-35 (E.D. Pa. Oct. 8, 1998) (upholding slow hand pill under Pennsylvania law).

64. 500 A.2d 1346 (Del. 1985).

65. *Id.* at 1354.

66. 551 A.2d 787 (Del. Ch. 1988). Cf. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986) (striking down takeover defenses under *Unocal*); *Grand Metropolitan Public Ltd. Co. v. Pillsbury*, 558 A.2d 1049 (Del. Ch. 1988) (same).

v. Time (1989),⁶⁷ the Delaware Supreme Court explicitly rejected Chancellor Allen's approach in *Interco*, and seemed to suggest instead that the right to reject a hostile bid was close to absolute, at least in some circumstances: "Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is *clearly no basis* to sustain the corporate strategy".⁶⁸ The Court found that Time's characterization of Paramount's all-cash, 100% tender offer as "inadequate" was sufficient basis for Time to pursue its acquisition of Warner, and thus (given Paramount's unwillingness or inability to bid for a combined Time-Warner) to deny Time shareholders the opportunity to decide for themselves whether Paramount's bid was inadequate. While Delaware jurisprudence does not say that courts will never order the redemption of a poison pill, there has not been since *Time* a single case in which redemption of a pill was ordered by a Delaware court. Thus, as a practical matter, a bidder has had to assume in planning a bid that a target could "Just Say No" and retain a pill unless and until the bidder obtained majority control of the target's board.

*Moore v. Wallace Computer*⁶⁹ illustrates how far the "Just Say No" defense can go under current Delaware law. Here, the federal district court for Delaware, applying *Unocal*⁷⁰ in the wake of *Unitrin*,⁷¹ held that the Wallace Computer board would receive the protection of the business judgment rule in its "Just Say No" defense against Moore's hostile bid. Applying the two-pronged enhanced scrutiny test set out in *Unocal*, the court first found that the Moore offer posed a threat to Wallace because Wallace shareholders "might tender their shares in ignorance or mistaken belief as to management's representations of intrinsic value and future expectations."⁷² Applying the second prong of the enhanced scrutiny test, the court went on to approve Wallace's refusal to redeem its poison pill, on the grounds that such defensive tactics were reasonable because they were proportionate to the threat from Moore and "not draconian."⁷³

The district court's decision in *Wallace Computer* represents a logical extension

67. 571 A.2d 1140 (Del. 1989).

68. 571 A.2d at 1154 (emphasis added). As some commentators observed, however, the Court in *Paramount v. Time* expressly noted that Paramount (the bidder) had not raised, and the court was thus not addressing, the question of whether Time (the target) could be required to redeem its poison pill in the face of Paramount's offer.

69. 907 F. Supp. 1545 (D. Del. 1995).

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

71. *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

72. *Wallace Computer*, 907 F. Supp. at 1557. It is possible that Delaware state courts might decline to follow the Third Circuit's holding in *Wallace Computer*, but they have yet to do so or to repudiate the "Just Say No" case in dicta.

73. *Wallace Computer*, 907 F. Supp. at 1563.

of *Time*—one would be hard-pressed to find a meaningful distinction in the abstract between a corporate strategy that involves a strategic merger (*Time*) and a corporate strategy that involves internal growth (*Wallace*). Yet the court's willingness to accept the "shareholder ignorance" argument seems to represent an important extension of "Just Say No."⁷⁴ While there may be alternative policy grounds to uphold the "Just Say No" defense, the *Wallace* court passed on the opportunity to set fiduciary duty constraints on how a target board deploys a pill. If these limits exist, *Wallace* suggests that they have moved well beyond their cautious origins in *Moran*.⁷⁵

2. *The ballot box safety valve.*

In developing the jurisprudence that today allows a target board to maintain the pill indefinitely, the Delaware courts relied explicitly on there being a safety valve against managerial abuse through the shareholder franchise. Because shareholders can replace the board, if the board were to sacrifice shareholder interests by maintaining the pill, the bidder or someone else (e.g., an arbitrageur) could run a proxy contest promising to elect a board that would redeem the pill and clear the way for the acquisition desired by shareholders. Indeed, the Delaware courts, at the same time that they seemed to be giving license to boards to maintain the pill indefinitely and otherwise block a bid, also indicated that they would protect against managerial moves to impede voting by shareholders to remove them.⁷⁶

The seminal case on this point is *Blasius Industries, Inc. v. Atlas Corp.*⁷⁷ In *Blasius*, the hostile bidder, Atlas, solicited written consents to increase the size of the Blasius board from seven to fifteen members, as well as to elect eight new members nominated by Atlas. In response, the Blasius board met through conference call and voted to increase the size of the board by two (thus making seven directors no longer sufficient for control). While refusing to adopt a *per se* rule against such conduct, Chancellor Allen invalidated the Blasius board-packing action on the ground that it violated the shareholders' fundamental right to elect directors: "The shareholder franchise is the ideological underpinning upon which

74. See Neil C. Rifkind, *Should Uninformed Shareholders Be a Threat Justifying Defensive Action by Target Directors in Delaware?: "Just Say No" After Moore v. Wallace*, 78 B. U. L. REV. 105 (1998).

75. Cf. Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511 (1997).

76. See *Unitrin*, 651 A.2d at 1373.

77. *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). See also *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992).

the legitimacy of directorial power rests.”⁷⁸ *Blasius* illustrates how the Delaware courts will protect the proxy contest route, because this route provides the basis for the courts’ deference to target managers in their use of structural defenses.

In the current legal regime, then, if the board wants to maintain the pill and not sell to a hostile bidder, the only way to gain control passes through the ballot box. The bidder will have to replace the board with one willing to redeem the pill. Winning control of the board via election of new directors became a prerequisite for buying a control block through a hostile acquisition. How much of an impediment this prerequisite causes is the question that we address below.

3. *The need for a ballot box safety valve.*

Before analyzing the viability of the shareholder referendum safety valve, we pause to determine whether this safety valve is even necessary. It might be argued that having the formal power to “Just Say No” does not mean that the board will use this power to prevent acquisitions that shareholders would like to have. Instead, managers might have sufficient incentives to avoid such results, if market forces and compensation schemes sufficiently align the interests of managers and shareholders. One reason that is given is the carrot stemming from executive compensation schemes.⁷⁹ Most stock option packages vest immediately in the event of takeover, which may provide substantial gains to executives in the event of a premium acquisition; golden parachutes, too, can provide extremely large side-payment to managers in the event of takeover.⁸⁰ If stock options and parachutes are sufficiently large, managers would use defenses to gain bargaining power but in the end would prefer to sell rather than remain independent.

Another reason that a safety valve might not be necessary is the presence of independent directors. Even if the executives on the board wish to remain independent, goes the argument, other directors will not let them do so if accepting the bid would maximize shareholder value. The independent directors will be willing to go along with saying no in order to get a higher price or to seek out a competitive alternative, but they will not agree to cause substantial harm to shareholders because that would hurt their reputation or would subject them to social or professional adverse consequences.⁸¹

78. See *Blasius*, 564 A.2d at 659.

79. See generally Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q. J. ECON. 653 (1998) (documenting the dramatic increase in U.S. stock option compensation in the 1990s).

80. See generally John C. Coates IV & Reinier Kraakman (working paper, on file with the authors) (discussing the effect of options and parachutes on incentive to sell).

81. Cf. Interview with partner at major Wilmington, Delaware law firm (Feb. 15, 2001) (“What we [the bidder] want to do is put directors in an irreconcilable position, where

We agree that the carrot of stock options and golden parachutes, and the potential stick supplied by independent directors, may sufficiently align directors and managers with shareholders. When this happens, we do not need a safety valve, because even absolute power to block bids would not be abused. But our premise, as is the premise of Delaware law, is that it would be unwise to rely solely on these incentives to align the interests of managers and shareholders. Indeed, any inquiry that seeks to evaluate alternative takeover arrangements (short of an outright ban on takeovers) implicitly assumes that these arrangements matter, which is the case only if managers' interests do not always coincide with those of shareholders. While such coincidence might happen occasionally, or perhaps often, it is unlikely to happen always. The takeover context in particular is one in which there is potential divergence between managers' and shareholders' interests. Furthermore, how often managers will do the right thing will depend on the consequences they face when they do not do the right thing. A safety valve that operates well is important not only in cases in which it is actually used, but also in cases in which its presence influences managers to do the right thing on their own.

Therefore, a safety valve is necessary. In the remainder of this Part, however, we argue that the safety valve is illusory when the target has an ESB. In the next Part we present empirical evidence in support of this view. This theory and evidence is particularly troubling because courts have relied on the ballot box safety valve as if it is viable. In Part V we suggest modifications to the Delaware takeover jurisprudence that would bridge this gap between the theoretical role for the ballot box and its actual functioning.

C. *Three Types of Targets*

In Part III.B above, we argued that, because the Delaware courts chose to give managers unfettered ability to use the poison pill, board control became a prerequisite for gaining voting control of a company rather than an *ex post* cleanup step. The courts allowed managers such broad discretion in the use of the pill precisely because they believed in the viability of the ballot box safety valve. Pitted against a board that was not acting in its shareholders' best interests, a hostile bidder could take its case directly to shareholders through a proxy contest. In this Part we begin addressing the question of whether the ballot box is a viable safety valve. Put differently, how much of an impediment is it to require a hostile bidder to win control of the board via election? The answer to this question, as we will show below, depends on the speed with which the bidder can gain access to the election mechanism.

Targets can be staggered into three categories with respect to their

they are not willing to sit around and take risks that implicate their fiduciary duty.”).

vulnerability to a proxy contest: no minimum term (NMT); effective annual term (EAT); and effective staggered board (ESB). In this Part we describe each of these three categories in more detail. In the next Part we examine the delay imposed on the proxy route for a hostile bidder facing targets in each of these categories.

1. *No minimum term.*

Consider the scenario in which the target has a pill, but does not have any other structural defenses that would prevent the bidder from marshaling support from shareholders to replace the board immediately. We classify these targets as no minimum term (NMT) targets. To fit into this category, the target's shareholders must have the ability to act by written consent⁸² or act through special meeting.⁸³ In addition, the target's shareholders must have the ability either (1) to remove directors without cause (and then petitioning the court to order a new election of directors),⁸⁴ or (2) to "pack the board" by increasing the number of directors and filling the vacancies created.⁸⁵

Against a NMT target, the bidder will announce its offer and run a proxy contest to replace the board, either through special meeting or through shareholder written consent. If elected, the slate offered by the bidder will commit to withdrawing the pill and accepting the bidder's offer. The proxy contest, therefore, will essentially be a referendum on the offer. Shareholders will vote in favor of the bidder's team if and only if they view the bidder's offer as superior to

82. Delaware firms may act through written consent unless prohibited in the firm's charter or bylaws. *See* DEL. CODE ANN. tit. 8, § 228(a) (2000). Forty-two states that follow the RMBCA reverse this rule, allowing shareholders to act only through unanimous written consent (which effectively bars action through written consent). *See* MODEL BUS. CORP. ACT § 7.04 (1999).

83. Delaware firms are prohibited from calling a special meeting unless otherwise specified in their charter or bylaws. *See* DEL. CODE ANN. tit. 8, § 211(d) (2000). Forty-one states that follow the RMBCA reverse this rule, allowing shareholders to call a special meeting on the call of 10% of the shareholders, unless prohibited at the firm level. *See* MODEL BUS. CORP. ACT § 7.02 (1999).

84. *See* DEL. CODE ANN. tit. 8, § 141(k) (2000) (allowing removal of directors without cause unless there is a staggered board); MODEL BUS. CORP. ACT § 8.08 (1999) (allowing removal without cause regardless of whether there is a staggered board). *See also* Coates, *supra* note 2, at Appendix B; Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Effect of Takeover Defenses* (work in progress).

85. DEL. CODE ANN. tit. 8, § 141(b), § 142(e) (2000) (allowing number of directors to be set in either the by-laws or the charter, and providing that the board shall fill vacancies unless otherwise provided for in the by-laws); MODEL BUS. CORP. ACT § 8.03(a), § 8.10(a) (1999) (allowing the number of directors to be set in either the by-laws or the charter, and allowing either shareholders or the board to fill vacancies).

remaining independent.

At the margin, requiring a proxy contest in this scenario may deter some value-creating bids that would have been made but for the incremental cost of the proxy contest. However, this social loss is offset by the social benefit of eliminating the pressure to tender. Without a shareholder referendum, shareholders may tender to the hostile bidder, even if they do not judge the offer to be value maximizing, for fear of being frozen out at an unattractive price should the offer succeed. By tendering, each individual shareholder eliminates this risk.⁸⁶ The proxy contest eliminates this collective action problem because shareholders will not be penalized if they vote against the bid and the bid is still approved. Therefore, shareholders will not vote in favor of the bid unless they want the bid to succeed. The bidder will win the referendum only if a majority of the shareholders view the offered acquisition price as exceeding the target's independent value, an "undistorted choice" that yields the socially optimal outcome.⁸⁷

In short, a proxy contest provides a viable safety valve in the specific context of an unstaggered board that can be removed immediately. IBM's hostile bid for Lotus illustrates how this mechanism can work. In June 1995, after months of friendly overtures, IBM launched a \$60-per-share all-cash hostile bid for Lotus, representing more than a 100% premium over Lotus's pre-bid share price (though slightly less than its 52-week high of \$59.50). When the Lotus board declared the offer inadequate and refused to redeem its poison pill, IBM solicited written consents from shareholders, as permitted by Delaware law,⁸⁸ seeking to replace all six Lotus directors. Lotus, meanwhile, searched for a white knight, reportedly approaching AT&T, Hewlett-Packard, and Intel.⁸⁹ On June twelfth, less than a week after IBM announced its offer, Lotus capitulated and agreed to a sweetened \$64 per share friendly deal. The breathtaking pace of the deal, "one of the fastest capitulations ever in a hostile takeover,"⁹⁰ occurred because IBM was able to force a shareholder referendum that it almost certainly would have won. Thus, without any provisions that delay or complicate the election process, the pill does not enable managers to impede for very long an offer that shareholders find attractive. As IBM/Lotus illustrates, the proxy contest safety valve works effectively when

86. See Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985).

87. See *id.*

88. See DEL. CODE ANN. tit. 8, § 228(a) (2000) (permitting shareholder action through written consent).

89. See Steven Lipin & Laurie Hays, *IBM Is Seeking to Force Ouster of Lotus Board*, WALL ST. J., June 7, 1995, at A3.

90. See Laurie Hays & Steven Lipin, *Lotus Gives In and Accepts IBM Offer of \$3.52 Billion, a Sweetened \$64 a Share*, WALL ST. J., June 12, 1995, at A3.

the board is not staggered and immediate removal is possible.

2. *Effective annual term.*

Now consider a scenario in which the bidder cannot replace the target board immediately, but can do so at the next annual meeting of shareholders. We classify these targets as effective annual term (EAT) targets. To fit into this category, the target must have eliminated the ability for shareholders to act by written consent and the ability to act at a special meeting or, alternatively, have both eliminated the power of shareholders to remove directors without cause and eliminated the ability of shareholders to “pack the board.” In addition, if the board is staggered, the hostile bidder must be able to dismantle the staggered board at the annual meeting in one of the ways specified above.⁹¹

As with NMT targets, in this scenario the bidder will announce its offer and run a proxy contest to replace the board. If elected, the slate offered by the bidder will commit to withdrawing the pill and accepting the bidder’s offer. The only difference between EAT and NMT targets is that here the bidder will have to wait until the next annual meeting of shareholders, which could be as long as 13 months away,⁹² before it can get an up-or-down verdict from shareholders.

On the one hand, there are many socially desirable reasons that the bidder might be unable to wait—the bidder may need to plan, may need to know where it stands, etc. Furthermore, the benefits might dissipate if the bidder has to wait—for example, if the bidder needs certain assets now, not a year from now. Therefore, by imposing costs of delay on bidders, the proxy contest route may not provide a sufficient safety valve against disloyal board members of EAT targets, in that some socially beneficial hostile takeovers may be deterred. On the other hand, a bidder who is so time-sensitive may be acting opportunistically—for example, trying to “scoop up” the target’s assets at a bargain price. Requiring the bidder to wait in this scenario could actually be socially beneficial.

Whether the delay required against EAT targets is socially efficient is beyond the scope of our project. This discussion at least illustrates that EAT targets are vulnerable to a rapid proxy fight immediately before their annual meeting. NMT targets, meanwhile, are always vulnerable to a rapid proxy fight; therefore the proxy contest is always an effective safety valve. There is a third class of targets—those with “effective staggered boards”—that are never vulnerable to a rapid proxy fight. We assess the viability of the proxy fight safety valve against these types of targets in the next section.

91. See *supra* text accompanying note 85-85.

92. See Koppes, Ganske & Haag, *supra* note 9.

3. *Effective staggered board.*

The third scenario—and the one in which we focus for the remainder of this article—is the scenario in which the bidder must go through two annual meetings in order to gain majority control of the target’s board. We classify these targets as effective staggered board (ESB) targets. To fit into this category, the target must have a staggered board, with at least three classes of directors,⁹³ which cannot be dismantled in any of the three ways specified above.⁹⁴

In this scenario, the bidder has no choice but to wait through two annual meetings in order to gain control of the board.⁹⁵ As with NMT and EAT targets, the bidder will announce its offer and run a first proxy contest to gain one-third of the target’s board seats. Unlike NMT and EAT targets, however, the bidder’s candidates will not be able to commit to withdrawing the pill if elected, because they will be in the minority. Instead, they will bide their time for a year, until a second annual election of directors will (hopefully) give the bidder a majority of board seats. At that time the board will vote to redeem the pill, paving the way for the target to accept the bidder’s offer.

93. A hostile bidder could gain 50% control of the board in just one proxy contest against a target with two classes of directors. (A particularly lucky hostile bidder might even win control of the board in one election if the target had an odd number of directors and the proxy contest were brought in the “right” year.) This qualification is technically necessary, though few staggered boards have only two classes of directors. For ease of exposition we assume a three-class staggered board throughout the remainder of our analysis (which is by far the modal staggered board), though our arguments on the potency of ESB’s take on even more force if the staggered board has four classes.

94. *See supra* text accompanying note 85. Note that shareholders’ ability to call a special meeting and shareholder ability to act by written consent are irrelevant in determining whether the target has an ESB. The reason is that even if shareholders can act early, if they cannot dismantle the staggered board then there is no action that they can take.

95. If the target has cumulative voting, and if insiders own a sufficiently large stake, then it may take three elections for the bidder to gain control of the board because the insiders may be able to preserve one seat in each election. For example, if there are three classes of three directors each, and insiders own 34% of the shares, insiders can elect one director in each election. *See* CLARK, *supra* note 57, at 363 (defining minimum number of shares required to elect one director under a cumulative voting system). After two elections, the bidder would have won four seats (not six) and still would not control a majority of the board. For our analysis we make the simplifying assumption that the target does not have a cumulative voting system. In fact, cumulative voting is relatively uncommon in real companies—in our IRRC sample, for example, approximately 10% of firms with staggered boards also had cumulative voting, yielding 6% of the total sample that had both a staggered board and cumulative voting.

U.S. Surgical's hostile bid for Circon illustrates the difficulty of this route.⁹⁶ In August 1996, Surgical launched a 100% cash tender offer for Circon at \$18.00 per share, representing almost a 70% premium over the pre-announcement share price. On the advice of Circon's outside counsel Wilson Sonsini, Circon installed a "morning after" poison pill with a 15% trigger immediately after the Surgical bid was launched. Circon's staggered board was provided in the charter, but Circon's bylaws specified that the number of directors would be set by a majority vote of the board.⁹⁷ While this configuration of defenses suggested at least the potential for board packing, Circon's bylaws also specified a two-thirds vote requirement (of outstanding shares)⁹⁸ which effectively eliminated this route.⁹⁹ Taken together, these provisions blocked removal and board packing and gave Circon an ESB. Surgical therefore began the prolonged process of going through two annual meetings to gain control of Circon.

In October 1997, more than a year after the bid had been launched, Surgical put up a dissident slate of directors and won two seats on Circon's board. Plans to put up a second slate of directors in October 1998, which would have almost certainly led to gaining control, were cut short when Surgical sold itself to Tyco in June of that year. Because Tyco had a policy of not making hostile acquisitions, Surgical withdrew its bid for Circon. In September 1998, under pressure from arbitrageurs (who threatened to run their own slate of directors), Circon sold itself in a friendly deal to Maxxim Medical Inc. for 17% less than the original Surgical bid, two years earlier.

Surgical's bid for Circon illustrates the difficulty of the proxy route. In fact, to our knowledge, no bidder has successfully fought through two proxy contests to win control of an ESB target.¹⁰⁰ This fact suggests that the ballot box is not a viable

96. See Hall, Rose & Subramanian, *supra* note 32.

97. Circon Bylaws § 3.3.

98. Circon Bylaws § 9.2.

99. Circon CEO Richard Auhll owned 12% of the company, and company insiders (employees and directors) held another 13%. See Hall, Rose & Subramanian, *supra* note 32, at 4. Thus Surgical would have had to win 89% of the remaining shares in order to successfully amend the bylaws. While this would have been at least mathematically possible, it was made even more difficult by the fact that 10-15% of the shares typically do not vote, for miscellaneous reasons, in proxy contests (e.g., they are out of the country, or they do not know they own the stock). Surgical could afford, at most, 8% shareholder nonparticipation, and 100% voting in favor among the remaining shareholders, in order to successfully pack the board. That Surgical did not even attempt this route—and chose instead the "easier" path of waiting through two annual elections—suggests its difficulty.

100. When this article was presented at a "bridge group" of academics and practitioners at New York University Law School in April 2001, some practitioners claimed to recall situations in which a bidder had in fact won two elections against an

safety valve against an ESB target. The next Part provides a theoretical explanation for why this is true.

D. *The Delay Problem*

In this Part we examine how quickly a hostile bidder can gain control of a target through the proxy route. We compare the three types of targets that we defined in Part III.C above—NMT targets, EAT targets, and ESB targets. In addition, we analyze the delay that would be imposed against hostile bidders in two hypothetical regimes—targets with effective biennial terms, in which a single class of directors is elected every other year (and midterm removal is not possible), and targets with effective triennial terms, in which a single class of directors is elected every third year. We first consider the average delay that is imposed against hostile bidders, and then we turn to the minimum delay that is imposed.

1. *Average delay.*

We make some simplifying assumptions without loss of generality. First, we assume that once a hostile bidder emerges, it has infinite patience and determination and will continue to pursue the deal to completion.¹⁰¹ Second, we assume that the target's shareholders are unanimously in favor of the bid, and will vote for the bidder in any elections that take place. Third, we assume the target's incumbent board (which by assumption does not own any shares) is unanimously against the bid, and will take all possible actions (within the extent permitted by the law) to prevent the bid from succeeding.

Comparison of existing regimes. With these assumptions in place, we now want to determine how long it will take for the bidder to acquire control, after initiating a hostile bid that shareholders would like to accept. The simplest case is NMT targets. Here, the hostile bidder can gain control within a matter of months, regardless of when the bid is launched relative to the annual shareholder meeting. IBM's hostile bid for Lotus, described in Part III.C.1. above, provides the clearest example of this case. For simplicity, we describe the delay imposed against NMT targets as zero.¹⁰²

ESB, but no one could provide a specific example of such an event. If such examples exist, they occurred before 1996—in Part IV we examine all proxy contests against ESB's between 1996 and 2000, and find no contests in which a bidder had won two elections against an ESB.

101. Later we explore the implications of relaxing this assumption. See *infra* Part III.D.2.

102. For completeness, we note that even bids for NMT targets are subject to some legal delay, due to SEC filing requirements, and notice requirements under state law and target charters and bylaws. Targets vulnerable to written consent solicitations will be

Next we consider EAT targets. Within this category, when the incumbent board loses a single proxy contest, it is out of office and the hostile bidder wins. Accordingly, the longest delay that would be imposed against an EAT target would be a full year, if the bidder appeared immediately after the target's shareholder meeting. The shortest delay against an EAT target would be zero, if the bidder appeared immediately before the target's shareholder meeting. If we assume that hostile bids are distributed uniformly throughout the year and are uncorrelated with annual meetings dates,¹⁰³ then the average delay imposed against EAT targets is six months.

Now consider the case of ESB targets. With an ESB, unlike an EAT, losing the first battle does not mean losing the war for the target's board. Against an ESB, a hostile bidder will have to win two proxy contests in order to gain majority control of the board. If the hostile bidder appears immediately after the target's annual meeting, it will wait one year, win a first election, wait another year, and finally have majority control of the board after two years. If the hostile bidder appears just before the target's annual meeting, it will win one-third immediately, but will have to wait another year to gain control, resulting in a total wait of one year. On average, and assuming the same uniform distribution of bids as described above, a hostile bidder against an ESB will face a delay of one-and-a-half years.

Recall the argument that Gilson and others made,¹⁰⁴ and with which we agreed,¹⁰⁵ that, before the pill, directors would not hide behind their staggered board but would resign if a bidder bought a majority of the shares. Couldn't one similarly expect that, even after the pill, if the board loses one election, it would in fact resign even though it could stay in power for another year? The answer is no.

more vulnerable than those vulnerable to special meeting calls, because a consent solicitation takes effect when filed with a target, whereas a special meeting typically requires a solicitation to call the meeting, and another solicitation to obtain proxies for use at the meeting. Still, NMT targets are vulnerable to much more rapid proxy fights (and hence, bids) than EAT and ESB targets.

103. This assumption is valid if bidders make bids immediately after identifying targets that they would like to purchase, and that such findings and the business needs of bidders are in no way correlated with the election calendars of target. Admittedly, this assumption is not completely valid – in a preliminary analysis we find that more than half of all annual meetings occur in April and May, and that there is a slight increase in hostile bid activity in the preceding two to three months. This sensitivity to annual meeting date is slightly greater against targets with ESB's. These findings suggest that the observable delay against the various types of targets, and particularly against ESB's, is slightly less than we estimate in our theoretical analysis. Still, as we show in Part IV, the impact of ESB's on bid outcomes is substantial.

104. See Gilson, *supra* note 57.

105. See *supra* text accompanying note 58.

The reason is that the incumbents still have a reason to fight with an ESB. Before the pill, when a bidder acquired a majority of the shares, further resistance would be futile. It would be simply be a matter of time before the target would be required to hold the perfunctory annual meeting that would displace an additional one-third of the board, thus giving the bidder control. Far better to exit gracefully, in this scenario, than be forced out a year later.

In contrast, with an ESB, the fight against the bidder is not doomed, because it is far from certain that the bidder will win the next election.¹⁰⁶ In the context of U.S. Surgical's hostile bid for Circon, for example, Circon board member George Cloutier provided this advice to his CEO, friend, and Harvard Business School sectionmate Richard Auhll:

I told Richard "Let's just wait it out." You never know what is going to happen. We're not going to give up here. We're staying until the last gun is fired. . . . That was my position: we fight until the last minute, last day, last hour, and something will happen. And I was actually right.¹⁰⁷

Indeed, with an ESB in place, a target board can reasonably attempt to wait it out. The target's share price may increase through the bid price (as was the case with Wallace Computer), a white knight may appear (Younkers), the bidder may lose interest or its ability to pursue the bid (Circon), or other unforeseeable circumstances may intervene (e.g., accounting fraud at Cendant forced it to abandon its bid for American Bankers¹⁰⁸). Thus the reasoning that Gilson and others offered in the pre-pill era no longer applies. With the pill, the board will no longer exit gracefully after losing the first proxy contest. Dissident directors may be uncomfortable or a nuisance to the incumbent board members, but with an ESB dissidents have little to no real power after a single election.¹⁰⁹

106. See John C. Coates IV, *An Index of the Contestability of Corporate Control: Studying Variation in Legal Takeover Vulnerability* (working paper July 17, 1999).

107. Interview with George Cloutier in Waltham, Mass. (Sept. 8, 2000), transcript at 15.

108. This example is imperfect because the fraud occurred after Cendant's bid had been accepted. See Emily Nelson, Leslie Scism & Steven Lipin, *Cendant Stock Plummets 46.5% on News That Accounting Woes Hurt Earnings; Pending Plan to Acquire American Bankers Is Put In Doubt by Price Drop*, WALL ST. J., Apr. 17, 1998, at A3.

109. See, e.g., memo from Richard Auhll to Circon employees (Sept. 30, 1997) ("[K]eep in mind that even if U.S. Surgical wins two seats on our Board, they will not have a majority and cannot force a sale of the Company. So although they may make a big deal about the results of the election, the reality is, little actually changes."), quoted in Brian Hall, Christopher J. Rose & Guhan Subramanian, Circon (B) (Harvard Business School Case Study N9-801-404) (Mar. 19, 2001). For a view from the other side, see the comments of Charles Elson, dissident director on the Circon board: "We were surrounded. Brute [Krulak, the other dissident director] and I were on opposite sides of the table, and the

Comparison to alternative regimes. For comparison purposes, we now examine the average delay under two hypothetical regimes. First, consider biennial elections of a single class of directors, without any possibility for removal in between elections. As noted earlier, all states, including Delaware, prohibit such biennial arrangements and instead require an election each year.¹¹⁰ Under this hypothetical regime, if the bidder emerged just before an election, it would not have to wait at all, and if it emerged immediately after an election (and thus two years away from the next election), it would have to wait two years. Assuming (as above) a uniform distributed of bids uncorrelated with annual meeting dates, the average delay under a biennial election arrangement would be one year. Thus a target with biennial elections would lead to longer delay, on average, relative to an EAT target (one year versus six months), but shorter delay relative to an ESB target (one year versus eighteen months).

As a second alternative regime, consider a triennial election of a single class of directors. If a bidder emerged immediately before an election, it would not wait at all; if it emerged immediately after an election it would have to wait three years. The average wait would be one-and-a-half years, which is the same delay as against an ESB target. This fact suggests that ESB's provide the same protection against a hostile bidder as a triennial election of a single class of directors. We now show, however, that other considerations might make ESB's even more potent against hostile bids than a three-year single-class arrangement.

2. *Minimum delay.*

So far we have limited our comparison to the average delay. Of course, any given bidder is influenced not by the average delay but by the delay in its particular case. We therefore now consider the distribution of potential length of delay. Table 1 summarizes the analysis from the previous section:

rest of them were all around us," cited in Hall, Rose & Subramanian, *supra* note 32, at 10.

110. See *supra* text accompanying note 6.

Table 1: Delay Imposed by Various Target Defenses (in years)

	Minimu m	Maximu m	Average ¹¹¹
No Minimum Term (NMT)	0	0	0
Effective Annual Term (EAT)	0	1	½
Effective Staggered Board (ESB)	1	2	1 ½
Biennial Election of a Single Class	0	2	½
Triennial Election of a Single Class	0	3	1 ½

Table 1 shows that, under a three-year arrangement, delay ranges from zero years to three years – thus the possibility remains open that a bidder lucky enough (or astute enough¹¹²) to emerge close to the next election would have to bear only a small delay in the event that the incumbent board rejects its offer. In contrast, with an ESB, delay ranges from one year to two years – under no circumstances can a bidder get a referendum on its offer without a delay of at least a year.

This difference is critical. At the outset of this Part we assumed that bidders have infinite patience and determination. However, there are many potential bidders whose patience is more limited. Buyers often need to have resolution, either way, and cannot allow the question to remain unresolved for more than a year. Consider a buyer that needs a certain type of asset. If it does not ultimately buy target T, then the buyer should acquire another company instead (or build the asset in-house). If T has an ESB and T's board is unwilling to sell, the buyer would be foolhardy to wait for a year (or longer) to determine whether its hostile bid against T will succeed. Instead the buyer should look elsewhere.¹¹³ Therefore an ESB should provide incumbents virtually complete protection from hostile bids, with all of the potential drawbacks in terms of managerial agency costs that are

111. This calculation assumes that bids are distributed uniformly throughout the year and are uncorrelated with shareholder meeting dates.

112. See *supra* note 103.

113. In a companion paper, however, we examine a large sample of firm-years and find no such deterrence effect. While attempts to explain this puzzling finding are at this point somewhat speculative, we document some anecdotal support for an imperfect information story (lawyers unaware of the full impact of ESB's on takeover contests), and possibly a buy-side lawyer agency story (weak incentives for lawyers to dissuade potential bidders from bringing bids). See Bebchuk, Coates & Subramanian, *supra* note 85.

associated with such insulation. In contrast, a three-year arrangement may or may not provide such protection, depending on when the bidder happens to emerge in relation to the time of the scheduled election.

Putting the same point slightly differently, an ESB condenses the distribution of delays toward the middle when compared to a triennial election of directors. It eliminates those cases in which the delay will be less than a year, but also eliminates those cases in which the delay will be more than two years. The first effect buys incumbents more protection than the possible reduction in protection caused by the latter effect. Having a significant possibility that a hostile bidder will face only a short delay will make the incumbent vulnerable. In contrast, shortening delay from two-and-a-half years to one-and-a-half years does not create very much incremental exposure for the target board, because one-and-a-half years is still a long time in a dynamic business environment. In short, the elimination of any possibility of delay below one year closes an important window of vulnerability, whereas the reduction of delay to the still long delay of one or two years is unlikely to have a significant impact.

E. *The Two-Election Problem*

So far we have seen why an ESB would impose a heavier burden on a hostile bidder than even a triennial election of directors, in terms of the delay in taking over the board. But there is another dimension, beyond mere delay. When all directors can be removed together, a bidder would have to win only one election. In contrast, an ESB requires such a bidder to win two elections, one year apart. This two-election requirement imposes an additional significant hurdle.

To see why, consider two situations, both with the same delay. In one scenario the bidder needs to win only one election, and in the other scenario the bidder needs to win two elections. To be concrete, compare (i) a situation in which all directors are elected to two-year terms, and in which a bidder emerges fifteen months before the next election; and (ii) a situation in which there is an ESB and a bidder emerges three months before the election. In both situations, delay would be fifteen months before the bidder could gain control of the board. But, as explained below, situation (ii) is more difficult for the bidder to gain control because, even though the total wait would be the same, the bidder would have to win two elections one year apart.

The problem is this: in the case of one election, once it comes, however distant in the future, the buyer will know how much it is willing to pay for the company, and will put an offer on the table. In example (i) above, the hostile bidder will wait until the election and then run a proxy contest. The bidder will announce its acquisition price concurrently with the proxy fight, which it will set on the basis of its own and general market conditions.

In situation (ii), with two votes a year a part, the bidder faces a problem. In

order to win the first election, the bidder will need to make a firm offer for the target; without a firm offer target shareholders will be reluctant to vote for the bidder's slate. But by making a firm offer, the bidder exposes itself to risk—essentially the bidder is providing the target shareholders with a year-long put option for their shares. For this reason two elections are far more difficult than one. In the discussion below we start with the general problem of winning the proxy contest without a firm offer on the table, and then turn to additional difficulties presented by an ESB.

1. *The importance of a firm offer for winning a proxy contest.*

There are strong reasons to believe that when a bidder in a proxy contest for control does not make an acquisition offer, it would be difficult for the bidder to win.¹¹⁴ Shareholders would be reluctant to vote for a bidder that does not put an acquisition offer on the table. The bidder might be interested in pursuing its own interests rather than increasing shareholder value. Because winning would provide the bidder with private benefits of control, shareholders cannot infer from the mere mounting of a fight that they will be better off if the bidder wins. Their welfare will depend on how the bidder and the incumbents compare, an assessment that shareholders may not be well-positioned to make. Being imperfectly informed about the quality of the bidders, the shareholders might vote on the basis of the average quality of bidders, which might lead them to vote generally against bidders in proxy contests not backed by a firm acquisition offer. This argument is consistent with empirical evidence suggesting that proxy contests for control, without an accompanying tender offer, are seldom successful.¹¹⁵

By making a firm offer for the target's shares in conjunction with its proxy

114. For a fuller analysis of this point, using a formal model of voting with and without an acquisition offer on the table, see Lucian Arye Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*, Working Paper No. 336, John M. Olin Center, Harvard Law School (October 2001), available on SSRN .

115. While we argue that it is difficult to win a first election without having a firm offer on the table, we do not claim that it is impossible. There have been situations in which shareholders are so dissatisfied with existing managers that, notwithstanding the considerations discussed here, they have voted for a challenger. In our hostile bid sample, described in more detail in Part IV below, only one bidder was successful in winning the target by bringing a proxy contest without an accompanying tender offer—this was Huntman's July 1996 offer to acquire Rexene Corp. Note that even in this bid there was a specific offer on the table (\$15 cash per share, eventually increased to \$16 cash), though the bidder did not make a formal tender offer. The proxy route on its own may have been more effective than usual in this case because it was initiated by Guy Wyser-Pratte, a 10% holder of Rexene and a noted shareholder activist.

fight, a bidder eliminates the need for shareholders to make an assessment of how well the bidder would run the firm. Instead, to determine whether they would be better off, shareholders simply need to compare the offer price (which is much less speculative than the expected monetary value of the company under the bidder's management) with their assessment of the target's value.

2. *The importance of a firm offer against an ESB.*

We now turn to the specific case of a first proxy contest against an ESB to elect a third of the board. Here, the contest is not over full board control but rather over a rival team putting its foot in the door. For the reasons described above, the bidder would find it difficult to win the proxy contest unless it put a firm offer on the table. In the specific context of an ESB, there are two additional reasons that a firm offer is necessary. First, shareholders may not want to let the bidder infiltrate their board with a minority of directors, who could then conduct due diligence from the inside and report back to the bidder, unless there was a firm commitment on the offer. Second, it may be costly to have a hostile, dissenting group on the board.¹¹⁶ Thus, if the bidder is not going to make an offer in a year (as happened in the end in Circon), putting the bidder's team on the board for now is costly. Circon Chairman and CEO Richard Auhll described the enormous difficulty in running his company with a hostile takeover bid pending and two dissident directors on his board:

We were terrified that we would lose our employees and that would destroy our ability to operate the company. That was a major, major issue, trying to hold our team together. . . . So I was a major cheerleader out there for the employees, trying to keep up morale and keep the *esprit de corps* up. . . . We spent a lot of money on incentives for the sales force to stay in place, because the sales force was vital to the whole issue. And it turns out, those efforts were not successful. No matter how much money we threw at it, it was not enough to keep the sales force in place. . . . Over the full 26 month period [of the hostile bid], our sales remained basically level.¹¹⁷

Electing a minority dissident slate can be thought of as an investment by shareholders in the bidder's program. If the bidder does not complete its takeover a year later, then shareholders do not get their "pay off" from this investment, and would have been better off not putting a disruptive group on the board in the first place.

116. See, e.g., Topps Co. Proxy Statement, Proposal No. 4 (May 28, 1998) ("A proxy fight, regardless of whether successful, can seriously distract a company's management and board of directors and impose substantial costs on the company.").

117. See Hall, Rose & Subramanian, *supra* note 32.

3. *The cost of committing to a price.*

What is so difficult in having to make a bid (or some strong commitment to a price) in the first election? Why would this deter or make difficult some potential acquisitions? The problem is that in a dynamic world the value of the target can change over time; thus making an irreversible or even strong commitment to a price for a considerable period exposes a bidder to substantial risk.

To illustrate, consider a bidder who emerges when the independent value of the ESB target is \$100. Assume the best case—the next annual meeting is imminent, and the following annual election is a year after that. Assume further that the target will have either positive developments or negative developments over the next year, and as a result the value of the target as an independent entity will be either \$130 or \$70, each with a 50% probability. Finally, assume that the bidder can manage the assets more efficiently, or can produce gains from synergy, which makes the value of the assets to the bidder 120% of the independent value of the target. This final assumption means that if the bidder were able to wait until a year from now and then make an offer, the bidder would always be able to make an offer that shareholders would find attractive.¹¹⁸

Now let us turn to the bidder's predicament if the bidder needs to win two elections, one now and one in a year. We have argued in the previous section that the bidder needs to commit to a price now that it will keep open until the next election. What price P should the bidder offer now, just before the first election? If the bidder makes a firm offer of P and binds itself to it for a year, shareholders will be free to accept or reject it later on, and the target board will be free to bring in rivals with competing offers.

For example, consider what would happen if the bidder were to offer a price of \$110, open for a year. This offer would be enough to win now, if there could be a decisive referendum now. In a year, if the target has positive developments, the independent value of the target would go up to \$130, and shareholders would reject the offer. If the target has negative developments, the independent value of the target would decline to \$70, and shareholders would accept the offer. Of course, in the event of negative developments getting the target for \$110 will be a losing proposition for the bidder, who would value it only at \$84 ($\$70 \times 120\%$).

The problem is that making a firm offer at \$110—or at any other price—effectively gives target shareholders a put option for their shares. In a single-election regime, the option is not worth a great deal because it expires relatively quickly. In a two-election regime, giving the option is costly because it will extend

118. Note that the bidder cannot commit now to bid 120% (or something between 100% and 120%) of the market price one year later because as the commitment date approached the target's share price would be bid up without any clear limit, stopping only at the point at which the bidder's commitment to the offer were no longer credible.

for a year or longer.¹¹⁹ In the simple numerical example provided above, the bidder will win only when the target experiences negative developments, but of course in this scenario the bidder does not want to win. The only solution to this manifestation of the classic “lemons problem” is for the bidder not to bid. Thus, in this example, even though the value of the target’s assets would be higher in the hands of the bidder, there is no firm offer that would enable the bidder to win the first round yet would be profitable for the bidder to make.¹²⁰ The bidder will be unwilling to make a firm offer, or will reduce the amount that it would be willing to offer, either of which would make it more difficult to win the requisite two elections.

We do not claim that it is impossible for a bidder to win two elections. If the shareholders are sufficiently desperate about their existing situation they might be willing to vote for the bidder even without a firm offer. And if the bidder values the target sufficiently highly, it might be worthwhile to bear the cost of making a firm offer. Our point is only that the two-election problem imposes an additional and substantial cost that makes the ballot box victory route extremely difficult.

4. *Comparison to the one-election case.*

To close this Part, it is worth highlighting the difficulty of having to win twice by noting how the volatility of the assets of the target over time would not be an impediment in a case in which the bidder faced delay but did not need to win two separate elections. Using the bidder in the above numerical example, assume an election arrangement in which the bidder would have to wait a year and then could run one proxy contest for the board as a whole.

In this case, assuming that the bidder is willing to bear the cost of delay, the volatility of the assets over the interim year would not be a problem, because the bidder could simply observe the target’s asset value just before making its bid. If the target had positive developments and its value increased to \$130, the bidder would bid somewhere between \$130 and \$156 ($=\$130 \times 120\%$). If the target’s had negative developments and its independent value went down to \$70, the bidder would bid somewhere between \$70 and \$84 ($=\$70 \times 120\%$). This example

119. In theory the bidder could adopt a hedging strategy that would provide insurance against the value of the target going down, but this strategy would simply replace the implicit cost of the free put with an explicit cost of the premium needed to purchase such insurance. Basic option theory predicts that these two costs should be equal.

120. For simplicity we have presented an example with two discrete outcomes (\$70 or \$130), but the argument continues to hold if we allow a continuous distribution of outcomes. As long as the value of the target could fall below \$92 as a stand-alone entity (which means that the value to the bidder would fall below \$110), the put option is costly for the bidder to give.

illustrates the point that the existence of one definitive election enables the bidder to make its final commitment to price just before the outcome is resolved through the proxy contest. Unlike the ESB scenario, in this scenario bids are not deterred.

The analysis in this Part demonstrates that even in those cases in which a ESB and a two-year (or three-year) arrangement would present the bidder with the same delay, the former would constitute a much more formidable takeover defense. Under the latter, if the bidder is sufficiently patient (a big if, to be sure), the bidder will be able to eventually reach an up-or-down referendum on an offer it will be able to determine at the time of the referendum. With an ESB, however, this possibility does not exist.

F. *Conclusion*

In closing this Part, we return to our initial objective, which is to assess the viability of the ballot box safety valve against disloyal target boards. In Part III.C we argued that we need to distinguish among three types of targets in order to answer this question: (1) targets with no minimum term for board members (“NMT targets”); (2) targets which have an effective annual term (“EAT targets”); and (3) targets with effective staggered boards (“ESB targets”). The ballot box is a meaningful safety valve against NMT targets, because a bidder can relatively quickly take its case directly to the shareholders of a disloyal target board. The ballot box is less effective against EAT targets, but still there is a meaningful path to success, particularly in the (approximately) three months before the target’s annual meeting. The ballot box is a much less effective safety valve against ESB targets. In this third regime, targets receive substantial takeover protection, stronger than has been commonly understood.

We have presented theoretical reasons that ESB’s should have a strong antitakeover effect. This effect is likely to be of a different order of magnitude than other types of antitakeover charter and bylaw provisions. Not only does an ESB provide more delay and longer guaranteed tenure for an incumbent board, but, more importantly, it creates additional impediments by (i) eliminating any possibility that a buyer might emerge at a point in time that would not require delay, and (ii) requiring victories in two elections rather than one. Indeed, our analysis has shown that the antitakeover effects of an ESB are stronger not only than other existing antitakeover arrangements, but of hypothetical arrangements (currently not permissible) under which elections would be held only every two or three years. The next Part goes on to test these theoretical arguments against the available empirical evidence.

IV. EMPIRICAL EVIDENCE

The theoretical arguments presented in Part III would predict that (1) ESB's make it more difficult for a hostile bidder to win control of the target's board through the ballot box mechanism; and (2) because the ballot box safety valve is rendered less effective when the target has an ESB, an ESB increases the likelihood that a target can remain independent when faced with a hostile takeover bid. We test these two hypotheses against the empirical evidence in Parts B, C, and D below, and find strong support for both. In Parts E and F, we examine whether ESB's provide countervailing benefits to takeover targets, and find that they do not. Part G concludes by estimating the aggregate losses caused to target shareholders by ESB's.

A. *Data Description*

Prior empirical studies of takeover defenses have found small or no effects of takeover defenses on bid outcomes.¹²¹ These results are consistent with practitioner wisdom that takeover defenses matter only at the margin.¹²² However, these studies are problematic because they focus exclusively on the pill, and fail to consider staggered boards and how they interact with the pill.¹²³ As described in Part III.B, the pill by itself is not a potent defense, but the pill/staggered board combination has a substantial effect on bids. Furthermore, whether a target has a pill in place prior to a bid is also not important, given the ability of targets to adopt pills rapidly in response to a bid.¹²⁴

121. See, e.g., James A. Brickley, Jeffrey L. Coles & Rory L. Terry, *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371 (1994) (finding that the proportion of outside directors does not influence the success rate of bids against firms with pills, but it does increase the likelihood that the target will be auctioned once a bid has been brought); Coates, *supra* note 60 (finding that pre-bid poison pills have no impact on bid outcomes); Michael Ryngaert, *The Effect of Poison Pill Securities on Shareholder Wealth*, 20 J. FIN. ECON. 377, 407-08 (1988) (finding that 31% of firms with pills remained independent, compared to 16% of firms without pills); Jamil Aboumeri, *Poison Pills and Shareholder Value, 1992-96* (Georgeson & Company, 1997) (finding that firms with pills are less likely to defeat hostile takeover bids than firms without pills).

122. See *supra* notes 51-55 and accompanying text.

123. See, e.g., Brickley, Coles & Terry, *supra* note 121; Ryngaert, *supra* note 121; Aboumeri, *supra* note 121. For a more detailed assessment of the existing empirical literature, see Bebchuk, Coates & Subramanian, *supra* note 85.

124. See Coates, *supra* note 60.

To correct these deficiencies, we construct a new data set, starting with data from Thompson Financial Securities Data (formerly Securities Data Corporation) (SDC), and including all hostile bids made against U.S. targets that were initiated and resolved between January 1996 and December 2000 (n=92). Specific charter and bylaw terms of each target were taken from the targets' filings with the SEC,¹²⁵ to determine whether staggered boards are effective or can be evaded as described in Part III.C. Bidder and target SEC filings, as well as newspaper accounts, were used to verify bid outcomes and to classify bids as bust-up or stand-alone.¹²⁶ Stock prices were obtained from the Center for Research in Securities Prices (CRSP) database. Summary data on target and bid characteristics and overall outcomes for this data set are presented in Table 2.

125. Specifically, each target's filings were found by searching for the target in the SEC's online EDGAR database, available at <http://www.sec.gov/edaux/formlynx.htm>. An exhibit list to the latest Form 10-K was reviewed to determine where to find the target's charter and bylaws; and relevant filings were obtained either from the target's online filings or, where they were unavailable, from Compact Disclosure (a private SEC filing service in CD-ROM and paper formats). Once obtained, charters and bylaws were analyzed as described in Coates, *supra* note 106.

126. Specifically, the target's filings were found, as described in the preceding note, and Schedules 14D-1 (or Schedules TO) were searched to see if the bidder made a tender offer as part of the hostile bid; if so, the "Background" section of the related offer to purchase (filed as an exhibit to the Schedule 14D-1) was read to determine if the bid was a bust-up bid, and to confirm bidder identity, premium, deal size, and other data, and outcomes were determined by reviewing subsequent amendments to the Schedule 14D-1. If no Schedule 14D-1 was filed, Schedules 14A were reviewed to see if the bidder conducted a proxy fight or consent solicitation as part of the bid; if so, similar procedures were followed. If not, Forms 8-K and 10-Q, as well as news stories in Lexis/News (available at <http://www.lexis.com>) were reviewed to confirm SDC data on the bid, its characteristic, and outcomes.

Table 2: Summary Data on Hostile Bid & Target Characteristics

% of sample or median (mean)	Total (n=92)	ESB (n=45)	No ESB (n=47)
Target Characteristics			
Size (\$ million)	\$481 (\$2,967)	\$704 (\$2,610)	\$280 (\$3,309)
Delaware corporation	51.1%	57.8%	44.7%
Defenses			
Staggered board	60.9%	100%	23.4%
Effective staggered board	48.9%	—	—
Fair price provision	25.0%	35.6%	14.9%
Pre-bid poison pill	68.5%	73.3%	63.8%
Supermajority vote provision	30.4%	37.8%	23.4%
Bid Characteristics			
Tender offer	54.3%	51.1%	57.4%
Proxy fight	43.5%	35.6%	51.1%
Tender offer & proxy fight	33.7%	33.3%	34.0%
Bust-up bid	19.6%	24.4%	14.9%
Bear hug bid	35.9%	46.7%	25.5%
Bid premium	37.2% (43.2%)	35.0% (44.1%)	35.0% (42.4%)

Table 2 shows that 61% of bids (56 bids) were brought against targets with staggered boards. Of those, eleven SB's were not "effective" as takeover defenses in the sense discussed above. Thus, of the ninety-two bids, 49% were brought against targets with ESB's. Pre-bid poison pills are present at nearly 70% of targets; moreover, all targets in our sample that did not have pills at the time of the bid announcement put in "morning after" pills as the first step toward resistance, or at least to gain time and bargaining power against the bidder.¹²⁷

127. E.g., Bill Atkinson, *Glen Burnie Bancorp Tries to Resist Hostile Takeover*, BALT. SUN (Feb. 18, 1998), at 3C (Glen Burnie adopts pill in response to hostile bid); Geraldine Fabrikant, *The Media Business; A Defense by Time Warner*, N.Y. TIMES, Jan. 21, 1994, at D1 (recounting how after Seagram Co.'s announcement that it intended to buy up to 15% of

B. *Viability of the Ballot Box Mechanism*

In Part III we argued that the ballot box mechanism is not an effective route against ESB targets. In this Part we test this prediction empirically by examining the outcomes of the proxy contests in our data set. Note that the mere existence of proxy solicitations against ESB targets does not necessarily mean that proxy contests are a viable route against such targets. Proxy contests could be launched for several reasons independent of their effectiveness as an inroad against the target – for example, to complement a concurrent public relations campaign; to show the bidder's seriousness; or, relatedly, to put pressure on target directors. The single best test to assess the effectiveness of the proxy contest route is to see whether there are ever cases in which a target is taken over against the wishes of the incumbent board due to the presence of this route.¹²⁸

Applying this test, we find that not a single proxy contest against an ESB went through the two elections that were necessary to gain control of the target's board. In fact, only one proxy fight against an ESB (Circon) went to a shareholder vote for the first time; after Circon, the bid in our data set that came the closest to an actual vote was Ahmanson's bid for Great Western Financial.¹²⁹

Time-Warner, Inc.'s stock spurred speculation that Seagram might make a hostile bid for Time-Warner, Time-Warner adopted a rights plan, which it previously had not done as part of a shareholder relations campaign); *Urocor Rejects Dianon's Acquisition Advances*, MEDICAL INDUSTRY TODAY, Aug. 21, 1998, available at <http://www.lexis.com> (Urocor adopted pill after it received hostile bid); Acme-Cleveland Corp. Form 8-A/A (filed June 3, 1996), available at <http://www.sec.gov/Archives/edgar/2066/0000950152-96-002745.txt> (referring to a rights plan adoption on March 11, 1996, four days after Danaher Corp. launched its bid for Acme-Cleveland); Hall, Rose & Subramanian, *supra* note 32, at 5 (reporting that Circon installed a poison pill just days after U.S. Surgical launched its hostile bid).

128. This test deliberately includes situations in which the target board capitulates after it is clear that the proxy contest route will be successful. To take the extreme case, it seems appropriate that a target board that caves just before it is about to lose a second election should be characterized as a ballot box victory.

129. Two other well-known instances in which the bidder gained one-third of the seats on the target's board are Moore's hostile bid for Wallace Computer and Carson Pirie Scott's hostile bid for Younkers. Both bids occurred in 1995, before our time frame for analysis. See Christina Duff, *Younkers Holders Urge Sale of Chain and Elect Three Carson Nominees to Board*, WALL ST. J. (May 30, 1995); *Moore v. Wallace Computer*, 907 F. Supp. 1545 (D. Del. 1995). There are also two situations that were still pending in December 2000, the endpoint for our analysis. Boston Bank of Commerce gained two seats on Carver Bancorp in May 2000, see Beth Healy, *Boston Bank Wins Legal Battle; Cohee, Williams to Get Seats on Carver Board*, BOSTON GLOBE (May 23, 2000) at E6, and Weyerhaeuser gained three seats on Willamette's staggered board in July 2001, see *Willamette Industries Inc.: Weyerhaeuser Slate Gains Seats on Company's Board*, WALL ST. J. (July 17, 2001) at C13.

Two proxy contests against ESB's eventually led to success for the initial bidder: Laidlaw's bid for Safety Kleen in November 1997 and Phelps Dodge's bid for Cyprus Amax in August 1999. Both of these bids were bust-up bids, meaning that the target boards in both cases were under additional, *Revlon*-motivated pressure to maximize short-term shareholder value.¹³⁰ Presumably a stand-alone hostile bidder, without the additional pressure imposed by *Revlon*, would have even greater difficulty in pursuing the ballot box route. Indeed, for ESB targets that were not in *Revlon* mode (and therefore could adopt a "Just Say No" defense under *Unocal*), not a single bidder successfully gained control of the target using the ballot box, either by winning two elections or by using the threat of two elections to force a negotiated sale. A good example of this phenomenon is North Folk's threatened proxy contest against Dime Bancorp, an ESB target. When North Folk announced its plan to nominate a slate of directors for the Dime board, Dime called the move "grandstanding."¹³¹ Indeed, North Folk eventually withdrew its bid, and Dime remained independent.

In contrast, the proxy contest mechanism seems to be an effective mechanism against non-ESB's. In March 1999, for example, Philips launched a proxy contest against VLSI after VLSI rejected its unsolicited \$17-per-share tender offer. VLSI was a NMT target, so Philips immediately began soliciting proxies to act by written consent.¹³² In May 1999, Philips withdrew its proxy solicitation when VLSI agreed to a negotiated sale for \$21-per-share.

Similarly, noted shareholder activist Guy Wyser-Pratte launched a proxy contest against Rexene in April 1997, in order to replace the incumbent board with

In January 2002, Weyerhaeuser announced that it had negotiated a friendly acquisition of Willamette. See Jim Carlton & Robin Sidel, *Willamette Agrees to be Bought by Weyerhaeuser*, WALL ST. J. (Jan. 22, 2002) at A3. None of these examples (yet) disproves our basic point: no hostile bidder has lasted through two annual shareholder meetings as is required to win control against an ESB.

130. Targets that have agreed to a prior cash sale of the company (or any deal in which a new controlling shareholder emerges and none previously existed) are subject to "*Revlon* duties," which require target managers to achieve the highest short-term value reasonably obtainable for shareholders. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). In contrast, companies that have not put themselves into play in this manner are generally believed to be able to "Just Say No" to a hostile bidder under Delaware law. See *Time v. Paramount*, 571 A.2d 1140 (Del. 1989); *Moore v. Wallace Computer*, 907 F. Supp. 1545 (D. Del. 1995).

131. See Scott Silvestri, *North Fork's Board Delays Decision on Dime Pursuit*, 165 AM. BANKER (Sept. 27, 2000) at 2.

132. See Steven Lipin, *Philips Electronics Readies Proxy Fight if VLSI Refuses to Negotiate on Offer*, WALL ST. J., Mar. 3, 1999, at B6 ("The biggest chink [in VLSI's takeover defenses] is that any entity that owns VLSI shares can effectively remove the board by canvassing shareholders via a so-called consent solicitation at any time).

directors who would accept Huntsman's hostile bid. The special shareholders' meeting was scheduled for May twenty-second; on May twentieth, Rexene entered into talks with Huntsman and negotiated the sale.

A third example of a ballot box victory against a target without an ESB is the Fant Industries' bid for HEI. In this case, Fant Industries actually went through with its proxy contest and won four seats on the target's board in August 1998. Fant then replaced the CEO and consummated its hostile bid.

Taken together, these findings support the theoretical arguments put forward in Part III, that the ballot box route is an ineffective route against an ESB but an effective route against a non-ESB. In fact, winning through the ballot box mechanism against an ESB may well be impossible in practice; we have not yet seen the example that rejects this claim. As emphasized earlier, the argument does not imply that hostile bidders will never be successful against ESB's. The target board members might be tempted by their stock options and golden parachutes, or by pressure from large-block shareholders. But the important point is that, if the incumbents decide to resist, the ability of the bidder to oust them remains extremely limited.

C. *Remaining Independent in the Short Run*

If the ballot box route is not an effective safety valve against an ESB, we would expect that targets will have more ability to remain independent with an ESB.¹³³ This Part examines bid outcomes in the short run, defined as the first nine months after the hostile bid announcement. In the next Part, we examine target independence in the longer run, defined as the thirty-month period after bid announcement.

1. *General findings.*

Figure 4 shows the short run outcomes of all bids against ESB's (n=45) and non-ESB's (n=47) between 1996 and 2000. For purposes of the analysis the short run is defined as nine months after the hostile bid is brought, though the results do not change in any significant way if we use six months or twelve months after bid announcement as the timeframe for analysis.¹³⁴

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

134. While the difference in target independence rates shows the same pattern in the six-month window (69% independence rate among ESB targets compared to 40% independence rate among non-ESB targets) this difference is not statistically significant in the multinomial logistic regression. We use a nine-month window rather than a six-

Figure 4: Bid Outcomes in the Short Run

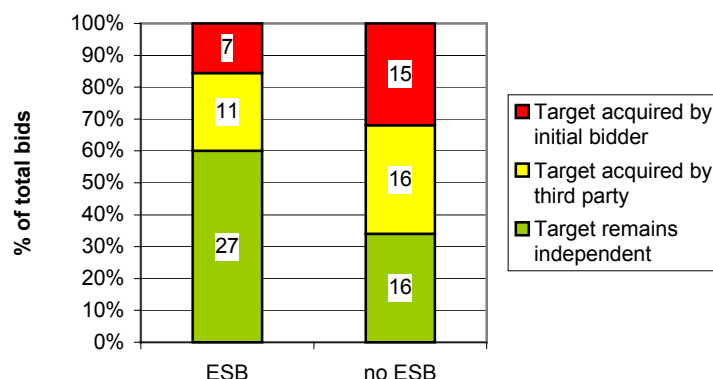


Figure 4 reveals a striking difference in success rates depending on the target's defenses: 60% of ESB targets remained independent against a hostile bid, compared to 34% of non-ESB targets. The difference is made up of fewer sales to initial bidders (16% of ESB targets versus 32% of non-ESB targets) and fewer sales to white knights (24% of ESB targets versus 34% of non-ESB targets). These results are consistent with our findings from Part IV.B, which show that proxy contests are an ineffective route against ESB's. These results also call into question the findings from prior studies which purport to show that takeover defenses generally have no impact on bid outcomes.

2. Controlling for other parameters.

We also use multivariate regression analysis in order to control for other factors that could plausibly influence the outcome of takeover contests. We include six dummy variables in our model to represent the various takeover defenses that may influence bid outcomes: staggered board, ESB, dual class, fair price provision (provided either at the state level or the firm level), pre-bid poison pill, and supermajority voting provision (again, provided either by the state or by the firm). Control variables include natural log of deal size, bid premium, and whether target is a Delaware firm.¹³⁵

month window for our short run analysis because even short run implications of the bid often take at least nine months to play out; therefore the six month data is considerably more noisy. Using a twelve-month window yields highly significant results for the ESB coefficient, in a direction that is consistent with our theory.

135. In unreported regressions we include financial performance measures for the target, to test the hypothesis that poorer performers are more likely to be acquired. While in a companion paper we find some evidence that poorer performers are more likely to be takeover targets, *see* Bebchuk, Coates & Subramanian, *supra* note 85, we find no evidence that poorer performers are more likely to be acquired once a bid has been made.

We also include four dummy variables to model the bidder's tactics: proxy fight, bear hug bid, tender offer,¹³⁶ and bust-up bid. On this last variable, we include BUSTUP as a control because bust-up bids are different from other hostile bids and may have a different outcome profile. When a hostile bid is a bust-up bid, a target that would otherwise be prepared to remain independent is under greater pressure to sell than following other ("stand-alone") hostile bids.¹³⁷ Bust-up bids are thus qualitatively different from stand-alone hostile bids, and may have a different effect on bid outcomes.

Three regressions are run: two logistic regressions and one ordered logistic regression. Ordered logit is used because it seems plausible to rank bid outcomes in an order of descending desirability for target managers (or ascending desirability for bidders): target remains independent, target is sold to white knight, target is acquired by bidder. Logit is also used, however, because target managers and target shareholders may both be relatively indifferent between a sale to a white knight and a sale to the original bidder, because both generally result in loss of control for target managers and premia for target shareholders, so that the important cutoff is simply whether takeover defenses allow the target to remain independent. Hostile bidders, on the other hand, may be relatively indifferent between sale to a white knight and the target remaining independent, so the important cut-off is whether the bid succeeds. Thus: for the ordered logit regression, the dependent variable is OUTCOME, set to 0 if the target remains

136. In prior work, two of us have shown that tender offers substantially increase the likelihood of consummation for friendly deals. See John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307 (2000).

137. At least two sources of additional pressure exist, both law-related. First, having determined to sell to an initial bidder, target managers can theoretically be compelled under *Revlon* into accepting a bust-up bid that is higher-valued. See *supra* note 130. Second, targets must receive some form of shareholder consent (in the form of votes or tenders) to consummate any sale or merger, which provides a bust-up bidder with a forum to convince target shareholders to register implicit approval of the bust-up bid by turning down the initial bid. If an initial bid is voted down, target managers are not legally obligated to accept a bust-up bid (outside of *Revlon*-land), but it will often be practically necessary for them to do so. The reason is that an initial bid will typically shift the shareholder profile of the target, as risk arbitrageurs buy and risk-averse individual shareholders sell the target's stock, with the result that if the initial bid falls through, the target's shareholders will be more likely to seek another deal. In addition, if target managers have committed to sell the company to an initial bidder, it will often be difficult for target managers to convince employees or labor unions to work in a coalition against a hostile bid, to lobby politicians to enact special legislation, or to convince regulators or courts to intervene against the hostile bid, unless the two bids are dramatically different on relevant dimensions.

independent when the bid is withdrawn, 1 if the target is acquired by a third party, and 2 if the original bidder acquires the target; for the first logit regression, the dependent variable is INDEPENDENT, set to 0 if the target is sold to a white knight or acquired by the bidder, and 1 if the target remains independent; and for the second logit regression, the dependent variable is COMPLETION, set to 0 if the target remains independent or is sold to a white knight, and 1 if the bidder acquires the target.

The sample is all completed or withdrawn hostile bids from 1996 to 2000 (n=92). Results are shown in Table 3:

Table 3: Short Run Bid Outcomes Model

MODEL #1 (logit): dependent variable is INDEPENDENCE, set to 1 if target remains independent, and 0 if the target is acquired by the initial bidder or by a third party.

Column # =>	(1)	(2)	(3)
Staggered board	0.48 (0.55)		
Effective staggered board		1.56 (0.56)	1.38 (0.50)
Dual class stock	1.37 (0.99)	1.43 (1.05)	
Fair price provision	0.70 (0.68)	0.71 (0.70)	
Pre-bid pill	-0.07 (0.59)	-0.32 (0.62)	
Supermajority voting provision	0.58 (0.60)	0.55 (0.62)	
Proxy contest	1.02 (0.76)	1.07 (0.80)	
Tender offer	-1.29 (0.89)	-1.79 (0.94)	-1.40 (0.49)
Bear hug bid	0.24 (1.12)	-0.28 (1.18)	
Bust-up bid	-1.76 (0.76)	-1.91 (0.78)	1.16 (0.62)
Ln(size)	0.06 (0.13)	0.04 (0.14)	-0.05 (0.12)
Premium	-0.02 (0.01)	-0.02 (0.01)	-0.01 (0.01)
Delaware	-0.64 (0.53)	-0.81 (0.56)	-0.59 (0.50)
Log likelihood	-52.6	-48.7	-51.9
Pseudo R-sq	17.3%	23.3%	18.3%

MODEL #2 (logit): dependent variable is COMPLETION, set to 1 if the initial bidder completes its bid, and 0 if the target remains independent when the bid is withdrawn or is acquired by a third party.

Column # =>	(1)	(2)	(3)
Staggered board	-0.62 (0.62)		
Effective staggered board		-1.19 (0.62)	-1.00 (0.56)
Equal class stock	-0.92 (1.23)	-0.80 (1.24)	
Fair price provision	-0.25 (0.78)	-0.21 (0.78)	
Pre-bid pill	-0.03 (0.65)	0.10 (0.66)	
Supermajority voting provision	0.37 (0.68)	0.42 (0.68)	
Proxy contest	-1.23 (0.75)	-1.19 (0.77)	
Tender offer	0.90 (1.21)	1.13 (1.23)	1.27 (0.58)
Bear hug bid	-0.90 (1.44)	-0.58 (1.46)	
Bust-up bid	0.13 (0.81)	0.28 (0.82)	-0.03 (0.70)
Ln(size)	0.16 (0.15)	0.18 (0.15)	0.12 (0.13)
Premium	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)
Delaware	0.12 (0.58)	0.15 (0.60)	0.24 (0.54)
Log likelihood	-44.0	-42.5	-44.7
Pseudo R-sq	13.1%	16.0%	11.7%

MODEL #3 (ordered logit): dependent variable is OUTCOME, set to 0 if the target remains independent, 1 if the target is acquired by a third party, and 2 if the initial bidder acquires the target.

Column # =>	(1)	(2)	(3)
Staggered board	-0.53 (0.48)		
Effective staggered board		-1.36 (0.48)	-1.30 (0.44)
Dual class stock	-1.24 (0.88)	-1.14 (0.89)	
Fair price provision	-0.54 (0.62)	-0.48 (0.62)	
Pre-bid pill	-0.03 (0.54)	0.12 (0.55)	
Supermajority voting provision	-0.26 (0.53)	-0.26 (0.53)	
Proxy contest	-1.16 (0.64)	-1.02 (0.65)	
Tender offer	1.10 (0.84)	1.59 (0.87)	1.38 (0.45)
Bear hug bid	-0.57 (1.02)	0.01 (1.06)	
Bust-up bid	1.23 (0.61)	1.37 (0.63)	0.83 (0.51)
Ln(size)	0.03 (0.12)	0.05 (0.12)	0.08 (0.11)
Premium	0.02 (0.01)	0.02 (0.01)	0.01 (0.01)
Delaware	0.30 (0.45)	0.39 (0.46)	0.37 (0.43)
Log likelihood	-86.2	-82.5	-85.4
Pseudo R-sq	11.4%	15.2%	12.2%

Notes: Standard errors in parentheses; coefficients significant at 95% confidence in bold. All models include a constant term (not reported). n=92 throughout.

We use the results from Table 3 to test our predictions that, as argued in Part III.C.3, ESB's substantially increase the likelihood that the target will remain independent and ESB's decrease the likelihood that the target will be sold to the initial bidder. We also expect that ineffective staggered boards should have no impact on bid outcomes, since by definition they do not provide any marginal impediment to hostile bids.

All three models provide strong support for these predictions. ESB's have the predicted impact on outcomes, with results that are statistically significant at the 95% level for bid outcomes and target independence rates, and at the 90% level for initial bid completion rates.¹³⁸ Estimated coefficients from column (3) of Model #3

138. The fact that the ESB coefficient is significant only at the 90% level for initial bidder completion may help explain why, in a companion paper, we find that staggered

predict that effective staggered boards nearly *double* the average target's odds of remaining independent, from 34% to 61%, cut the odds of a bidder completing its bid from 34% to 14%, and cut the odds that the average target in our sample will be forced into selling to a white knight, from 32% to 25%.¹³⁹ These results are consistent with the basic results presented in Figure 4.

Also consistent with our theory, we find that ineffective staggered boards do not have a statistically significant effect on bid outcomes in any model. This finding suggests that hostile bidders are able to, and do, dismantle or evade ineffective staggered boards (e.g., Danaher's 1996 bid for Acme-Cleveland). Consistent with prior work by one of us,¹⁴⁰ neither pre-bid poison pills nor fair price provisions nor supermajority provisions have any impact on bid outcomes in any regression.¹⁴¹ It is also interesting that dual class capital structures have no impact in any regression, suggesting that many dual class structures lose their antitakeover effect as insiders sell down voting shares over time.¹⁴²

boards do not seem to deter hostile (or friendly) bids. See Bebchuk, Coates & Subramanian, *supra* note 85. However, in our thirty-month analysis reported in Table 4, the ESB coefficient becomes highly significant and negative in Model #2, suggesting that ESB's do in fact reduce the likelihood of success for an initial bidder over a longer time horizon. Taken together, the evidence presented in Tables 3 and 4 indicate that expected-value-maximizing bidders with anything but the shortest of time horizons should be deterred at the margin from making hostile bids against ESB's.

139. These calculations use the method of recycled predictions, which compares the likelihood of each outcome in two hypothetical scenarios: one in which all targets have ESB's, and one in which all targets do not have ESB's.

140. See Coates, *supra* note 60.

141. In unreported regressions, variables interacting staggered boards and pre-bid pills, and effective staggered boards and pre-bid pills, also have no impact on bid outcomes.

142. Some of the controls in the model are also interesting. For example, the willingness of a bidder to make a tender offer as part of a hostile bid is strongly related to bid outcomes and target independence rates. While not quite as powerful as an ESB in determining bid outcomes, tender offers are apparently an important way that a bidder signals its seriousness about its bid. Somewhat surprisingly, bust-up bids are not correlated with target independence rates or bid completion rates, consistent with the hypothesis that the primary effect of a bust-up bid is not to reduce the first bidder's odds of success, but inconsistent with the hypothesis that a bust-up bid makes it more likely that some bidder will win, and the target will not be able (or will elect) to remain independent should the initial bid not be completed. Target size also has no significant impact, suggesting that the difficulty of financing large bids may be well understood by bidders, and so may not play a major role in determining bid outcomes, conditional on a bidder deciding to bring the bid. The fact that a target is a Delaware firm, thus subjecting the bid to Delaware law (and usually to Delaware courts) is not a significant factor in

3. Selection problems.

It might be suggested that ESB's have another effect on remaining independent that is not captured by the analysis so far. So far we have taken as given that a bid has been made. But whether a bid is made might depend on defenses – specifically, the presence of an ESB might discourage some bids. Thus, the bids that are made for ESB's might be a subset of bids that would have been made otherwise; indeed, this subset might be skewed toward buyers that are relatively more determined and motivated.

We agree that such a selection might be taking place.¹⁴³ However, its presence would imply that the effect of an ESB on the likelihood of remaining independent is even larger than suggested by our already strong results. Here we show that an ESB increases the odds of independence by defeating bids that occur; a selection effect would imply that ESB's also increase the odds of independence by discouraging offers from being made in the first place.

In addition to this bidder-side selection effect, there is a potential target-side selection effect: it might be the case that targets with ESB's are different in some underlying features, which lead to the adoption of the ESB in the first place. According to this view, it would be these underlying features, and not the presence of the ESB, that are responsible for the increased likelihood of independence. However, this potential target-side endogeneity problem is mitigated considerably by the fact that most of the targets in our data set existed prior to 1990. For such mature companies, ESB installation could have occurred only before 1990, because (for reasons discussed in Part II.D) a charter amendment to install a staggered board became extremely difficult after 1990. So whether these targets had ESB's in the mid- to late 1990s depended on actions taken in the 1980s or even earlier. Different decisions in this earlier era are unlikely to translate into large enough differences between the ESB and non-ESB targets in the 1990s to account for the results we get.¹⁴⁴

determining outcomes of hostile bids. Whatever Delaware may add to a firm's price-to-book ratio, *cf.* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 535 (Table 3), it does not seem to do so by affecting the outcomes of hostile takeovers.

143. *But cf. supra* notes 51-55 and accompanying text (finding that practitioners seem to underestimate the antitakeover power of staggered boards, which in turn suggests that bid deterrence might be minimal). *See also infra* note 151.

144. In prior work one of us has argued that selection effects may be the cause for Robert Daines' finding that Delaware firms have higher Tobin's Q than non-Delaware firms. *See* Bebchuk & Ferrell, *supra* note 47; Daines, *supra* note 142. The critical difference between the reincorporation decision and the staggered board decision is that reincorporations continued to be a viable option for managers throughout the 1990s, *see* Subramanian, *supra* note 29, manuscript at 23 (Table 2) (reporting 624 midstream reincorporations among U.S. public companies in the 1990s), while the ability to adopt a

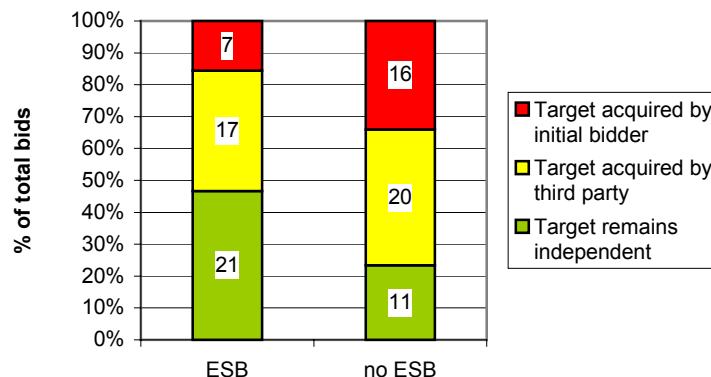
D. Remaining Independent in the Longer Run

In Part II.E we described the conventional wisdom among M&A practitioners that a target, once put into play by a hostile bidder, will be sold either to the hostile bidder or to a white knight. The empirical evidence presented in Part IV.C suggests that this conventional wisdom is incorrect, at least in the short run, if the target has an ESB. Nevertheless, it might still be argued that ESB targets are eventually sold once a bid is made, but the outcome takes longer to play out because of the delay imposed on the initial bidder by the ESB. In this Part we examine whether targets remain independent in the longer run, defined as the thirty-month window after bid announcement. Following the approach from the previous Part, we first look at aggregate statistics, and then control for other factors that might plausibly influence bid outcomes.

1. General findings.

Figure 5 presents basic statistics on the status of the targets in our sample thirty months after the initial hostile bid is announced, again divided between ESB targets (n=45) and non-ESB targets (n=47).¹⁴⁵

Figure 5: Bid Outcomes in the Long Run



staggered board was effectively unavailable to managers after 1990. See Klausner, *supra* note 43 at 3-4 (“This decline [in staggered board proposals] reflects management realization that there is no point in even asking shareholders to support a classified board.”). In short, the staggered board decision, unlike the reincorporation decision, was effectively frozen as of 1990; therefore it seems reasonable to take ESB incidence as exogenous to events that occurred in our 1996-2000 sample period.

145. While it is conceivable that a target could have changed from a non-ESB target to an ESB target (or vice versa) between the announcement of the hostile bid and thirty months later, none of the targets in our sample did so.

Not surprisingly, the independence rate has decreased for all targets relative to Figure 4: the number of independent ESB targets has declined from 27 to 21; and the number of independent non-ESB targets has declined from 16 to 11 in this longer timeframe. The basic finding that ESB targets are much more likely to remain independent remains, and in fact becomes even more pronounced relative to the short run analysis: 47% of ESB targets remain independent thirty months after the initial hostile bid is launched, compared to only 23% of non-ESB targets. As in the short run, the difference is made up of fewer sales to initial bidders (16% of ESB targets versus 34% of non-ESB targets) and fewer sales to other bidders (38% of ESB targets versus 44% of non-ESB targets).

2. *Controlling for other parameters.*

Following our methodology in Part IV.C.2, we use a multivariate regression analysis to control for other factors that might plausibly influence bid outcomes. The dependent variable in all of these models is the status of the target thirty months after the announcement of the initial hostile bid, staggered (as above) into three outcomes: sold to initial (hostile) bidder, sold to white knight or other third party (friendly) bidder, or remained independent. For bids that began less than thirty months before the end of our timeframe of analysis, we use the status of the target as of December 2000. Independent variables and model specifications remain unchanged, and are described in Part IV.C.2. Results are reported in Table 4 below.

Table 4: Long Run Bid Outcomes Model

MODEL #1 (logit): dependent variable is INDEPENDENCE, set to 1 if target remains independent, and 0 if the target is acquired by the initial bidder or by a third party.

Column # =>	(1)	(2)	(3)
Staggered board	0.68 (0.59)		
Effective staggered board		1.85 (0.63)	1.68 (0.56)
Dual class stock	-0.22 (1.06)	-0.55 (1.15)	
Fair price provision	1.19 (0.73)	1.19 (0.74)	
Pre-bid pill	-0.52 (0.61)	-0.82 (0.65)	
Supermajority voting provision	0.32 (0.63)	0.36 (0.67)	
Proxy contest	0.41 (0.81)	0.36 (0.87)	
Tender offer	-1.36 (0.92)	-1.93 (1.00)	-1.40 (0.54)
Bear hug bid	-0.13 (1.16)	-0.73 (1.25)	
Bust-up bid	-1.80 (0.86)	-1.86 (0.87)	-1.06 (0.68)
Ln(size)	0.12 (0.15)	0.08 (0.15)	0.01 (0.13)
Premium	-0.04 (0.01)	-0.04 (0.01)	-0.04 (0.01)
Delaware	-0.77 (0.59)	-0.96 (0.62)	-0.96 (0.56)
Log likelihood	-47.2	-42.9	-45.3
Pseudo R-sq	22.2%	29.2%	25.2%

MODEL #2 (logit): dependent variable is COMPLETION, set to 1 if the initial bidder completes its bid, and 0 if the target remains independent when the bid is withdrawn or is acquired by a third party.

Column # =>	(1)	(2)	(3)
Staggered board	-0.79 (0.61)		
Effective staggered board		-1.37 (0.62)	-1.18 (0.57)
Dual class stock	-0.97 (1.26)	-0.83 (1.26)	
Fair price provision	-0.48 (0.78)	-0.45 (0.79)	
Pre-bid pill	0.07 (0.65)	0.23 (0.67)	
Supermajority voting provision	0.34 (0.67)	0.35 (0.68)	
Proxy contest	-1.28 (0.75)	-1.23 (0.78)	
Tender offer	1.03 (1.21)	1.28 (1.23)	1.34 (0.58)
Bear hug bid	-0.77 (1.44)	-0.46 (1.46)	
Bust-up bid	0.62 (0.78)	0.80 (0.81)	0.35 (0.67)
Ln(size)	0.16 (0.15)	0.18 (0.15)	0.14 (0.13)
Premium	0.01 (0.01)	0.01 (0.01)	0.01 (0.01)
Delaware	-0.05 (0.58)	-0.02 (0.59)	0.09 (0.54)
Log likelihood	-44.3	-42.5	-44.7
Pseudo R-sq	14.3%	17.8%	13.6%

MODEL #3 (ordered logit): dependent variable is OUTCOME, set to 0 if the target remains independent, 1 if the target is acquired by a third party, and 2 if the initial bidder acquires the target.

Column # =>	(1)	(2)	(3)
Staggered board	-0.72 (0.48)		
Effective staggered board		-1.48 (0.48)	-1.44 (0.44)
Dual class stock	-0.22 (0.76)	-0.05 (0.78)	
Fair price provision	-0.89 (0.61)	-0.82 (0.61)	
Pre-bid pill	0.29 (0.54)	0.44 (0.54)	
Supermajority voting provision	-0.03 (0.52)	-0.01 (0.52)	
Proxy contest	-0.98 (0.65)	-0.80 (0.66)	
Tender offer	0.89 (0.77)	1.33 (0.80)	1.31 (0.44)
Bear hug bid	-0.66 (0.97)	-0.09 (1.01)	
Bust-up bid	1.30 (0.60)	1.37 (0.61)	0.87 (0.52)
Ln(size)	0.01 (0.12)	0.03 (0.12)	0.05 (0.11)
Premium	0.03 (0.01)	0.03 (0.01)	0.02 (0.01)
Delaware	0.32 (0.46)	0.42 (0.47)	0.53 (0.43)
Log likelihood	-86.8	-82.8	-84.5
Pseudo R-sq	12.8%	16.8%	15.1%

Notes: Standard errors in parentheses; coefficients significant at 95% confidence in bold. All models include a constant term (not reported). n=92 throughout.

Table 4 shows that the longer-term results are in fact stronger than the short-term results. In particular, the ESB coefficient is now statistically significant at 95% confidence in all three models, in directions consistent with our theory that ESB's make target independence far more likely. Other results are generally consistent with those reported in Table 3—in particular, none of the other defenses have any statistically significant impact in any of the outcome models. The BUSTUP coefficient is statistically significant and negative in Model #1, for the first time, suggesting either that *Revlon* pressure does in fact reduce the likelihood of target independence, or that the target of a bust-up bid will usually consummate its preexisting friendly deal if the hostile bid is defeated. Also for the first time, the coefficients for deal premia are statistically significant in Model #1 and Model #3, consistent with practitioner wisdom that higher premia make target independence less likely.

E. *The Cost of Remaining Independent*

In the prior two parts we showed that a target can remain independent far more often when it has an ESB, both in the short-run and in the longer-term. In this section we show that target shareholders generally suffer when the target remains independent – that is, remaining independent makes the shareholders of hostile bid targets worse off compared with the scenario in which the bid would have been successful. It might be argued that incumbents retain independence in those instances in which they would be able to achieve the same or higher value-creating gains on their own, either by achieving stand-alone operational improvements, or by providing information to the marketplace that corrects an underpricing of their firm. The remainder of this section demonstrates that this hypothesis is, in general, not correct.

1. *General findings.*

As a starting point, Table 5 provides aggregate statistics on shareholder returns by bid outcome.¹⁴⁶ These calculations include the premia achieved through subsequent completed bids against targets that remain independent, in order to give full credit for management plans to sell to a “better” bidder than the initial hostile bidder. The calculations also assume that cash received at any time (e.g., at the completion of a bid) is re-invested at the risk-free rate, assumed to be 6%.¹⁴⁷

146. In current work-in-progress we estimate abnormal returns rather than absolute returns, *see* Bebchuk, Coates & Subramanian, *supra* note 85, though we do not believe that this adjustment will change our overall conclusions. The bids in our sample are distributed uniformly over the sample period, and the market overall moved fairly consistently in an upward direction during this time. Simple correlation analyses yielded low correlations between bid incidence and monthly stock market returns ($r=0.06$), and between bid incidence and lagged monthly stock market returns ($r=0.01$).

147. Note that using the risk-free rate rather than a market return biases our results in favor of ESB's: shareholders in non-ESB targets generally receive cash sooner than shareholders in ESB targets; presumably these non-ESB shareholders have opportunities to re-invest this cash at higher than the risk-free rate. We nevertheless use a risk-free reinvestment rate assumption as a conservative estimate.

Table 5: Shareholder Returns by Bid Outcome and Target Defenses

Returns:	Short-Run (9-month) Returns:			Long-Run (30-month)		
	Bid Outcome	ESB	No ESB	Total	ESB	No ESB
Remained Independent	15.6%	22.9%	18.2%	25.3%	24.4%	25.0%
Sold to Other Bidder	58.1%	63.3%	61.1%	83.1%	91.2%	87.3%
Sold to Initial Bidder	52.5%	43.9%	46.7%	73.0%	65.3%	67.6%
Average Return in Case of Sale	56.0%	53.6%	54.5%	80.1%	79.3%	79.7%
Average Cost of Remaining Independent	40.4%	30.7%	36.3%	54.8%	54.9%	54.7%

Table 5 shows large statistical differences in shareholder returns across outcomes. In the short run, targets that are sold to an initial bidder achieve nine-month returns that are 29% higher than targets that remain independent; and targets that are sold to a white knight achieve an additional 14% beyond that. Combining the two sale outcomes, nine-month returns in the case of a sale are 55%. Compared against the 18% returns from remaining independent, this result suggests a 36% cost of remaining independent in the short-run.

In the long run, targets that are sold to an initial bidder achieve thirty-month returns that are 43% higher than targets that remain independent; and targets that are sold to another bidder achieve an additional 20%. Combining the two sale outcomes, thirty-month returns in the case of a sale are 80% on average, compared to 25% returns for targets that remain independent.

In short, the large and statistically significant differences between outcome categories indicate that the shareholders of targets that remained independent were made substantially worse off by the defeat of the hostile bid compared with the scenario in which the bid would have been accepted.

2. *Controlling for other parameters.*

We now control for other factors that might influence shareholder returns. We model both short run (nine-month) returns and long run (thirty-month) returns. The results from these two models are reported in Table 6.

Table 6: Shareholder Returns Model

Model # =>	(1)	(2)
Dependent Variable:	9-Month Returns	30-Month Returns
Independent Variables:		
Sold to other bidder	0.41 (0.15)	0.72 (0.21)
Sold to initial bidder	0.17 (0.15)	0.44 (0.22)
ESB	-0.02 (0.14)	-0.02 (0.21)
ESB*Sold to other bidder	-0.05 (0.22)	-0.03 (0.29)
ESB*Sold to initial bidder	0.14 (0.23)	0.14 (0.32)
Dual class stock	0.06 (0.15)	-0.05 (0.20)
Fair price provision	-0.12 (0.12)	-0.06 (0.16)
Pre-bid pill	-0.03 (0.10)	0.04 (0.14)
Supermajority voting provision	-0.04 (0.10)	-0.02 (0.14)
Proxy contest	0.01 (0.13)	0.03 (0.17)
Tender offer	0.18 (0.17)	0.15 (0.23)
Bear hug bid	0.07 (0.21)	0.34 (0.28)
Bust-up bid	-0.02 (0.13)	-0.15 (0.18)
Ln(size)	0.02 (0.02)	0.00 (0.03)
Delaware	-0.11 (0.09)	-0.20 (0.13)
R-sq	30.4%	30.3%

Notes: Standard errors in parentheses; coefficients significant at 95% confidence in bold. All models include a constant term (not reported). n=90 throughout.

Consistent with the findings from Table 6, nine-month returns are significantly

higher when the target is sold to a bidder other than the initial hostile bidder. The 0.41 coefficient from Model (1) is comparable to the 43% higher returns reported in Table 5. This difference persists in the long run: Model (2) shows that returns to target shareholders are 72% higher when the target is sold to another bidder, comparable to the 62% figure reported in Table 5.

In the long run model, returns from initial-bidder sales also become significant at 95% confidence. Model (2) shows that thirty-month returns to target shareholders from sales to an initial bidder are 44% higher than returns to shareholders of targets which remain independent. These findings suggest that target shareholders bear substantial costs, on average, from remaining independent.¹⁴⁸

F. *Do ESB's Produce Offsetting Benefits by Increasing Premia ?*

So far we have demonstrated that an ESB allows a target to remain independent more often against a hostile bid, and that remaining independent is generally rather bad for target shareholders. Against these costs, however, ESB's might provide countervailing benefits for target shareholders. One such benefit might be increased bargaining power for target managers, which in turn would raise the premium in the event of an acquisition. If true, this theory would be consistent with some poison pill studies showing that higher premia are correlated with whether the target has adopted a poison pill prior to a hostile bid or friendly merger.¹⁴⁹

In this Part we test the theory that ESB's might create value for target shareholders by providing target managers with greater bargaining power ("bargaining power hypothesis"). As a starting point, Table 2 shows that the average final bid that a hostile bidder makes for an ESB target is 44.1% over the pre-bid market price, statistically indistinguishable from the 42.4% average final bid premium for non-ESB targets. Focusing only on successful bids, we find that the final acquisition premium is 54.4% for targets with ESB's and 49.6% for targets without ESB's. While this 5% difference in favor of ESB's provides some marginal evidence in favor of the bargaining power hypothesis, we find that it is also statistically insignificant ($t=0.76$). Finally, we run an ordinary least squares regression, with final bid premium as the dependent variable and using the same independent variables as in Tables 3 and 4,¹⁵⁰ and similarly find that the

148. In unreported regressions, we use the log of 9-month and 30-month returns as the dependent variable and obtain similar results.

149. See Aboumeri, *supra* note 121; J.P. Morgan & Co., *Poison Pills and Acquisition Premiums* (manuscript 1995). *But see* Coates, *supra* note 60 (arguing that pre-bid pills should be irrelevant due to the "shadow pill").

150. The results from this regression are on file with the authors. Alternative

coefficient for ESB is not statistically significant in predicting bid premium ($t=0.15$).

Given the lack of any significant differences in premia, it is unsurprising that shareholder returns are not statistically different between ESB and non-ESB targets that are sold. Examining the columns of Table 5, we find that short-run returns for targets that are sold is 56.0% when there is an ESB, and 53.6% when there is not. In the long run, returns for ESB targets that are sold are 80.1%, compared to 79.3% for non-ESB targets. Neither of these differences is statistically significant. While these results do not rule out the possibility that premia and returns against ESB targets might be higher (and statistically significant) if we were to examine a larger sample, the data does suggest that the differences are not of the order of magnitude that would be necessary to offset the big differences in the likelihood of achieving these premia.

In short, ESB's do not provide sufficiently large countervailing benefits for shareholders of hostile bid targets, in the form of higher deal premia, to offset the substantially lower likelihood of being acquired. In fact, the evidence is not sufficient even to conclude that there is any positive effect at all of ESB's on deal premia, though we cannot reject this possibility with our small-sample analysis. However, even if future research were to conclude that ESB's do yield somewhat higher premia for target shareholders in deals that are successful, ESB's clearly do not have a major impact on premia of the kind that would be necessary to outweigh their negative effects on bid outcomes.

G. Overall Effect on Target Shareholder Value

To summarize the argument thus far, we have shown that (1) ESB's substantially increase the likelihood of remaining independent; (2) remaining independent is quite costly compared with accepting the bid; and (3) ESB's do not provide sufficient countervailing benefits (and may produce no benefits at all) in terms of increasing the premium in the event of an acquisition. We now aggregate these various elements and quantify them in order to calculate the overall effect of ESB's on target shareholder value.

1. General findings.

The effect of ESB's on shareholder wealth can be disaggregated into two pieces: first, the increased likelihood of remaining independent that an ESB provides; and second, the cost associated with remaining independent. We have shown so far that both pieces are substantial: Figure 4 shows that the likelihood of remaining

specifications (including using the log of deal premium as the dependent variable) yield similar results.

independent is 26% higher for ESB targets; Table 5 shows that the short-run cost of remaining independent is 36%. This Part quantifies this effect more carefully.

As a starting point we examine total shareholder returns, irrespective of bid outcome, for ESB and non-ESB targets. Shareholders in the ESB targets in our sample achieved 31.8% returns in the nine months after a hostile bid was announced, compared to 43.4% returns for the shareholders in non-ESB targets, representing an 11.6% difference. As noted above, this difference is driven entirely by the difference in success rates for the hostile bidders between the two samples.

2. *Controlling for other parameters.*

Following our methodology in previous Parts, we now control for other factors that might have an independent impact on bid outcomes. Our samples of ESB targets and non-ESB targets may have different characteristics that may lead us to mis-estimate the wealth effects of ESB's when we look only at simple averages. To take an extreme example, if all ESB targets also had fair price provisions and all non-ESB targets did not, and if fair price provisions had an independent impact on either bid outcomes or bid returns, then some of the effect that we attribute to ESB's should in fact be attributed to the fair price provisions. In this Part we attempt to control for this possibility.

If a bid is made,¹⁵¹ returns to shareholders equal:

$$\begin{aligned} & \text{Prob (Acquisition by Initial Bidder)} * E [\text{Return}_{\text{STIB}}] \\ & + \text{Prob (Acquisition by White Knight)} * E [\text{Return}_{\text{STWK}}] \\ & + \text{Prob (Independence)} * E [\text{Return conditional on no acquisition}] \end{aligned}$$

Table 7 provides the appropriate probabilities for the three outcomes (derived from Table 3), along with premia for ESB's and non-ESB's in our data set:

151. In a related paper we address the question of whether takeover defenses affect bid incidence. See Bebchuk, Coates & Subramanian, *supra* note 85. Naturally, if defenses deter bids, then the reduction in target shareholder value would be greater than what we document here, and if defenses (in some counterintuitive fashion) encourage bids, the value reduction would be mitigated. We, however, find that defenses have little to no effect on bid incidence. See *id.*

Table 7: Overall Effect of ESB's on Target Shareholder Value

	Prediction for all targets with ESB's	Prediction for all targets without ESB's	Difference (ESB - no ESB)
Prob (Acquisition by Initial Bidder) *	13.8%	34.0%	-20.2%
E [Return _{STIB}]	46.3%	46.8%	-0.5%
+ Prob (Acquisition by White Knight) *	25.0%	32.0%	-7.0%
E [Return _{STWK}] +	60.3%	60.8%	-0.5%
Prob (Independence) *	61.2%	34.0%	27.2%
E [Nine-Month Return]	17.9%	18.4%	-0.5%
Nine-month target shareholder returns (conditional on a bid being made)	32.4%	41.6%	-9.2%

Notes: Event window is one month prior to bid announcement to nine months after bid announcement, and includes returns from subsequent acquisitions by other bidders.

Probabilities and returns are calculated using the method of recycled predictions, and control for other factors, as listed in Table 3, that may influence bid outcomes.

Model assumes that cash received at any time (e.g., at the completion of a bid) is reinvested at the risk-free rate (assumed to be 6%).¹⁵²

152. Note that the wealth effect differences that we estimate would be larger if we assumed instead that cash was re-invested in the stock market, which was rising

Table 7 shows no statistically significant differences in the returns to target shareholders by type of defense, conditional on a particular outcome being realized. However, the dramatic differences in likelihood of outcomes yield substantial differences in the expected returns to target shareholders. Using the window from one month prior to bid announcement to nine months after bid announcement, the expected returns to target shareholders when an ESB is not present are 41.6%, compared to 32.4% when an ESB is present, a 9.2% difference in returns.¹⁵³

We also estimated the difference in returns using the method of recycled predictions. We run a robust regression to predict nine-month returns, including ESB as a dummy variable in the model and controlling for variables (listed in Table 3) that also might influence bid outcomes and bid returns.¹⁵⁴ We then predict returns in two scenarios: one in which all 92 targets have ESB's, and one in which none of the 92 targets have ESB's. We find that nine-month returns is 32.2% for our set of ESB targets and 40.4% for our set of non-ESB targets, a 8.2% difference.

substantially during the timeframe of our analysis.

153. In a related paper, we show that there is no statistically significant difference in stock price reactions to hostile bids against ESB's and hostile bids against non-ESB's. If past performance is similar to future performance (and we have argued in Part III that there are theoretical reasons to believe that it is), then the results presented here suggest an arbitrage opportunity: short-sell targets with ESB's, and buy targets without ESB's, just after they are put into play. For more detail on this point, see Bebchuk, Coates & Subramanian, *supra* note 85. Other commentators have also identified apparent arbitrage opportunities involving takeover defenses. See Gompers, Ishii & Metrick, *supra* note 56

154. The coefficient for ESB is negative (-0.08), consistent with our theory, but the standard error is sufficiently large (0.10) that the variable is not statistically significant at 95% confidence. At least part of the difficulty arises from the high variability of returns that arises from our relatively long event window. Other commentators have noted the difficulties in examining stock returns over long event windows. See, e.g., Brad M. Barber & John D. Lyon, *Detecting Long-Run Abnormal Stock Returns: The Empirical Power and Specification of Test Statistics*, 43 J. FIN. ECON. 341, 342-43 (1997) (also finding that long run tests are misspecified and identifying new listing bias, rebalancing bias, and skewness bias as reasons); S.P. Kothari & Jerold B. Warner, *Measuring Long-Horizon Security Price Performance*, 43 J. FIN. ECON. 301, 301 & 337 (1997) (finding that tests of multiyear abnormal returns around firm-specific events are "severely misspecified" and concluding that "the interpretation of long-horizon tests requires extreme caution."); Craig E. Lefanowicz & John R. Robinson, *Multiple Bids, Management Opposition, and the Market for Corporate Control*, 35 FIN. REV. 109 (2000) (excluding acquisitions that took more than 250 days to complete "because of the problems . . . in cumulating abnormal stock returns over long event windows.").

Taken together, these calculations suggest that an ESB reduces target shareholder returns on the order of 8-10% in the nine months after a hostile bid is launched. This finding can explain why the passage of Massachusetts staggered board statute reduced the value of companies incorporated in Massachusetts.¹⁵⁵

V. DID SHAREHOLDERS CONSENT?

We have thus far shown that ESB's are by far the most important takeover defense mechanism in the market for corporate control and that they have a substantial negative impact on the wealth of target shareholders. Defenders of ESB's might nevertheless suggest that, whether ESB's are good or bad for shareholders, ESB's received shareholder approval. A SB must be specified in the charter in order to become an ESB, and a charter provision must be specified either at the IPO stage (at which time shareholders would have implicitly accepted the provision by purchasing the IPO shares) or through midstream charter amendment (which requires a shareholder vote). In either case, goes the argument, shareholders would have consented to the ESB.

In this Part, however, we argue that even though all ESB's received formal approval from shareholders, the potency of ESB's as an antitakeover device was never genuinely consented to by the shareholders of the large majority of companies that now have ESB's. Thus, the effects of ESB's that we document were largely unintended by target shareholders when provisions establishing staggered boards were included in corporate charters. To put it more starkly, our argument is that shareholders did not know what they were accepting when they agreed to ESB's.¹⁵⁶

In Part V.A we provide a brief review of Delaware takeover jurisprudence. In Part V.B, we assess the degree of shareholder consent we have today in view of

155. See Robert Daines, *Do Staggered Boards Affect Firm Value? Takeover Defenses After the Poison Pill* (working paper, on file with authors); L. Mick Swartz, *The Massachusetts Classified Board Law*, 22 J. ECON. & FIN. 29 (1998).

156. The "mid-stream problem" resulting from the adoption of charter provisions prior to the developments in takeover law that gave them substantial antitakeover significance was highlighted in Bebchuk & Ferrell, *supra* note 47. We provide below empirical evidence for the very substantial magnitude of the problem as far as charter provisions establishing staggered boards are concerned. We believe the picture is similar with respect to other kinds of antitakeover charter provisions. See also Lucian Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, forthcoming NW. U. L. REV. (2002) (discussing the problem of mid-stream changes in takeover law); Sharon Hanes, *The Determinants and Consequences of Corporate Stagnation: Discussion and Reform Proposal* (2001) (working paper, on file with authors) (discussing the problem of "stagnation" of corporate arrangements).

this chronology. In Part VI, we move on to offer implications of our analysis for takeover law that we believe would restore the intended balance between target shareholders and target managers in responding to hostile takeover bids.

A. *A Brief History of Takeovers and Staggered Boards: From Inco to Moran to Time*

Before the invention of the poison pill, the staggered board was fairly innocuous as a takeover defense. As described in Part III.A, a staggered board could not block a bidder from acquiring a control block and creating a situation in which a board control shift would be inevitable. Given this inevitability, a lame duck incumbent board would resign rather than waiting through two elections. As a result, target boards were unable to use staggered boards to block beneficial acquisitions of a controlling block.¹⁵⁷

The pre-pill era can itself be divided into two distinct periods. Before Inco's successful tender offer for ESB in 1974, hostile tender offers were uncommon, particularly for large, established targets.¹⁵⁸ Thus it is unlikely that the staggered boards that were adopted prior to 1974 were adopted for takeover defense reasons.¹⁵⁹ Even after hostile bids became part of the acceptable toolkit in 1974, neither shareholders nor managers could foresee the advent of the pill, which would cut off the tender offer route and force shareholders to depend on the ballot box as a safety valve against disloyal managers. As a result, although true motives are difficult to discern, managers typically proposed staggered boards before 1984 primarily for the board stability reasons described in Part II.C.1, and shareholders approved staggered boards in that period primarily for the board independence reasons also described there.

From our sample of Investor Responsibility Research Center (IRRC) companies

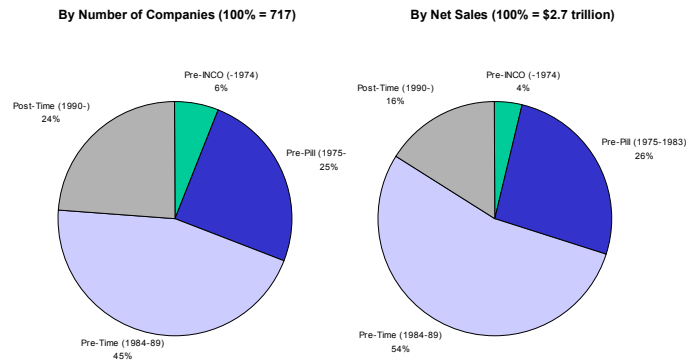
157. In fact, during this period, even deals that were not beneficial might have succeeded. During the era before the poison pill, target shareholders ran the risk that if they did not tender, they would be squeezed out in a back-end squeeze-out (at a lower price) in the event the bidder won. *See supra* text accompanying notes 85-87. In fact, acquirers during this era exploited this possibility through two-tier tender offers, cascading tender offers, and other coercive tender offer structures. *See Guhan Subramanian, A New Takeover Defense Mechanism: Using an Equal Treatment Agreement as an Alternative to the Poison Pill*, 23 DEL. J. CORP. L. 375, 387-389 (1998).

158. *See* BRUCE WASSERSTEIN, *BIG DEAL* 73 (1998). Morgan Stanley's willingness to represent Inco in its bid gave hostile bids a new respectability. *See id.*

159. It is possible that some pre-Inco CB's were adopted to defend against pure proxy fights, of the sort that were not uncommon in the 1950s. But proxy fights in that era were rarely coupled with hostile takeover bids, such that the dynamics and likely effects of those fights on target shareholder returns were vastly different than proxy fights designed to facilitate takeover bids.

(described in Part II.B), Figure 6 below shows that 6% of staggered boards were installed pre-Inco,¹⁶⁰ and another 25% were installed before *Moran* validated the poison pill. Thus, roughly one-third of staggered boards in place today were approved in a dramatically different takeover environment than presently exists.

Figure 6: Staggered Board Incidence by Era



Moreover, while *Moran* changed the landscape, it initially appeared to change it only slightly. After *Moran*, a bidder would have to use the ballot box to gain control of the board, but an alternative, viable route to bid success appeared to remain over and beyond the proxy mechanism, because of the qualified right for target boards to resist a hostile offer. The line of cases beginning with *Moran* and proceeding through *AC Acquisitions Corp.*,¹⁶¹ *Revlon*,¹⁶² *Interco*,¹⁶³ and *Macmillan*,¹⁶⁴ all demonstrated that the right to resist a hostile bid was not absolute, and suggested that Delaware courts would continue to interpret a target board's fiduciary duties so as to enable hostile bids to succeed even without a proxy fight.

Figure 6 shows that 45% of staggered boards by number and 54% by sales were installed after *Moran* but before *Time*. During this period, managers were no doubt motivated by the threat of hostile takeover in proposing staggered boards. Shareholders, meanwhile, generally approved staggered boards during this period

160. Of these, 30% (14 out of 46) were installed before the Williams Act, passed in 1968, which represents another important reference point in takeover regulation.

161. *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986) (enjoining defensive recapitalization under *Unocal*).

162. *Revlon v. MacAndrews & Forbes Holdings*, 506 A. 2d 173 (Del. 1986) (enjoining asset lockup and other defensive actions under *Unocal*).

163. *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988) (enjoining recapitalization and mandating redemption of pill under *Unocal*).

164. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261 (Del. 1989) (enjoining management buyout, following earlier decision to enjoin defensive recapitalization).

because a hostile bidder still had a viable route against a disloyal target board. When a bidder made an offer that shareholders wanted, the case law suggested that the Delaware courts would force a redemption of the pill if the target board did not redeem the pill on its own.

Time, of course, seemed to change all that. To many observers, *Time* transformed what was a highly qualified right to use the pill into a seemingly absolute right to “Just Say No.” Cases such as *Wallace Computer* have shown that courts will allow incumbents to retain a pill and resist a hostile bid indefinitely.¹⁶⁵ Figure 6 shows that only a quarter of staggered boards (and only 16% by sales) appeared post-*Time*, in the modern pill era. Even this figure overstates the number of truly new staggered boards that appeared in the 1990s. Many staggered boards came from IPO’s, where shareholder approval was not necessary (e.g., OfficeMax, Bed Bath & Beyond, Adobe).¹⁶⁶ Many others came from spin-offs, a type of IPO but one where market discipline is weakened by the fact that the pre-IPO “owner” is itself a public company (e.g., Aviall, spun off from Ryder).¹⁶⁷ Finally, many others in the sample came from mergers, in which the surviving company adopts the staggered board in conjunction with the merger (e.g., MCA, Morgan Stanley/Dean Witter, Alumax). In these deals, the staggered board vote is bundled with the merger vote, and shareholders do not have the ability to vote in favor of the deal without also approving the staggered board.

B. *Assessing the Degree of Shareholder Consent*

The analysis in the previous Part suggests that shareholders in companies which adopted ESB’s before 1990 (which is the vast majority of ESB companies today) did not contemplate when the ESB’s were adopted that they were supporting such a strong antitakeover device. Short of a shareholder vote in ESB companies (which we propose in the next Part as one possible approach), we therefore need to infer their current preferences as the shareholder vote (or IPO purchase) is not a sufficient indication of where they stand now. While such an endeavor is at least somewhat speculative, we believe that we are on strong ground in predicting that if shareholders were asked after 1990, when the antitakeover significance of ESB’s became known, they would most likely have rejected ESB’s. The reason is that midstream companies, as documented in Part II.D, have been largely unable to obtain shareholder approval for staggered boards since 1990. In fact, quite the opposite, institutional investors have been increasingly proposing, and shareholders have been increasingly voting for,

165. See *supra* text accompanying notes 69-75.

166. See Coates, *supra* note 2 (documenting the increase in staggered boards among IPO companies).

167. See Daines & Klausner, *supra* note 2.

proposals recommending declassification of the board. This evidence suggests that shareholders of ESB companies would generally vote against staggered boards if the issue were presented to them today.

It might be argued that the preferences of shareholders today can be inferred not from their opposition to midstream adoption of staggered boards in the 1990s, but rather from the fact that many shareholders continue to buy shares in companies that went public with a staggered board. In fact, one of us in other work documents the growing trend in staggered board incidence in IPO companies during the 1990s.¹⁶⁸ However, this evidence is not telling as to shareholder preferences, because it is possible that the ESB may have been reflected in a discounted share price at IPO. In other words, IPO shareholders may have been compensated for the decrease in value caused by the ESB.¹⁶⁹ Because midstream shareholders cannot be similarly compensated, we believe that the actions of midstream shareholders are a better indication of actual shareholder preferences. Put somewhat differently, if shareholders of companies that adopted ESB's prior to 1990 were asked post-1990 to ratify the antitakeover use of their ESB, the choices that they would have been confronted with would have been most similar to those of shareholders that would have faced a vote in the 1990s on whether to adopt a staggered board. This comparison, if correct, strongly suggests that shareholders today would vote against ESB's if given the opportunity.¹⁷⁰

To summarize, staggered boards today are largely the unintended consequence of two unrelated sets of events: uninformed approval of staggered boards by shareholders when staggered boards had little impact on hostile bids, and a series of fact-specific court decisions that increasingly channeled hostile bids into the ballot box route. For lawmakers, this conclusion should seem unsatisfying, to say the least. At a minimum, it might reinforce the perceived lack of legitimacy surrounding judicial approval of the poison pill in *Moran*: not only did the Delaware judiciary in that case allow corporate boards to impose a surprising and dramatic new constraint on the ability of shareholders to sell their stock, but in subsequent cases (would go the criticism) they also greatly enhanced the power of the pill by allowing managers to hide behind staggered boards that were never approved for that purpose – in both cases without legislative action or

168. See Coates, *supra* note 2, at 1353, 1376 and sources cited at *supra* note 2.

169. Of course, it remains a puzzle why pre-IPO owners would prefer to install a device that decreases value to them at the IPO stage. One of us, in the same work cited above, argues that law firm characteristics are important in determining the antitakeover provisions that are installed at the IPO stage. See *id.* at 1370-75. Another possible explanation (not necessarily mutually exclusive) is that takeover defenses may not be adequately priced in the secondary market. Cf. Gompers, Ishii & Metrick, *supra* note 56.

170. Our argument on the validity of shareholder consent does not apply to those companies that adopted ESB's in their IPO charter and went public after 1990. What consequences should be attached to this consent is a question we return to in Part VI.B.

shareholder consent.

VI. IMPLICATIONS FOR TAKEOVER LAW

In view of the powerful antitakeover impact of ESB's, the negative wealth effects associated with this potency, and the absence of clear shareholder approval for this regime, we propose in this Part a modest modification to the existing Delaware law on takeovers. In Part VI.A we describe our recommended approach in the absence of a genuine opt-out by shareholders. We then address the question of whether shareholders should be allowed to opt-out of such a regime.

A. *Redeeming Pills Following Defeat in One Election*

The basic proposal can be stated simply: courts should not allow managers to continue blocking a takeover bid after they lose one election conducted over the offer. Note that without an ESB, no court intervention is necessary in order to achieve this outcome. If managers are defeated in one election, bidders will have control of the board and can redeem the pill and consummate their bid. However, with an ESB, the current Delaware case law allows a board to maintain the pill even after it has lost one election over one third of the directors. Under our proposal, after managers of an ESB target have lost one election that is effectively a referendum on the offer, they should be required to redeem the pill and let the bidder (whose offer has received shareholder support) proceed with its bid.

Compared to other ways of reducing the power of ESB's that we have considered, our recommended approach has several advantages. First, our approach sits well with the basic principles of existing Delaware case law. In fact, we argue that our approach is called for by these principles once the special antitakeover power of ESB's is recognized. Second, and following from the first point, our approach requires no legislative intervention and can be easily implemented by the courts. Third, our approach involves minimal disruption to the existing corporate governance regime because it prevents ESB's from having adverse and unwarranted antitakeover effects without undermining the other, non-takeover reasons for board classification. In the remainder of this Part we discuss each of these points in turn.

1. *Consistency with fundamental principles of Delaware case law.*

First, even if our approach represents a departure from current trends, we believe that it better reflects the fundamental principles of the Delaware case law. An important factual assumption of current takeover jurisprudence has been the existence of a ballot box safety valve against managers who abuse the power to maintain the pill. However, as we have shown theoretically and confirm

empirically, this assumption is incorrect in the case of targets with ESB's. Because of the illusory nature of the ballot box safety valve against ESB targets, the fundamental principles of takeover law justify (if not require) courts' intervention to order managers to redeem the pill following one ballot box defeat.

To see why, begin with *Unocal*, which allows managers to engage in defensive tactics only as long as they maintain balance and "proportionality" against the perceived threat from the hostile bidder.¹⁷¹ Once it is understood that the ballot box route is not viable against an ESB target, then the act of maintaining a pill after a shareholder referendum in favor of the bidder could readily be construed as disproportionate to the threat posed. Thus our proposal is simply an elaboration of the "intermediate" standard of review announced in *Unocal*.

Our approach is also consistent with *Moran*, which states that directors should not "arbitrarily reject" an offer made by a hostile bidder.¹⁷² Refusing to concede after losing an informed shareholder referendum on a bid could fairly be considered "arbitrary," and thus within this intent. More generally, while *Moran*'s language seems to reserve for the court the right to intervene if appropriate circumstances arise, courts have historically declined to use this power, in large part due to their belief that the ballot box safety valve is a viable check against excessive abuse. Once it is recognized that the ballot box route may not be a viable check against disloyal directors of ESB targets, a court-ordered redemption of the pill in appropriate circumstances would represent only a small step from the *Moran* Court's sensible mandate.

Our approach is also consistent with *Unitrin*. Even though this case is known for giving especially strong support to defensive tactics, such tactics cannot be "preclusive" and must fall within a "range of reasonableness."¹⁷³ Given our findings that in not one out of 92 bids in the second half of the 1990s did a bidder win via the ballot box against a target with an ESB,¹⁷⁴ and that ESB's generally and dramatically reduce bid completion rates,¹⁷⁵ our proposed approach flows directly from *Unitrin*'s requirement that a target's defensive response not "preclude" hostile bids. Our analysis suggests that, unless managers are allowed to use a pill-ESB combination to force only one election rather than two, the combination would become preclusive. Our approach is also consistent with

171. Under *Unocal*, the Delaware Supreme Court outlined a two-prong analysis: first, the target board must have some basis for concluding that the hostile bid poses a threat to the company; and second, the defensive measure "must be reasonable in relation to the threat posed." *Unocal*, 493 A.2d at 955.

172. See *Moran*, 500 A.2d at 1354.

173. The second prong of the *Unocal* test was elaborated in *Unitrin* to mean that a defense could be neither preclusive nor coercive, and must otherwise fall in a "range of reasonableness." *Unitrin*, 651 A.2d at 1387-88.

174. See Part IV.B *supra*.

175. See Part IV.C *supra*.

Unitrin's requirement that a target's defensive response fall within a "range of reasonableness": for a target board to continue to maintain a poison pill in place after *both* failing to obtain informed shareholder consent to the combined effect of a staggered board and a pill *and* losing a shareholder referendum on a given bid – with the full opportunity that such a vote provides for target directors to articulate why the bid is not in the interest of shareholders generally – can readily be characterized as unreasonable.

In short, by focusing on the fact that a target has already lost an initial proxy contest in the context of a given bid, our approach provides a way for Delaware courts to create boundaries on the scope of "Just Say No" in a way that is consistent with its existing jurisprudence on the issue.¹⁷⁶ It is helpful to note that our approach would not differ in terms of actual holding, though it would differ in reasoning, from *Wallace Computer*. Recall that in that case, a federal district court, applying Delaware corporate law, refused to order managers armed with an ESB and a pill to redeem the pill even though more than 70% of the shareholders had tendered into the offer. Although we would not be inclined (unlike the *Wallace* court) to allow managers to retain the pill indefinitely, our approach would not call for judicial intervention at the point at which such intervention was requested in *Wallace*. Under our approach attracting enough tenders would not be sufficient to require redemption of the pill – there needs to be a shareholder vote as well.¹⁷⁷ Only after managers have lost an election in the form of a proxy contest should they be required to redeem the pill.

2. *Legislative intervention not required.*

A natural outgrowth of the first point above is that our proposal could be implemented by the Delaware courts without the need for legislative intervention. We believe that this feature makes it more attainable at a practical level. In other work, two of us have independently shown that state legislatures have incentives to pass antitakeover legislation in order to attract and retain companies.¹⁷⁸ To the extent that the Delaware courts are less influenced by the desire to attract incorporation revenues than are state legislatures, courts may be more likely at the margin to make a pro-takeover move.

In addition to this practical benefit, a judicial solution would have a

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

177. For the view that expression of shareholder support through a vote and not only through tender decisions is necessary for a hostile takeover, see Bebachuk and Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*, Olin Working Paper No. 336 (2001); Lucian Arye Bebchuk, *The Case against Veto Power in Corporate Takeovers*, U. CHI. L. REV. _ (2002).

178. See sources cited at *supra* note 29

substantive benefit as well over a legislative approach. A legislative solution would most likely involve the elimination of SB's from the menu of options. As discussed in Part II.C.1, however, there may be legitimate, non-takeover related reasons to have SB's. A judicial approach would preserve these benefits by requiring redemption of the pill only after the incumbent board has lost one election. Therefore a judicial solution could be crafted in a more targeted way than a legislative solution.

3. *Minimal disruption to existing corporate governance regime.*

In fact, this targeted solution may seem so minimalist as to be insignificant. After all, only four hostile bidders in recent memory have won a first proxy contest against an ESB: Moore against Wallace Computer, Carson Pirie Scott against Younkers, U.S. Surgical against Circon; and Weyerhaeuser against Willamette.¹⁷⁹ It would seem, therefore, that our approach would matter only for a very small number of cases from the 1990s.

However, this argument misses the point that all the actions of bidders and targets in all takeover contests occur against the background of the ultimate powers and threats available to the parties.¹⁸⁰ With a non-ESB target, against which the ballot box route is viable, the outcome is influenced not only in those cases in which the bidder wins a ballot box victory, but also in those cases in which target managers decide to proceed to a negotiated sale because they know that they would not be able to defend against an offer capable of obtaining shareholder support. Similarly, with an ESB target, the outcome is affected not only in the few instances in which the bidder wins the first election and then gives up; it is also affected in the larger number of cases in which bidders give up earlier against an ESB knowing that the ballot box route is unviable. Thus, while our approach would only be directly relevant in the very few instances where a bidder was able to last through the first ballot box referendum, it would influence the outcomes of bids against all ESB targets.

In effect, our approach would convert ESB targets into EAT targets for takeover purposes – targets for which the board could be fully ousted but only at the next annual meeting. By doing so, our approach would revitalize the ballot box safety valve against ESB targets. This safety valve would check managerial abuse and would ensure that managers are unable to pursue a course of action that does not ultimately have shareholder support. Our approach targets precisely the antitakeover feature of ESB's while leaving intact other features of

179. Note that two of these bids occurred before our time frame for analysis (Wallace Computer and Younkers) and one occurred afterward (Willamette).

180. Cf. Mnookin & Kornhauser, *supra* note 133.

SB's that may be desirable for non-takeover-related reasons.¹⁸¹ Thus our proposal is both significant (by influencing the "shadow" negotiation that occurs in every hostile bid contest) and minimally disruptive (by preserving existing board structures and allowing staggered boards when they are justified by other business considerations).

B. *The Permissibility of Opt-Out*

The question arises, as is often the case in corporate law policy discussions, whether and to what extent should opting out be allowed. Consider a hypothetical company that adopted an ESB in the 1990s, and would do so again if it were to come to a shareholder vote in the future. Should this company be allowed to have the antitakeover power currently provided by ESB-pill combinations?

The question of contractual freedom has been extensively debated elsewhere¹⁸² and is beyond the scope of our project. For those who believe in unfettered contractual freedom, the answer is that companies should be allowed to opt into any arrangement that receives shareholder approval. This is not our view, nor has it been the view of corporate law in general or of takeover jurisprudence in particular. Corporate law does not offer companies an unlimited choice. Rather, it offers a certain menu of options from which companies may choose.¹⁸³ Thus, the question is whether the arrangement currently offered by an ESB-poison pill combination is one that should be part of the menu from which companies may choose.

As a starting point, we wish to note that even if one were to include this arrangement in the menu, the acceptance of shareholders of staggered board charter provisions prior to 1990 should not count as genuine consent for such an antitakeover device. As already stressed, the considered powerful antitakeover device was not contemplated at the time.

Furthermore, the insights offered by our analysis suggests that the ESB

181. See *supra* Part II.C.1.

182. For an overview of the debate, see Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1395-1415 (1989). An argument for constraining contractual freedom in the context of takeover arrangements is presented in Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989). For a recent empirical work casting some empirical doubt on the optimality of antitakeover arrangements adopted at the IPO stage, see Coates, *supra* note 2, at 1301.

183. To take just one of many examples, companies may choose whether shareholders can act before the annual election or only at the annual election, but companies must hold an election every year, and may not opt-out from this requirement. Similarly, companies may have elections each year for fewer than all of the directors, but there is a limit on the number of classes in which the board may be staggered.

antitakeover device should not be included in the menu – even if one wants to include in the menu some options that provide managers with a greater veto power than an EAT provides. We say “if” because the question of board veto power is one on which there are different views.¹⁸⁴ However, even someone who wishes to include in the menu options that provide greater, even far greater, veto power than provided by an EAT would be well advised to do it through other arrangements rather than the two-election staggered board device.

One way to expand veto power would be to expand the duration of terms to which directors may be elected – an arrangement allowing directors to be elected for a period of X years, where X is greater than the current 1. Another way to expand veto power would be to enable votes on the election of directors take place only Y months after the making of a bid. The first type of arrangement would provide directors that are elected to a certain guaranteed time after they are elected. The second type of arrangement would provide directors with a certain guaranteed period of Y months after a bid is made to prepare and communicate alternatives to shareholders. But both arrangements, however much time they provide, would provide at some point a one-time up-or-down referendum on acquisition offers.

In contrast, such a one-time up-or-down referendum on acquisition offers is never possible, as we have shown, under the current ESB arrangement. While reasons can be given for providing managers more time under one of the two types of arrangements above, there is in our view no good reason whatsoever to prevent the possibility of ever getting a one-time referendum on an offer. There is no good reason for the frictional, ill-functioning arrangement of two votes, one year apart. For this reason, an arrangement under which a hostile bidder would have to win two elections one year apart to gain control should not be among the menu of offered options.

VII. CONCLUSION

Effective staggered boards are the most potent antitakeover device in the current arsenal of takeover defense weapons. An ESB prevents a hostile bidder, no matter when it emerges, from gaining control of the target unless it can wait at least fourteen months and win two elections that are far apart in time. Because of these impediments, the ballot box route becomes illusory against an ESB target.

We find strong empirical support for this argument. ESB’s substantially increase the likelihood that a target receiving a hostile bid will remain independent, which we find to be quite costly for target shareholders, without providing sufficient or even countervailing benefits in terms of higher acquisition

184. For a survey and critique of the arguments for board veto power, see Lucian Arye Bebchuk, *The Case against Board Veto Power in Corporate Takeovers*, U. CHI. L. REV. _ (2002).

premia. We estimate that an ESB reduces the expected return of target shareholders in the nine months after a hostile bid is launched by a substantial 8-10%. The negative wealth effect associated with ESB's is particularly problematic from a policy perspective because the majority of staggered boards were established before the judicial developments that gave them their antitakeover potency.

We propose an approach that courts could follow to address these problems. Specifically, we propose that target managers should not be permitted to maintain a pill after losing a first proxy contest against a hostile bidder. Although our proposal seems to go against the current trend in Delaware case law that is solidifying and expanding the "Just Say No" defense, it would in fact best serve the principles and concerns underlying proportionality review under *Unocal*. Essentially, our proposal would revitalize the ballot box route, which the Delaware courts have relied on so heavily in developing takeover jurisprudence, but whose existence is currently illusory for companies with ESB's.

Our approach would eliminate the entrenching effects of ESB's by addressing both the minimum delay problem and the two-election problem. At the same time, our approach could be easily implemented by courts without the need for legislative change, while maintaining the non-antitakeover benefits that staggered boards might provide. Our approach could, with little cost, contribute significantly to a vibrant acquisition market and thereby to subsequent increases in shareholder wealth.