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## WHY FIRMS ADOPT ANTITAKEOVER ARRANGEMENTS

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# WHY FIRMS ADOPT ANTITAKEOVER ARRANGEMENTS

Lucian Arye Bebchuk*

Abstract: Firms going public have increasingly been incorporating antitakeover provisions in their IPO charters, while shareholders of existing companies have increasingly been voting in opposition to such charter provisions. This paper identifies and analyzes possible explanations for this empirical pattern. Specifically, I analyze explanations based on (1) the role of antitakeover arrangements in encouraging founders to break up their initial control blocks, (2) efficient private benefits of control, (3) agency problems among pre-IPO shareholders, (4) agency problems between pre-IPO shareholders and their IPO lawyers, (5) asymmetric information between founders and public investors about the firm's future growth prospects, and (6) bounded attention and imperfect pricing at the IPO stage.

I also discuss the policy implications of the possible explanations. Among other things, the analysis implies that researchers should not automatically infer that arrangements adopted in IPO charters are ones that enhance shareholder value. The analysis also indicates that board veto arrangements is unlikely to serve shareholders in companies with dispersed ownership and should not be chosen as a default. The analysis provides some support for limits on contractual freedom at the IPO stage. Finally, the analysis suggests that it might be desirable for corporate law to use sunset strategies, requiring that entrenching arrangements adopted by charter provisions lapse after a certain period unless renewed by a shareholder vote.

Key words: corporate governance, corporate control, takeovers, mergers and acquisitions, takeover bids, tender offers, takeover defenses, antitakeover charter provisions, staggered boards, corporate charters, IPO, mandatory rules, sunset arrangements.
JEL classification: G30, G34, K22.

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# I. INTRODUCTION

Strong antitakeover defenses are common among publicly traded firms. Why do firms adopt such arrangements? Furthermore, does the adoption of such arrangements indicate that board veto over takeovers is beneficial to share value? What explains the fact that at the IPO stage firms adopt strong takeover provisions, such as effective staggered boards, that shareholders systematically reject midstream? To what extent should corporate law place limits on firms' choice of antitakeover arrangements? This paper seeks to address each of these questions.

Firms opt for antitakeover protection in two main ways, and both have attracted some attention. First, firms adopt antitakeover charter provisions. Recent work has documented that in the last decade firms that go public have increasingly been incorporating such provisions in their charters.[1] Second, firms incorporate in states that have statutes or case law that make takeovers difficult. Recent evidence indicates that firms making incorporation decisions tend to be attracted to states that provide such protection from takeovers.[2]

Supporters of board veto, whose position has been otherwise disfavored by the accumulating empirical evidence, have argued that the adoption of antitakeover arrangements at the IPO stage provides a "market proof" that board veto is desirable for shareholders.[3] Their inference is unwarranted, however, because shareholder preferences for antitakeover protections are, at the minimum, rather mixed. While the adoption of antitakeover protections at the IPO stage has increased

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1 See John C. Coates IV, Explaining Variation in Takeover Defenses: Blame the Lawyers, 89 Cal. L. Rev. 1301 (2001); Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 17 J. L. Econ. Org. 83 (2001); Laura Casares Field & Jonathon M. Karpoff, Takeover Defenses of IPO Firms, 57 J. Fin. 1857 (2002).

2 See Lucian Arye Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate, 46 J. L. & Econ. (forthcoming 2003); Lucian Arye Bebchuk, Alma Cohen, & Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law, 90 Cal. L. Rev 1775, 1815-18 (2002); Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching, 150 U. Pa. L. Rev 1795 (2002).

3 See, e.g., Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate* Law, 87 VA. L. REV. 961, 985–86; John Elofson, *What If They Gave a Shareholder Revolution and Nobody Came? Poison Pills, Binding Shareholder Resolutions and the Coase Theorem*, working paper (2002); Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 151 U. PA. L. REV (forthcoming 2003); Martin Lipton, Pills, Polls, and Professors Redux, 69 U. Chi. L. Rev. 1037 (2002); Jonathon R. Macey, Displacing Delaware: Can the Feds Do Better than the States in Regulating Takeovers?, 57 Bus. Law. 1025 (2002);. Lynn A. Stout, Do Antitakeover Statutes Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem, 55 Stan. L. Rev. 845 (2002).

over the last decade, shareholder opposition to antitakeover protections through voting decisions has increased as well.[4] In the wake of this seemingly contradictory evidence, a theory is needed that is sufficiently rich to account for the behavior of firms and investors both at the IPO stage and in midstream.[5]

Below I identify and work out several possible explanations that can account for both IPO and midstream behavior.[6] First, under the explanation of <u>encouraging do-concentration of ownership</u>, antitakeover provisions serve the interests of shareholders when firms go public because, in the absence of such arrangements, founders would be discouraged from subsequently reducing their holdings and relinquishing the lock on control coming with concentrated ownership. Under this explanation, while public investors would fare best under dispersed ownership with weak antitakeover provisions, having strong antitakeover provisions in the IPO charter is still preferable because it results in less entrenchment. Thus, antitakeover provisions are desirable at the IPO stage only because they encourage founders to break up their control blocks. Then, once ownership is sufficiently dispersed so that the votes of public investors matter, the benefits of antitakeover protections disappear. This can explain the midstream opposition of such investors to antitakeover arrangements.

Under the <u>efficient rent protection</u> theory, antitakeover arrangements are always undesirable for public investors and reduce the value of their shares. However, the benefits of rent protection obtained by the founders through the antitakeover provisions are, at least at the IPO stage, greater than the resultant reduction in share price that the provisions cause. In this case, antitakeover arrangements are efficient overall; thus, assuming no informational problems, founders find it in their interest to adopt them at the IPO stage even though this reduces the price they can get for their shares. At the midstream stage, however, if

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[4] See Lucian Arye Bebchuk & Allen Ferrell, Federalism and Corporate Law: The Race to Protect Managers from Takeovers, 99 Col. L. Rev. 1168 (1999) (discussing the implications of this midstream behavior for an assessment of shareholders' preferences); Lucian Arye Bebchuk & Allen Ferrell, 87 Va. L. Rev. 993 (2001) (same).

[5] See Michael Klausner, Institutional Shareholders' Split Personality on Corporate Governance: Active in Proxies, Passive in IPOs, 151 U. Pa. L. Rev (forthcoming 2003). Klausner provides a compelling account of seemingly conflicting patterns of IPO and midstream behavior and of the need to reconcile them. He ends by discussing some explanations that differ from the ones I put forward below, but he continues to view the observed patterns as a "puzzle."

[6] As I will note, some of the suggested explanations are new, and some build on earlier works written by myself and by others. For all explanations, my analysis seeks to contribute by working out fully the explanation, examining the extent to which it can explain empirical patterns, and drawing its implications for legal policy.

an antitakeover arrangement is proposed to shareholders, they have every reason to vote against it as long as they do not receive appropriate compensation for the resulting reduction in the value of their shares. Similarly, if they could undo the antitakeover arrangement, shareholders would vote to do so in midstream.

Under agency cost explanations, antitakeover arrangements may be adopted even though they are inefficient. That is, the cost to the pre-IPO shareholders from reduced IPO revenues caused by such arrangements is smaller than the benefits to them in the form of rent protection. And given that antitakeover provisions reduce share value, shareholders can be expected to vote against such arrangements in midstream. The question remains, however, as to why pre-IPO shareholders adopt such arrangements; the answer given is that agency problems on the side of the pre-IPO shareholders lead them to adopt inefficient charter provisions.

One type of agency problem is an agency problem among IPO shareholders. Here, when only some of the pre-IPO shareholders will continue to run the firm after the IPO, these founders-managers might have an incentive to put antitakeover arrangements in the charter because they will fully capture the benefits in terms of rent protection while bearing only part of the cost in terms of reduced IPO share price.

Another type of agency problem is an agency problem between lawyers and pre-IPO shareholders. To the extent that lawyers' expertise gives them influence over decision-making, they might have an incentive to tilt their recommendations in the direction of antitakeover arrangements. The downside of not having an antitakeover protection -- that incumbents might find themselves unprotected from a hostile bid down the road -- might be attributed to the lawyers and might negatively affect their reputation. And the potential upside from not including antitakeover provisions -- a slightly higher IPO share price -- would hardly be credited to the lawyers' work. As such, while the adoption of antitakeover provisions provides a benefit to lawyers and no cost to them, they have an incentive to use their influence over the drafting of the charter to encourage antitakeover arrangements, even though these arrangements are inefficient for both founders and shareholders.

Under the asymmetric information theory, public investors are assumed to have perfect information about the effect of the provision given any value of the company's assets, but to have imperfect information about the value of these assets. In such a case, assuming that higher asset value is associated with higher expected benefits from rent protection, some or all founders will have an incentive to signal a high asset value by adopting antitakeover arrangements. While shareholders know that antitakeover arrangements are inefficient and will reduce the share price at the

IPO stage accordingly, the increase in share price as a result of the information conveyed concerning asset value outweighs this negative antitakeover effect. Thus, this signaling effect may provide founders with an incentive to adopt inefficient antitakeover provisions at the IPO stage. Shareholders, however, will oppose such inefficient protections in midstream.

Last, but not least, under the bounded attention theory, investors at the IPO stage do not bother to price antitakeover arrangements that fall within a certain set of conventional arrangements. The exact location of the firm's choice within this set is viewed as relatively less important than the other uncertainties involved in valuing a closely held company that is going public. Without the aid of prior market pricing and exposure to market analysis, the level of uncertainty about the value of the company's assets and management is relatively high. Furthermore, the consequences of the chosen antitakeover arrangement would have the most impact down the road after shares become more dispersed. As a result, even if investors view some antitakeover arrangements as theoretically inefficient, they might not bother to factor them into the price they are willing to pay for IPO shares. In contrast, down the road, at the midstream stage, when questions concerning antitakeover arrangements come to a vote in circumstances that make investors focus on the issue in isolation from others and that make the issue practically important, the inefficiency of antitakeover arrangements will lead shareholders to vote against them.

The paper concludes with a discussion of the implications of the analysis for legal policy. First, I argue that the evidence provides no basis for believing that board veto is a beneficial default for public investors of companies with dispersed ownership. To be sure, there are explanations under which such arrangements would be desirable if they were part of the bargain clearly made in the IPO stage. Under all explanations, however, the value of the shares of public investors in companies with dispersed ownership is lower under a board veto regime, and there is no reason to impose such a regime on companies in midstream as some judicial decisions and antitakeover statutes have done.

Second, the analysis of some of the possible explanations for the adoption of IPO antitakeover arrangements hardly reassures us that the selection of corporate governance provisions at the IPO stage represents the fine and careful optimization that some influential views claim it is. While the considered empirical patterns do not rule out the possibility that IPO arrangements are optimal, they are equally supportive of accounts that view IPO choices as rather imperfect. Thus, the long-standing legal policy of providing IPO firms with a menu of limited options rather than with unlimited contractual freedom might well be wise. When an arrangement seems sufficiently likely to be value-reducing, it may be efficient not to permit shareholders to adopt it in their IPO charters. Staggered boards, for example, might well be an arrangement that should not be included in the menu of options even if it is desirable to permit opting out into arrangements that provide directors with a longer horizon.

Third, the analysis highlights the difference between what might be optimal at the IPO stage and what might be optimal down the road. Even when certain measures that operate to the benefit of managers and controllers are permitted at the IPO stage, this hardly implies that companies should be permitted to adopt such measures for an indefinite term. State corporate law has thus far opted either to prohibit a given arrangement or permit its adoption for an indefinite period. An additional and potentially valuable strategy is to permit firms to adopt provisions that opt out of the law's default that (unless the charter is amended to re-adopt them) would remain in place no longer than a certain specified period. The potential value of this strategy is suggested by the analysis of the differences between IPO and midstream stages.

Fourth, the lessons of the analysis carry over to other corporate governance questions. We should not automatically infer that arrangements adopted at the IPO stage must be ones that enhance shareholder value. Furthermore, there are reasons to be skeptical about claims for complete contractual freedom in IPO charters. Some limits on the menu of permissible choices, and some use of sunset provisions, might well be warranted.

The rest of this paper is organized as follows. Section II describes the conflicting evidence of shareholder preference for antitakeover provisions. Section III develops and analyzes alternative explanations for the difference in behavior between the IPO and midstream stages. Finally, Section IV discusses public policy implications.

## II. The Optimality Inference and its Shortcomings

### *A. The Debate Over Board Veto in Corporate Takeovers*

There are reasons to believe that strong antitakeover protections decrease share value, and I review them in detail elsewhere.[7] Ex post -- that is, once a bid is on the table -- incumbents can use their veto power to block an acquisition that would be beneficial to shareholders. The evidence indicates that incumbents armed

7 *See generally* Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002).

with a staggered board are much more likely to retain independence in the face of a hostile bid, and that the decision to remain independent commonly makes shareholders worse off.[8]

Furthermore, ex ante, having a board veto reduces the disciplinary force that the takeover threat can exert on incumbents. The evidence indicates that, when managers are protected from takeovers by strong antitakeover statutes or by antitakeover provisions, managerial slack increases.[9] When managers have less to fear from takeovers, they fail to reduce costs and have poorer operating performance, including lower profit margins, return on equity, and sales growth.

Proponents of strong antitakeover protections often cede, or at least do not challenge, that the above costs of board veto exist.[10] Their strategy has been to stress the potential benefits of board veto, but thus far they have failed to show empirically that these benefits exist and are of sufficient magnitude to outweigh the costs of board veto. One suggested benefit is that, even if incumbents might abuse their veto in hostile bid cases, they can use it to benefit shareholders by raising premia in negotiated transactions.[11] There are reasons to doubt, however, that board veto provides substantial countervailing benefits in terms of increased premia. In a recent preliminary study of this question, Coates, Subramanian, and I find no statistically significant effect of staggered boards on premia in bids. Furthermore, there is evidence that managers are willing to trade off premia for personal gains in the wake of a takeover,[12] which further casts doubt on the suggestion that giving managers more bargaining power would result in more value to shareholders.

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

[9] *See* Marianne Bertrand and Sendhil Mullinathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999); Gerald T. Garvey and Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519, 520 (1999). *See also* Paul A. Gompers, Joy L. Ishii, & Andrew Metrick, *Corporate Governance and Equity Prices*, NBER Working Paper No. 8449 (2001), *available at* http://papers.nber.org/papers/w8449.pdf.

[10] *See* sources cited *supra* note 3.

[11] See e.g., Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819 (2002).

[12] *See* Jay Hartzell, Eli Ofek, and David Yermack, What's in It for Me?: Personal Benefits Obtained by CEO's Whose Firms Are Acquired 3, (2002) (New York University Stern School of Business working paper), *available at* http://www.stern.nyu.edu/~eofek/papers.htm ( last visited Mar. 21, 2003) (reporting that CEOs whose firms are acquired obtain total financial of gains with a median value of $4 to $5 million and a mean value of $8 to $11 million); Julie Wulf, Do CEOs in Mergers Trade Power for Premium?: Evidence from "Mergers of Equals" (2001)

Proponents of board veto have also argued that it might have beneficial effects ex ante. It is argued that board veto can encourage long-range investment and prevent managerial myopia. As I explain elsewhere, there is currently no empirical support for the view that these conjectured effects are sufficiently significant to outweigh the adverse ex ante effects of board veto.[13] All the above can explain why proponents of board veto have so much welcomed and relied heavily on the recent evidence that companies adopt antitakeover provisions at the IPO stage.

### *B. IPO Behavior and Optimality*

While state corporate law has for the most part sanctioned the various elements of board veto, it has by no means mandated these elements. Corporate charters could seek to tie management's hands from blocking offers by restricting board power to use poison pills. Alternatively, corporate charters could provide arrangements that reinforce the pill by making it more difficult for a hostile bidder to replace the board with a team that would redeem the pill. Recent empirical evidence that has attracted much attention indicates that firms going public during the past decade have designed their charters to support, rather than eliminate, board veto.[14]

To begin, while state law universally recognizes the validity of the poison pill, charters routinely authorize the use of blank check preferred stock that is used for creating poison pills. This practice is not surprising, however, for the poison pill by itself does not result in board veto, and is probably not, on its own, value-decreasing. The poison pill still allows shareholders to decide whether to authorize the takeover; it merely forces them to express their preferences through a vote on replacing the directors.

While the ability to force a shareholder vote through the poison pill is not by itself value-decreasing, there are other antitakeover protections -- those that substantially impede the ability of shareholders to replace the board quickly -- that can provide management with substantial veto power. In particular, the combination of the poison pill and an effective staggered board provides management with considerable veto power. Unlike the poison pill, which can be

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(working paper), *available at* http://knowledge.wharton.upenn.edu/PDFs/1009.pdf (last visited March 21, 2003).

13 See Bebchuk, supra note 7, at 1011-13.

14 *See* sources cited *supra* note 1.

adopted at any time by the board and does not require shareholder approval, staggered boards usually require a charter provision.

Empirical evidence suggests that IPO firms opted for staggered boards and other antitakeover provisions at an increasing rate throughout the 1990's. For instance, in his comprehensive study of IPO charter provisions, Coates found that only 34% of firms adopted staggered boards at the IPO stage in 1991-92, while that number rose to 66% in 1998 and 82% in 1999.[15]

According to a widely held view,[16] firms at the IPO stage have powerful incentives to adopt arrangements that benefit shareholders, and the adoption of arrangements at this stage thus provides evidence of their optimality. Applying this general view to the takeover context, supporters of board veto argue that this pattern was due to—and thus was evidence of—the positive effects of board veto on share value.[17] On their view, the IPO evidence indicates that shareholders –- who are in the best position to know their interests –- wish to implement board veto. The existing direct evidence concerning the adverse effects of board veto, they argue, should take back seat to the clear expression of shareholder preferences that IPO charters provide.

### *C. Conflicting Midstream Behavior*

The evidence with respect to shareholders' preferences, however, is much more mixed than supporters of board veto would like to believe. Indeed, while IPO charter provisions are argued to enable an inference of shareholder preferences, shareholders have been expressing their preferences directly and clearly in their voting decisions.

Throughout the past decade, shareholders of existing companies have been generally unwilling to vote in favor of amending the charter to include antitakeover provisions that would make replacement of the board more difficult. In the wake of this dwindling shareholder support, boards have all but stopped proposing such amendments. From 1986 to 2000, the annual number of such proposals dropped by 90 percent.[18]

Furthermore, shareholders' opposition to antitakeover charter provisions has been reflected in the large and growing support given to precatory resolutions to

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15 Coates, *supra* note 1, at 1376.

16 *See* Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

17 *See* sources cited *supra* note 3.

18 *See* Klausner, *supra* note 3, at 3–4.

dismantle existing staggered boards.[19] For instance, Patrick McGurn, Special Counsel for Institutional Shareholder Services, has stated:

> "In the wake of the corporate scandals of the past several months, ISS often receives inquiries as to our views on the two or three key governance changes that—if adopted by all issuers—would help investors to avoid similar market meltdowns in the future. Unquestionably, the item on our wish list that draws the blankest stares from corporate America is the call for annual elections of all members of corporate boards.[20]"

McGurn goes on to note that over the last three years, precatory resolutions to repeal staggered boards have on average received support from a majority of the shareholders participating in the vote.[21] The evidence shows that this support is strong and has been increasing over the last decade.

That these proposals have been able to gain a majority is particularly striking due to the tendency of shareholders to side with the board in votes on precatory resolutions. Many other such resolutions, even those that are potentially beneficial for shareholders, receive little institutional support, in part due to institutional shareholders' desire to maintain good relationship with management. But on the issue of staggered boards, the institutional shareholders speak loudly, persistently, and with a clear voice. This pattern provides very strong evidence that shareholders do not favor charter provisions that facilitate board veto.

### *D. Attempting to Reconcile IPO and Midstream Behavior*

Can supporters of board veto reconcile the shareholder voting evidence with their claim that shareholders often prefer a board veto? One possible response is that it may take time for shareholders to learn about the precise effects of board veto on share value.[22] On this view, shareholder voting against takeover defenses is a

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19 *See* GEORGESON SHAREHOLDER, ANNUAL CORPORATE GOVERNANCE REVIEW: SHAREHOLDER PROPOSALS AND PROXY CONTESTS (2002) (noting that 60% of voters favored precatory resolutions to repeal classified boards in 2002).

20 Patrick S. McGurn, *Classification Cancels Corporate Accountability*, 55 STAN. L. REV. 839, 839 (2002).

21 *Id.*

22 See Kahan and Rock, supra note XXX (?).

transient phenomenon that will gradually go away as all shareholders learn to recognize the beneficial effects of such defenses.

This explanation, however, is undermined by an examination of the trends over time. During the 90's, the incidence of antitakeover provisions in IPO charters has been increasing, while the percentage of shareholder voting in opposition to staggered boards has been increasing as well. Under the learning conjecture, learning should gradually lead to convergence of IPO and midstream behavior, but in fact we've seen the opposite. As players' experience with antitakeover provisions has increased, both the IPO adoption and the midstream opposition have become more pronounced.

The second argument advanced by the supporters of board veto is that strong antitakeover protections are beneficial for some companies but not for others.[23] On this view, IPO adoption of antitakeover arrangements is limited to companies of the former type that go public, while midstream opposition to such arrangements occurs in firms of the latter type. This heterogeneity-based explanation, however, is also undermined by the evidence.

For one thing, IPO adoption of antitakeover arrangements has become practically universal rather than limited to certain types of companies. The incidence of staggered board adoption at the IPO stage has been increasing considerably and now exceeds 80%.[24] At the same time, shareholders' midstream opposition to staggered boards is also practically universal rather than limited to some types of companies. To be sure, precatory resolutions to dismantle staggered boards, which are non-binding anyway, occur in only a limited fraction of companies. However, there is a very large number of existing companies without staggered boards that are all practically precluded from adding a staggered board due to practically universal opposition to such charter amendments.

Could one argue that all existing companies without a staggered board are of a type for which a staggered board is not beneficial, rather than of a type for which a staggered board is beneficial? That would be implausible because the selection of existing companies that do not have staggered boards does not reflect their current type. Most publicly traded companies went public prior to 1990, and since 1990 companies that did not already have a staggered board have been unable to get shareholders to approve the adoption of a staggered board. Thus, the absence of staggered boards in existing pre-1990 companies at most reflects their pre-1990 type rather than their current type. Thus, the inability of such companies to obtain shareholder support for a charter amendment establishing a staggered board

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[23] *See generally* Kahan & Rock, *supra* note 15.

[24] *See generally* Coates, *supra* note 1.

indicates that shareholder opposition to midstream adoption of such an amendment is universal rather than specific to some types of companies.

Thus, it is not possible to accept the simple Panglossian theory that the common adoption of antitakeover provisions in IPO charters indicates that shareholders prefer to have such arrangements. The view that IPO charters simply seek to satisfy shareholders' wishes to have companies governed by antitakeover provisions is inconsistent with shareholders' midstream strong and persistent opposition to such provisions. What is needed, then, is a richer account that can explain both IPO and midstream behavior. Investigating what such an account might be is the task of the next section, which identifies several explanations for the complex empirical reality that we observe.

## III. EXPLAINING IPO AND MIDSTREAM BEHAVIOR

### *A. A Simple Model*

In order to explore the incentive effects facing firms and shareholders, both at the IPO stage and midstream, it is helpful to consider a paradigmatic, stylized model. Through this model we will be able to view the various possible theoretical explanations for the empirical data described above, namely the efficiency theory, the agency cost theory, and the signaling theory.

The model contains three different time periods. In the first period, $T_0$, the founders of a company are taking a company public. The founders have decided to sell only a fraction $\alpha$ of their shares. I assume that, as is common in IPOs, the fraction $\alpha$ amounts to a minority of the shares, so that immediately after the IPO the pre-IPO shareholders still hold a majority of the shares. The founder-manager running the firm prior to the IPO is expected to continue running the firm after the IPO.

When the founders take the company public, they also must choose whether to incorporate antitakeover charter provisions in the IPO charter. For simplicity, I will assume that the choice made is between an arrangement BV under which the board has a veto power over takeover bids, and arrangement No-BV under which the board will not have such a veto power. Because this choice might affect the value of public investors' shares in the event that the company will move to dispersed ownership down the road, this choice might also affect the price paid for shares at the IPO. Let P denote the price that public investors are willing to pay for the fraction $\alpha$ of the shares under a No-BV arrangement, and let $P + \Delta P$ denote the price they would be willing to pay for the shares with BV.

In the second period, $T_1$, there is a probability $\theta$ that the manager of the firm will face a profitable investment opportunity. To finance such an expansion, the firm would need to raise an amount K in a secondary offering of shares. The investment would produce a value of $K + \Delta K$ (where $\Delta K$ is positive). It is assumed that the amount needed is sufficiently large that, if the expansion is pursued, the founders would no longer have a majority of the votes and thus would not have a lock on control, which would make the initial choice between BV and No-BV relevant. Such a development will be referred to as "a move to dispersed ownership."

In the third period, $T_2$, the company operates. If the company did not expand in $T_1$, the company will produce a cash flow of V for its shareholders, as well as a private benefit of B for its manager. If the company did expand and move to dispersed ownership, the values captured by the shareholders and the manager will depend on whether BV or No-BV was initially chosen.

If the company adopted a BV arrangement at the IPO, the manager will be able to continue and enjoy a private benefit of B even though the company is now in dispersed ownership. In contrast, under No-BV and dispersed ownership, the manager will be able to enjoy only a lower level of private benfits, $B\text{-}\Delta B$. Thus, $\Delta B$ is the positive effect on private benefits that antitakeover protection provides. This effect can be composed of the security of getting the private benefits of office, or the extra benefits that they would be able to extract without fear of a takeover.

As to the cash flow captured by shareholders, it will be $V+K+\Delta K$ under a BV arrangement. In this case, even though private benefits are assumed not to decline, cash flow will increase because of the expansion. A No-BV arrangement, which would reduce private benefit by $\Delta B$, would increase cash flows by $\Delta V$. While we have every reason to assume that $\Delta B$ is positive – that not having takeover protection will reduce the manager's private benefits – I make no assumptions about $\Delta V$. If antitakeover protection benefits shareholders – say, due to increased bargaining power for the board, or decreased pressure to focus on short-term results -- $\Delta V$ will be actually negative, i.e., No-BV will reduce cash flows. In contrast, if the antitakeover protection reduces cash flows – say, due to increased shirking or extraction of benefits by management -- $\Delta V$ will be positive. The question whether antitakeover protection enhances share value is equivalent to the question of whether $\Delta V$ is negative.

## *B. Efficiency-Based Explanations*

### *1. Inducement to De-concentrate Ownership*

Under this theory, BV has a negative effect on shareholders given dispersed ownership. But shareholders are even worse off when the company does not move to dispersed ownership. Thus, under this explanation, shareholders prefer BV in the IPO charter at $T_0$ because, in the event that a profitable investment opportunity emerges, it will encourage the firm to raise capital and to move to dispersed ownership at $T_1$. [25]

The value of minority shares in the company if the company does not move to dispersed ownership will be lower than the value of shares under dispersed ownership. In our model, the increase in value comes from the fact that the investment opportunity is a profitable one and the public investors share in the value of it. Furthermore, while in our model we assume for simplicity that BV with dispersed ownership enables the manager to enjoy as high a level of private benefits as he would with concentrated ownership, this is unlikely to be the case in general. The lock on control when the founders maintain a controlling block of shares is stronger than their lock on control under BV with dispersed ownership.

Let us suppose that $\Delta V$ is positive. In this case, if public investors could count on the company moving to dispersed ownership in the event that the profitable opportunity arises, they would prefer to have a No-BV arrangement, and would be willing to pay a higher price at the IPO for their shares under No-BV than under BV. However, getting to dispersed ownership is not a certainty, and, more importantly, the likelihood they will get there might depend on whether there is BV.

At $T_1$, the controller will clearly elect to expand if the initial arrangement chosen is BV. The expansion will not reduce private benefits. At the same time, it will increase the cash flows that will be captured by the initial shareholders including the founders. The expansion will increase cash flows by $K + \Delta K$, but to raise the needed K it will be necessary to provide claims to cash flow in the amount of K. Thus, the initial post-IPO shareholders – the founders and the shareholders purchasing shares at the IPO will gain an amount of $\Delta K$, and the founders will capture a fraction $(1-\alpha)$ of this gain.

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[25] The analysis in this section builds on Lucian Bebchuk, Rent-Protection and the Evolution of a Firm's Corporate Ownership, Working Paper, October 1999. This paper establishes that controlling shareholders might be discouraged from making efficient moves to dispersed ownership when such a move would reduce their private benefits of control.

However, under a No-BV arrangement, the manager might elect not to pursue the efficient expansion opportunity if it emerges. With No-BV, the expansion will reduce private benefits by $\Delta B$, a cost that the manager will fully bear. The expansion will also increase the cash flows captured by the initial shareholders by $\Delta K+\Delta V$, but the founders will capture only a fraction $(1-\alpha)$ of this increase. Thus, because the manager will bear the full cost of the expansion in terms of forgone private benefits, but will not fully capture the benefits in terms of increased cash flows, the manager's private interests might be served by not taking the efficient investment opportunity. This will occur if

$$(1-\alpha)(\Delta K + \Delta V) - \Delta B < 0,$$

or, alternatively stated, if

$$\Delta K+\Delta V-\Delta B < [\alpha/(1-\alpha)]\Delta B.$$

Thus, if this condition is satisfied, the shareholders will prefer a BV arrangement to a Non-BV arrangement even though $\Delta V$ is positive and a No-BV arrangement increases the value of shares under dispersed ownership. When this condition is satisfied, the company will not reach dispersed ownership if Non-BV is chosen, and the effect of Non-BV in such a case is thus irrelevant.

In the simple model that I use, because the profit from an efficient expansion opportunity is fixed at $\Delta K$, the adoption of a No-BV arrangement will either prevent efficient expansion or will have no effect on the likelihood of such expansion. In a more general model, in which there is a distribution of possible values for $\Delta K$, a No-BV arrangement will prevent efficient expansion when the value of $\Delta K$ is small enough but not when the value of $\Delta K$ is large enough. In such a case, the cost of a No-BV arrangement is that it will reduce the likelihood of efficient expansion and a move to dispersed ownership. And this cost might lead buyers of shares at the IPO to prefer, and to be willing to pay more for, shares with a BV arrangement.

Thus, the effect of BV arrangements on the likelihood of a subsequent move to dispersed ownership might make such an arrangement preferable for buyers of shares at the IPO stage. This could explain the adoption of BV in the IPO charter. Such an adoption would increase the value that buyers would be willing to pay for the $\alpha$ of the shares sold, and at the same time would enable the value of the founders' block in the event that the company will later on move to dispersed ownership. This explanation is also consistent with the midstream opposition to BV arrangements. Once a company moves to dispersed ownership, and how public investors vote becomes important, the effect of BV on the likelihood of a move to dispersed ownership is irrelevant. At this stage, as long as $\Delta V$ is negative, shareholders will have an incentive to vote against amendments to adopt BV arrangements and to attempt to remove existing BV arrangements should the opportunity arise.

Assuming that this explanation accounts for the IPO adoption of BV arrangements, what does this tell us about antitakeover policy? It suggests that, when BV arrangements are adopted at the IPO stage, they perform an efficient role and such adoption should be permitted and respected. Otherwise, firms would be discouraged from making efficient investments that require a move to dispersed ownership, or would be forced to resort to less efficient alternatives such as the issuance of dual class stock. At the same time, however, this explanation also implies that BV arrangements reduce the value of shares in companies that already have dispersed ownership. Thus, BV arrangements should not be used as a default, and should not be imposed in midstream (as has been done by some courts and legislatures) on dispersed shareholders of existing companies that did not explicitly include such arrangements in their IPO charters.

*2. Efficient Rent Protection*

Let us now put aside the first explanation considered above by assuming that the company is going to move to dispersed ownership whenever an efficient opportunity to expand arises. Under an efficient rent protection theory, $\Delta V$ is assumed to be positive, so that the value of shares under dispersed ownership is lower with a BV arrangement. However, the reduction in cash flow $\Delta V$ is smaller than $\Delta B$, the increase in private benfits enjoyed by the manager under BV. Thus, even given a move to dispersed ownership, the use of BV is overall efficient.

Under this explanation, public investors will be willing to pay less for shares both at the IPO stage and in the subsequent second offering stage. However, the founders will be willing to bear this cost because the benefit to them of capturing higher private benefits will outweigh the costs arising from the lower value attached by public investors to shares in the company.

The efficient rent protection hypothesis can help explain the empirical data. Under this theory, we should expect founders to put antitakeover provisions in IPO charters because, even after "fully paying" for their higher private benefits enjoyed under BV arrangements, they will be better off retaining these higher benefits. However, given that the effect of BV arrangements on public investors is negative, we would expect them to reject a move to such arrangements midstream, and to vote to remove them when the opportunity to do so arises.

If BV arrangements produce an overall efficient increase in private benefits, one might wonder why managers of existing companies with such arrangements do not "bribe" shareholders to approve an antitakeover charter amendment – i.e., offer to pay a certain amount to the company if the shareholders approve such an amendment. One possible explanation is that managers might be concerned that offering to make such a side payment could be regarded as a violation of fiduciary duties. Second, at later stages in the life of mature companies, managers might have cash constraints that prevent such a payment. If the founders reduce their ownership over time not by selling their own shares and keeping the proceeds, but rather by raising more capital for the firm and issuing more shares to finance the raising of capital, the founders-managers might not have enough cash to purchase shareholders' consent to move to a BV arrangement.

The two efficiency-based explanations thus far explored have different empirical implications that can provide the basis for empirical testing. Under the explanation based on incentives to de-concentrate ownership, a BV arrangement has a positive effect on the value of public investors' shares immediately following the IPO. Thus, share value (as measured, say, by Tobin's Q, should be higher for firms with BV provisions than for firms without such provisions. In contrast, under the efficient rent-protection theory, a BV arrangement has a negative effect on the value of public investors' shares immediately following the IPO. Thus, share value should be lower for firms with BV provisions than for firms without such provisions.

As for policy implications, the efficient rent protection theory has similar implications to those of the explanation based on incentives to de-concentrate ownership. Under the efficient rent protection explanation, because BV provisions at the IPO can increase the overall pie, adopting them in the IPO should be permitted. However, in the absence of explicit charter authorization of a BV arrangement, the default arrangement should be one of No-BV. Under the considered explanation, as long as public investors are not compensated for such a change, a move to a BV regime makes them worse off. Thus, the past imposition of BV arrangements on the shareholders of existing firms made them worse off and was not warranted.

### *C. Agency-Based Explanations*

Under the above two explanations, the founders – the pre-IPO shareholders – overall benefited from the adoption of BV arrangements in the IPO charter. In contrast, under the set of explanations to which I now turn, such adoption makes the pre-IPO shareholders worse off as a group, but agency problems lead these shareholders to make an adoption decision that leaves them overall with a smaller pie. The first such explanation focuses on agency problems among the firm's founders. The second such explanation focuses on agency problems between the founders and their lawyers.

*1. Agency Problems Among Pre-IPO Shareholders*

Consider a situation in which the founders consist of five shareholders with equal holdings who are all members of the same extended family. One of the members manages the firm and is expected to continue to do so after the IPO, while the other members conduct a life of leisure and philanthropic activities. In this case, the interests of the shareholder-manager, who might have a dominant influence on the design of the IPO, are different from, and in particular more favorable to a BV arrangement, than the interests of the other shareholders. [26]

The reason for this is that the shareholder-manager can capture 100% of the higher private benefits that a BV arrangement would produce. In contrast, the shareholder-manager would not fully bear the costs of such an arrangement to the pre-IPO shareholders as a group. These costs would come from lower cash flow down the road and correspondingly from lower prices for shares sold at the IPO stage and the second public offering. However, the shareholder-manager would bear only 20% of these costs.

Thus, because the shareholder-manager would capture 100% of the benefits of a BV arrangement to the pre-IPO shareholders as a group but would bear only 20% of the cost, the shareholder-manager might prefer to include a BV arrangement even if such an arrangement would reduce the overall wealth of this group. Essentially, the distortion arises from the fact that the shareholder-manager might ignore the external cost that the adoption of a BV arrangement might impose on the other pre-IPO shareholders.

The question raised by this explanation, of course, is why the other founders do not prevent such an agency problem from occurring. If a BV arrangement would make them worse off, why wouldn't they prevent the shareholder-manager from adopting it or, alternatively, "bribe" this shareholder-manager not to do so. The other shareholders might sometimes be passive and uninformed, and thus have little ability to control or monitor the decisions of the shareholder-manager with respect to many of the fine points of the IPO design.

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[26] See Field and Karpoff, *supra* note 1.

This explanation, like the others, is one under which the optimal default in the absence of a charter provision to the contrary is that of No-BV. However, unlike the two efficiency-based explanations discussed above, this explanation does not imply that it is desirable to permit IPO charters to adopt BV arrangements. To the extent that such arrangements are adopted due to an agency problem, such adoption cannot be expected to produce efficiency benefits. A recent study by Field and Karpoff provides evidence that is consistent with the considered agency problems playing a role in the IPO adoption of antitakeover protections.[27] The study finds that, during the 1988-1992 period, the likelihood that a firm going public adopted antitakeover provisions was inversely related to the fraction of the pre-IPO shares held by the manager. The smaller this fraction, of course, the greater the incentive of the manager to include antitakeover provisions even if they are value-decreasing. The study also finds that the likelihood of antitakeover provisions was positively related to various parameters that are correlated with greater power to the manager at the time of the IPO.

*2. Agency Problems Between Pre-IPO Shareholders and Lawyers*

Another possible agency problem could be an agency cost between the pre-IPO shareholders and their lawyers. In making the decision to choose BV or No-BV, the founders may defer to the recommendation of counsel. Lawyers, in turn, might have distorted incentives to prefer BV over No-BV even if a No-BV arrangement would be somewhat better for the pre-IPO shareholders.

Founders taking their company public may elect to defer to counsel with respect to the choice between BV and No-BV because of their recognition that counsel might have superior information and expertise. In particular, the lawyers, with their greater expertise in advising public companies, might have better information about the effects of BV or No-BV down the road.[28] Furthermore, lawyers might be perceived to have a better understanding of the effect of BV or No-BV on the price that public investors would be willing to pay for shares.[29]

The fact that founders may defer to lawyers' superior information creates a potential for agency costs. The very reason why founders might wish to rely on the lawyers' recommendation implies that founders will not be able to fully monitor whether lawyers are giving them the right recommendation or the one that reflects

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27 See Field and Karpoff, supra note 1.

28 *See* Robert Daines, *The Incorporation Choices of IPO Firms*, N.Y.U. L. REV. 1559, 1580-82 (2002).

29 *See* Coates, *supra* note 1, at 1383.

the lawyers' undistorted judgment. Because lawyers thus have some discretion, the lawyers' incentives might influence the recommendation they will give.[30]

Lawyers' incentives point toward favoring BV over No-BV. The reason for this is that lawyers can expect to feel the costs of a No-BV arrangement might more than its benefits. As to costs, a No-BV choice means a greater likelihood that down the road, the company will be taken over and the lawyer will lose a valuable client. Furthermore, the lawyer stands to suffer reputational costs as a result of its company being taken over without difficulty. If managers find themselves without takeover defenses, they might well blame the lawyers.

In contrast, as to the benefits, which stem from a slightly higher IPO price, these are unlikely to be visible or, more important, to be attributed to the lawyer. The founders are not going to observe the extra value obtained by the use of a No-BV arrangement. And, in any event, the professional assessment of the lawyers' work is unlikely to be much affected by the IPO price.

To illustrate this point, consider a situation in which, for whatever reason, both BV and No-BV have become viewed as conventional and standard, and each type of arrangement is used by a substantial fraction of the companies going public. At this point, we can expect to see tipping in the direction of growing use of BV arrangements, because lawyers would have less to lose from recommending a BV arrangement than from recommending a No-BV arrangement.

The evidence is consistent with this analysis. In the early 90's, there were a substantial number of IPO firms that included, and firms that did not include, antitakeover provisions. According to a study by Coates, firms elected to adopt BV in their charter provisions at increasing rates throughout the 90's; by the end of the decade, a very great majority of IPO charters adopted staggered boards.[31]

Coates views this trend as evidence of an agency problem that differs from the one on which I focus. In his view, the adoption of BV at the IPO stage was good for pre-IPO shareholders, and the reason why some firms did not adopt BV arrangements was that their lawyers were not doing their job well. Over time, even bad lawyers caught up and learned to serve their clients well by adopting BV arrangements. The evidence, however, is also consistent with a different account. Under the account considered in this section, pre-IPO shareholders were best served

[30] This problem is not unlimited, however. The lawyers can only affect the decision of the founders within a range of reasonable options. Each client will have a set of reasonable options—likely those most often utilized in the market—between which they cannot distinguish. It is among these indistinguishable options that lawyers can influence decisions, and may be motivated by their own incentives rather than those of the founders.

[31] See Coates, supra note 1.

by not including a BV arrangement, and lawyers deviated from their clients' interests when they recommended BV rather than when they recommended No-BV. Over time, lawyers increasingly switched to recommending a BV arrangement, because this was the safest route for them, producing the smallest likelihood that their clients would complain about the legal advice they received.

Finally, I should note that the policy implications of this account are similar to those of the first agency-based explanation. Like the first explanation, this explanation implies not only that No-BV is the best default arrangement, but also that the adoption of BV charter provisions does not necessarily imply that they will produce efficiency benefit and thus should be permitted.

### *D. Information-Based Theories*

#### *1. Asymmetric Information*

Under this explanation, at the IPO stage, it is common knowledge among founders and public investors that, in the event that the company converts to dispersed ownership, a BV arrangement would be inefficient compared with a No-BV arrangement. However, while both founders and public investors have the same information about the identity of the efficient arrangement, founders have some private information about the magnitude of the benefits to them and the costs to public investors of the BV arrangement. In a model developed in a companion piece, I show that such asymmetry of information might lead to founders to adopt inefficient provisions at the IPO stage.[32]

To appreciate the intuition, consider the following numerical example. Suppose that firms going public sell 30% of the shares, and that such firms are equally likely to be either of high-value type H, or low-value type L. Founders know their firm's type but public investors do not. H and L firms differ in the likelihood that they will have an investment opportunity that will lead them to move to dispersed ownership. For simplicity, suppose that H firms have a 100% likelihood and L firms have a 10% likelihood of facing such an opportunity. Suppose also that, when an opportunity emerges, it will be sufficiently profitable that the founder-

32 See Lucian Arye Bebchuk, "Asymmetric Information and the Choice of Corporate Governance Arrangements," Harvard Olin Discussion Paper No. 398, available athttp://papers.ssrn.com/abstract_id=327842.

manager will pursue it under either a BV or a No-BV arrangement. And suppose that a No-BV arrangement will be less efficient (i.e., $\Delta V > \Delta B$). [33]

Even though investors know that a No-BV arrangement is efficient for both H and L firms, it can be shown that an efficient pooling equilibrium – one in which both types of firms go public with a No-BV arrangement – might not exist. In such an equilibrium, public investors, unable to distinguish between H and L types, will pay for a No-BV arrangement its average value. As a result, founders with H firms are not fully capturing the value of the cash flows they confer on public investors by adopting a No-BV arrangement and forgoing their private benefits under BV. Consequently, founders with an H firm would have an incentive to deviate from the efficient equilibrium. They would have an incentive to be willing to accept a somewhat lower price at the IPO stage but have a BV arrangement. This incentive to deviate would prevent an efficient pooling equilibrium.

Indeed, under some conditions, the unique equilibrium is one of inefficient pooling in which all founders choose to go public with an inefficient BV arrangement. L firms would have an incentive to follow the H firms and pool with them in the offering of BV arrangements. Even though a BV arrangement is less valuable for founders with L firms, such founders will wish to avoid being identified by IPO investors as an L firm with a lower value.

Thus, the asymmetric information explanation might explain why IPO firms might adopt BV arrangements that shareholders oppose in midstream. An inefficient pooling might arise at the IPO stage; at the midstream stage, however, shareholders would have no reason to vote for BV arrangements that they know to be inefficient.

To the extent that BV arrangements adopted at the IPO stage are explained by the considered model, the policy implications are similar to those of the agency-based explanations. Under the considered model, No-BV is the optimal default arrangement. Furthermore, it might be beneficial not to allow opting into BV at the IPO stage. A prohibition on such opting-in might move the equilibrium from an inefficient pooling equilibrium in which all firms offer BV to an efficient pooling equilibrium in which all firms offer No-BV, and both H and L firms will benefit from such a move.

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33 In the model of Bebchuk, supra note _, H and L differ in the value of their assets rather than the value of their investment opportunities. The latter difference might be more relevant for the choice between BV and No-BV arrangements, and I therefore adjust below the discussion to apply to this case.

### 2. *Bounded Attention and Imperfect IPO Pricing*

#### *a. Bounded Attention at the IPO Stage*

Bounded attention arises at the IPO stage when rational buyers do not have unlimited informational and computational capacities.[34] As such, potential buyers only take into account aspects of the company that are sufficiently salient or important, and other aspects that may have some effect on value are simply not factored into the estimates of value formed by the buyers. [35]

Under the bounded attention explanation of BV arrangements, IPO buyers do not pay attention to the particular choices that companies make among a range of conventional takeover arrangements. IPO buyers might pay attention to some unconventional arrangements or to the adoption of dual-class structure. But as long as the company retains a one-share, one vote structure, the nuances of takeover provisions are not given weight.

One reason for paying no attention to such nuances is that there is inherently a large degree of uncertainty regarding firms that go public. Such firms have not been subject to the scrutiny and valuation of the market prior to the IPO. Potential IPO buyers thus might concentrate their efforts on assessing the business prospects of the firm going public.

Furthermore, takeover arrangements might be less important at the IPO stage because their effects on shareholders are not relevant immediately. Whether BV will become relevant for shareholders off in the future depends on the probability of a move to dispersed ownership. And the adoption of BV will impact shareholders only if and when such a move occurs down the road.

Indeed, at road shows, buyers tend not to inquire about the fine details of firms' corporate charters, so long as those details fall within the established set of

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[34] For a detailed explanation of bounded rationality in general, see David M. Kreps, *Bounded Rationality*, in THE NEW PALGRAVE DICTIONARY OF ECONOMICS (Peter Newman ed., 1998).

[35] The argument of this Section is a particular type of the general argument that capital markets do not generally price each and every corporate provision. For earlier works expressing skepticism about the existing of such pricing, see Brudney, Corporate Governance, Agency Costs, and the Rhetoric of Contract, 85 Colum. L. rev. 1403, 1411-27 (1985); Robert Clark, Agency Costs versus Fiduciary Duties, in Principals and Agents: The Structure of Business (J. Pratt & R. Zeckhauser, eds. 1985); Lucian Bebchuk, The debate on Contractual Freedom in Corporate Law, 89 Colum. L. Rev. (1989). Some of the analysis below draws on an unpublished section of Lucian Bebchuk, Freedom of Contract and the Corporation: an Essay on the Mandatory Role of Corporate Law 50-62, Discussion Paper No. 46, Harvard Program in Law and Economics (1988).

arrangements. Buyers do not inquire, and indeed might not even bother to check whether, say, shareholders can act by written consent, or how quickly shareholders can call a special meeting.

Assuming that IPO buyers do not pay attention to differences among takeover arrangements within a certain set of conventional arrangements, founders have an incentive to gravitate toward the arrangements in this set that protect them most from takeovers. Because founders benefit from such arrangements in terms of expected private benefits of control, it would be rational for them to adopt whatever takeover protections will not cost them in terms of the IPO price. The gravitation during the 90's toward adoption of staggered boards is consistent with this explanation.

*b. Midstream*

Why would shareholders who pay little attention to certain antitakeover provisions in IPO charters vote against them in midstream? One important reason is that, in midstream voting, the issue comes to shareholders in isolation. In the IPO stage, potential buyers have many aspects and dimensions of the company to look at. In contrast, when faced with a vote on a charter amendment to establish a staggered board, or on a precatory resolution to de-stagger the board, the only question that shareholders face is whether a staggered board is good for them. Standing in isolation, the question is salient.

Furthermore, at the IPO stage, potential buyers might act on the presumption that, even though conventional antitakeover provisions have a negative expected effect, the effect is not sufficiently significant for them to try to assess its magnitude and factor it into their decision whether to buy shares at the IPO. In contrast, when shareholders face a voting decision, the recognition that the effect of conventional antitakeover provisions is negative, even if small, is sufficient to lead to a nay vote.

It is also worth noting that midstream votes on such questions often come at a stage in which the issue of takeover bids already has more practical significance. Unlike BV in a charter at the IPO stage, the effects of BV on share price are likely to be directly felt by shareholders by the time a vote on the issue is happening, as the company has already moved to dispersed ownership, and thus the negative effects of BV in terms of entrenchment are relevant. The significant discounting for time and the probability of moving to dispersed ownership that might have rendered BV non-salient at the IPO stage are no longer an issue.

Suppose that shareholders' priors are that, in the event that the IPO company moves to dispersed ownership down the road, having a BV arrangement would then reduce their share value by 0.5%. The discount of this difference for the time and probability that the company will move to dispersed ownership, along with the fact that other factors are more relevant to an assessment of the IPO value might make the choice between BV and No-BV one to which IPO buyers pay little attention. However, when the same shareholders hold shares in existing companies with dispersed ownership, they can be expected to vote against BV in any votes on charter amendments or precatory resolutions.

Thus, because midstream voting is not afflicted by bounded attention problems, the bounded attention explanation is consistent with the persistent midstream voting against BV. This pattern can be explained by the fact that, in midstream, the issue of antitakeover provisions comes to a vote in isolation from other issues, and that voting against a provision requires no more than a qualitative judgment that its impact is negative.

*c. Investment Bankers*

An argument that is often made is that the presence of underwriters protects buyers of stock at IPOs and provides them with a reliable signal concerning the quality of the initial charter's provisions.[36] The underwriter, so the argument goes, will have an incentive to study the charter provisions and will have an incentive to bargain for the optimal provision. The underwriter, as it were, will represent the interests of the buyers of stock. As explained below, however, the existence of underwriters cannot be expected to prevent the inclusion of conventional but inefficient provisions to which buyers do not pay attention. [37]

To examine this argument in our context, suppose that founders take a company public and that they must decide whether to include a charter provision BV that would (holding the price of stock fixed) produce a transfer of .1% of the company's value from the buying shareholders to the founders. And suppose that buyers cannot be expected to pay attention to this issue in their IPO purchase decisions. Would the presence of an underwriter, which we can assume knows the effect of BV, lead the founders not to include BV in the company's charter?

The answer is no, because the underwriter would have no incentive to prevent the inclusion of BV. In examining the underwriter's incentives, researchers have suggested two reasons why the underwriter might care about the shareholders' interests. First, the underwriter commits itself to purchasing the shares if the public does not, and this commitment gives the underwriter an

[36] See, e.g., Gilson & Kraakman, supra note _, at _.

[37] The discussion below draws on Bebchuk, supra note _, at _.

incentive to make the stock more appealing to the public. But if, by hypothesis, the public investors do not pay attention at the IPO stage to the effects of BV, the inclusion of BV would not affect the salability of the stock, and therefore the underwriter would have no reason to object to it. That is, the interest of the underwriter, as far as the underwriting commitment is concerned, is solely to cater to the market's demand which is based on the potential buyers' information, and not to act on the basis of the underwriter's own superior information concerning BV.

Second, it is often said that the underwriter has a valuable reputation, and that the underwriter would defend the interests of buyers of stock to prevent damage to its reputation. Whether this reputational element would provide the underwriter with an incentive to oppose BV, however, is far from clear. The presence of a reputable underwriter only guarantees to buyers that charter provisions are not misleading or unconventional or shady in any way, and not that it does not include non-optimal but conventional provisions.

### *E. Note on Private vs. Social Optimality*

Before concluding my exploration of possible explanations for the observed patterns, I should note one factor that might well be at work but that cannot explain the observed combination of IPO and midstream behavior. There is literature showing that socially inefficient restrictions on control contests might be adopted at the IPO because such restrictions might impose a negative externality on outside bidders.[38] Because such bidders are not "at the table" at the time of the IPO, designers of the IPO charter have no reason to take their interests into account. While extracting a higher premium from outside bidders would be merely a transfer from a social point of view, it would be desirable from the private perspective of the target's shareholders. Thus, shareholders might prefer a socially undesirable arrangement that inefficiently reduce the likelihood of a takeover but raises premia. It follows that, on the margin, shareholders prefer to restrict takeovers more than is socially optimal.

The above analysis implies that, even if standard antitakeover provisions were desired by shareholders, there would be possible grounds for not permitting some such provisions. The evidence, however, indicates that shareholders do not in fact

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[38] See Sanford J. Grossman & Oliver D. Hart, Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation, 11 Bell J. Econ. 42, 42–43 (1980); Lucian Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy Toward Proxy Contests, 78 Cal. L.Rev. 1071 (1990); Lucian Bebchuk & Luigi Zingales, Ownership Structures and the Decision to Go Public *in* Concentrated Corporate Ownership 1, 55–75 (R. Morck, ed. 2000).

prefer to have these provisions. If the effect of these provisions on expected future premia were sufficient to make them desirable for shareholders, shareholders of existing companies would not systematically oppose the midstream adoption of such provisions. These shareholders' opposition indicates that they do not judge the effect of these provisions on surplus extraction from bidders sufficient to make them overall beneficial for shareholders.

While the externality point cannot by itself explain the pattern under consideration, readers should keep it in mind when reaching the discussion of policy implications. My analysis abstracts from effects on bidders and, as will be discussed, still reaches a skeptical position toward complete contractual freedom to adopt antitakeover arrangements. Because the externality issue suggests an additional social cost of such arrangements, it reinforces this position.

## IV. Policy Implications

### *A. No Board Veto as Best Default*

One important question for which the evidence analyzed in this paper is relevant concerns the optimal default arrangement. Even assuming that opting out is permitted, state law must choose default arrangements. The analysis of this paper indicates that the optimal default arrangement is one that does not include a board veto over takeover bids.

Over the last two decades, state courts and legislatures have chosen defaults that go in the direction of board veto. States have adopted antitakeover statutes that, while offering the opportunity for companies to opt out, set default rules that impose restrictions on hostile bidders. Clearly legislators had an alternative: they could have provided an antitakeover arrangement which firms could affirmatively elect by adopting a charter provision to this effect. However, many state legislatures elected to set antitakeover arrangements as the default.

State courts have acted similarly in adopting defaults in favor of management and against takeovers. With the invention of the poison pill, courts had to decide whether and when this device could be used by management. As in the case of legislatures, courts had two options. First, they could have allowed boards to adopt poison pills only if the use of poison pills was authorized by shareholders in a charter provision or otherwise. Alternatively, courts could have set the permissibility of poison pills as a default, permitting boards to use this device as long as it is not prohibited by the charter. Courts took the latter route.

In a recent article, Assaf Hamdani and I put forward a "reversible defaults" approach to the adoption of defaults for existing companies.[39] Under this approach, when courts and legislatures face a choice between two possible defaults, they should err on the side of choosing the arrangement that is more restrictive with respect to management, even if the other arrangements appear to be somewhat more likely to be value-maximizing for shareholders.

The reason for this lies in the fact that, under state corporate law rules, any proposal for a charter amendment must be brought to a shareholder vote by the board. This gives management an effective veto power over any potential charter amendment. As a result, choosing the arrangement more restrictive with respect to management would be most likely to result in the arrangement most favored by shareholders. If the restrictive arrangement is chosen as a default, and then turns out to be disfavored by shareholders, relatively little will be lost because both shareholders and managers will support a charter amendment opting out of this arrangement. In contrast, if the nonrestrictive arrangement is chosen and then turns out to be inefficient, it might persist despite its inefficiency, because managers would have no incentive to initiate a charter amendment.

It follows that, even if public officials view BV as somewhat more likely to be value-maximizing than No-BV, No-BV should still be set as a default. The analysis of this paper makes the case for choosing no board veto as a default all the more compelling, because this analysis indicates that such a regime is more likely to be optimal for shareholders of companies with dispersed ownership.

Under all the six possible explanations of the empirical evidence, BV makes shareholders of an existing company with dispersed ownership worse off. To be sure, under some of these explanations, it is desirable for shareholders that IPO charter provisions providing BV be permitted and respected when adopted. However, even under these explanations, in all cases in which such an explicit provision is not included in the charter of an existing company with dispersed ownership, there is no reason to provide BV as a default.

It follows from this analysis that legislatures and courts erred in the late 80's and early 90's when they imposed BV arrangements on the shareholders of existing companies. A more sensible approach would have provided for the possibility of a BV arrangement, but would have required firms to opt into such an arrangement through a charter amendment. In any event, the setting of default rules is a process

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39 See Lucian Bebchuk and Assaf Hamdani, "Optimal Defaults for Corporate Law Evolution," 96 *Northwestern Law Review* 489-520 (2002).

that never ends. For instance, as Leo Strine recently observed,[40] it is currently an open question under Delaware law as to whether boards may generally maintain a poison pill to block an acquisition offer after losing an election conducted over the offer. This paper indicates that, when courts resolve this question, shareholders' interests would be best served by a negative answer.

### *B. Limited Menu*

The analysis above also indicates that there are reasons to be skeptical about allowing unlimited contractual freedom with respect to corporate charters. It thus provides some support for the existing strategy of state law, which offers a menu of options rather than unlimited contractual freedom. State law currently provides firms with some board veto options, but not others. For instance, while staggered boards are allowed, state law generally requires that some directors be elected at each annual meeting. Thus, state law does not permit arrangements under which elections for directors are held only every two or three years, even though it does permit dual-class structures that can provide even stronger entrenchment.

An influential view in corporate law scholarship strongly supports contractual freedom in IPO charters.[41] This position is based on a view of the IPO process as rather perfect, with all those involved in the design of the IPO charters having powerful incentives to select value-maximizing provisions. In contrast, the picture of IPO decisions emerging from the analysis of this paper is more mixed, and it does not support the view that all IPO charter provisions should be strongly presumed to be value-maximizing.

To be sure, under the two efficiency-based explanations discussed above, even though BV arrangements do not increase the value of shares under dispersed ownership, it is desirable to allow and respect the adoption of BV arrangements at the IPO stage. However, each of the two agency-based explanations, and each of the two information-based explanations, indicates that some limitations on the freedom to adopt antitakeover provisions might be desirable.

More empirical evidence on the extent to which each of the six explanations plays a role in the real world is needed before definite conclusions can be reached on the optimal limits on BV arrangements. The available state of knowledge, however, does justify a reasonable measure of skepticism toward claims of unlimited

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40 See Leo Strine, *The Professorial Bear Hug: The ESB Proposal as Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 55 Stan. L. Rev. 863, 877-78 (2002).

41 See, e.g., *See* Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 Colum. L. Rev. 1416 (1989).

contractual freedom to adopt antitakeover charter provisions. For now, when public officials attach substantial likelihood to some arrangements being undesirable or at least dominated by other arrangements, it would be sensible not to include them in the menu of permissible choices for charter provisions.

A case in point might be the use of staggered boards. There are reasons to believe that, even if it is desirable to allow firms to opt into arrangements that provide boards with a veto power over an acquisition for a substantial period, a staggered board is not a good way to go about it.[42] The problem with staggered boards is that there is no point in time in which shareholders can replace the full board. Even an arrangement under which all directors come up for an election once every two years is superior, because it at least provides some point in time when such replacement is feasible. Thus, eliminating the (currently permitted) option of a staggered board would be desirable even at the cost of adding the (currently prohibited) option of once-every-two-years elections.

### *C. Sunset Arrangements*

The analysis also implies that, for arrangements that expand board power, it is desirable not to limit the law's choice between permitting such arrangements outright and prohibiting them. The law should make a greater use of the strategy of allowing some arrangements but only for a certain period after they are last approved by shareholders. Thus, for example, even if staggered boards provisions were permitted, one might want to consider having them lapse after, say, 7 years from the date of their last approval by shareholders.

The reason for using such a sunset strategy is the existence of significant differences for both shareholders and management between the IPO and midstream stages. The identity of the desirable arrangement might well change over time. As the analysis has highlighted, the optimal arrangements for a publicly traded company that just went public and still has a rather concentrated ownership structure might well be different from those optimal for a large, mature publicly traded company with dispersed ownership. As such, we should not expect that IPO-stage arrangements would remain optimal for the firm decades after it first went public.

Because of the board's control over charter amendments, there is concern that entrenching arrangements that were chosen at the IPO stage for an efficient reason would remain in place long after they outlive their value.  A sunset strategy would ensure that, in such a case, there will be a resetting after a certain period following

[42] See Bebchuk, Coates, and Subramanian, supra note XXX.

the IPO that would ensure that an entrenching mechanism remains in place only if it serves shareholder value.

To be sure, if the IPO process were perfect, we would expect that IPO charter provisions would themselves provide for automatic lapse after a certain period of time or when certain conditions obtain. Given the likelihood that no single arrangement will fit all times, one would expect optimal IPO charters with antitakeover arrangements to include provisions for their elimination or amendment after, say, 25 years, or the death of certain founders, or the reaching of a certain ownership structure. Yet, I am unaware of any significant use of such time-contingent arrangements in IPO charters. This absence is likely to be rooted in bounded attention problems; IPO buyers are not going to pay attention to, or be willing to pay extra for, terms governing adjustments in 25 years. Be that as it may, the absence of such provisions makes it desirable to consider the use of sunset rules that would ensure that long-living public corporations not be stuck with inefficient arrangements.

### *D. Lessons for Corporate Governance in General*

Because of the importance of takeovers, researchers have invested to gather substantial evidence about the incidence of antitakeover charter provisions and about their direct effects, and shareholders have invested to express their opposition to some arrangements in corporate votes. As a result, antitakeover charter provisions provide an excellent "case study" for examining the larger questions of whether charter provisions adopted at the IPO stage should be presumed to be optimal and whether any limits should be placed on the adoption of such provisions.

The analysis of this paper is thus relevant for general questions that arise with respect to all corporate governance issues and arrangements. The six reasons that I have identified as to why firms might adopt IPO charter provisions that do not increase the value of dispersed investors' shares can apply not only to antitakeover provisions but also to provisions governing other corporate governance issues. Indeed, if anything, the problem of bounded attention might be even more severe with respect to other corporate issues than it is with respect to takeover arrangements. Similarly, given the smaller importance of non-takeover governance issues, agency problems with respect to such issues might well be more severe than with respect to takeover issues.

Thus, one general lesson suggested by the analysis is that we should not infer from the adoption of certain provisions in IPO charters that they provide the arrangement that best serves shareholders. There is a substantial amount of corporate work that relies on such inferences to make claims about optimal arrangements. For example, scholars have argued that, since no firms are known to have prohibited insider trading in their charters prior to the laws finding the practice illegal, insider trading must be beneficial for shareholders.[43] The analysis of this paper indicates that such inferences are often unwarranted.

Another general lesson of the analysis is with respect to the long-standing debate concerning contractual freedom in corporate law.[44] The single but important example of antitakeover provisions provides an opportunity to enrich the debate by using the large amount of empirical evidence and information that we have about IPO provisions and shareholder preferences in the takeover area. The takeover area thus provides us with a good lens through which to investigate the optimality of charter provisions and of charter design in IPOs. As we have seen, this investigation provides reasons to be skeptical about claims for complete contractual freedom in IPO charters.

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43 *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 858, 857 (1983).

44 *See* Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. (1989).