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THE CASE AGAINST BOARD VETO IN CORPORATE TAKEOVERS

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THE CASE AGAINST BOARD VETO IN CORPORATE TAKEOVERS

Lucian Arye Bebchuk†

This paper argues that once undistorted shareholder choice is ensured, which can be done by making it necessary for hostile bidders to win a vote of shareholder support, boards should not have veto power over takeover bids. The paper considers all of the arguments that have been offered for board veto, including ones based on analogies to other corporate decisions, directors' superior information, bargaining by management, pressures on managers to focus on the short-run inferences from IPO charters, interests of long-term shareholders, aggregate shareholder wealth, and protection of stakeholders. Examining these arguments both at the level of theory and in light of all available empirical evidence, the paper concludes that none of them individually, nor all of them taken together, warrants a board veto. Finally, the paper discusses the implications that the analysis has for judicial review of defensive tactics.

Key words: corporate governance; corporate control; takeovers; mergers and acquisitions; takeover bids; tender offers; takeover defenses.

JEL classification: G30, G34, K22.

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INTRODUCTION

In the last thirty years, takeover law has been the subject most hotly debated by corporate law scholars. During the same period, takeover law has undergone many changes and much development, receiving the frequent attention of both legislators and courts. State legislators have been busy adopting a variety of antitakeover statutes. Courts have been busy developing a rich body of takeover doctrine. And an army of lawyers and investment bankers has been busy improving and practicing techniques of takeover defense and attack.

A central issue in the debate has been whether boards should have power to block unsolicited acquisition offers. To some scholars, such power is a serious impediment to efficient corporate governance.¹ To others, a board veto is, on the contrary, necessary for effective corporate governance.² Whereas opinions on the role of boards in corporate takeovers greatly differ, there is wide agreement about the importance of this question for corporate governance and for the allocation of corporate assets.³

The aim of this paper is to present the case against board veto over takeovers. Board veto could be justified in the absence of mechanisms that ensure an undistorted choice by shareholders—that is, a choice reflecting their judgment on whether acceptance of the acquisition offer would serve their collective interest.⁴ However, such an undistorted choice can be secured by appropriate mechanisms, especially ones based on shareholder voting.

¹ For an early work taking this view, see Frank Easterbrook and Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv L Rev 1161 (1981). Whereas Easterbrook and Fischel argued that management should remain completely passive in the face of a takeover bid, other works that were opposed to board veto at the time took the view that management should be permitted to solicit competing offers but not to block any bids. See Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 Harv L Rev 1028, 1054–56 (1982); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 Stan L Rev 819 (1981).

² For an early work taking this view, and starting the subsequent big takeover debate of the 1980s, see Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 Bus Law 101, 103 (1979).

³ See William T. Allen, Jack B. Jacobs, and Leo E. Strine, *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U Chi L Rev XX, XX (2002) (suggesting that the “great takeover debate” reflects a fundamental struggle between competing models of the corporation and corporate governance). But see Marcel Kahan and Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U Chi L Rev XX (2002) (arguing that the takeover debate has lost much of its practical significance due to developments in executive compensation schemes).

⁴ Thus, when shareholders exercise undistorted choice, an acquisition offer will

In the presence of a mechanism ensuring shareholders' undistorted choice, I argue, boards should not have a veto power over acquisitions beyond the period needed for the board to put together alternatives for shareholders' consideration. In the course of my analysis, I examine the full array of arguments that supporters of board veto have made over the years. I also take advantage of and rely on the substantial body of empirical evidence that has accumulated since the debate on the subject started. Concluding that board veto is undesirable, at least in the absence of explicit shareholder authorization to the contrary, I also discuss how takeover law should best proceed *given* its established structure and principles.

Part I discusses arrangements needed to ensure undistorted shareholder choice. In the absence of any such arrangements, arguments for board veto could be based on collective action problems that could lead shareholders to tender even if they view remaining independent (at least for the time being) as best. Such collective action problems, however, can be effectively addressed without providing boards with a veto power. One approach that has received considerable support is to block "structurally coercive" bids,⁵ but such an approach, I show, is not an effective instrument for securing undistorted choice. A better approach for this purpose is "the shareholder voting approach" that makes it necessary for hostile bidders that wish to gain control to win a vote of shareholder support. Such a vote would provide a genuine reflection of shareholders' preferences regarding the acquisition offer.⁶

There are different ways, some better than others, to introduce winning a shareholder vote as a formal or practical condition for a takeover. Many existing arrangements, both in the United States and in Europe, have indeed introduced voting as such a condition. In the United States, most states have

succeed if and only if the shareholders view the offered acquisition price as higher than the target's independent value. The concept of undistorted choice in the face of an acquisition offers was introduced and analyzed in Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 Harv L Rev 1695 (1985), Lucian Arye Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 Del J Corp L 911 (1987), and Lucian Arye Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J Legal Stud 197 (1988).

⁵ Ronald J. Gilson and Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 Bus Law 247, 265 (1989).

⁶ In a recent work with Oliver Hart, we put forward, using a formal model, shareholder voting as a mechanism for shareholders' choice that is superior to tender decisions. See Lucian A. Bebchuk and Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control*, Harvard Olin Discussion Paper No 336 (2001), available online at <<http://papers.ssrn.com/id=290584>>. I also argued for requiring bidders to win a vote or some other vote-like test as a condition for an acquisition in Bebchuk, 98 Harv L Rev at 1695 (cited in note 4); Bebchuk, 12 Del J Corp L at 911 (cited in note 4); and Bebchuk, 17 J Legal Stud at 197 (cited in note 4).

control share acquisition statutes that make it practically necessary for a bidder to win a vote in order to gain control.⁷ Furthermore, states generally allow boards to adopt poison pills that prevent an acquisition as long as they are in place. And the power to maintain pills implies that a hostile bidder would be able to gain control over incumbents' objections only if the bidder first won a ballot box victory to replace the incumbents with directors that would redeem the pill.

In my view, once a mechanism that ensures an undistorted choice by shareholders is in place, the board should not be able to veto an acquisition beyond the period necessary for preparing alternatives for shareholder consideration. The board must not use its powers either to deny shareholders access to a vote beyond the period necessary for putting together alternatives for shareholder consideration or to impede bids that have won shareholder support in a vote.

However, boards in most companies around the U.S. have some significant veto power that enables them to block for a substantial period of time an offer that could (or even did) win a vote of shareholder support. Some of this veto power comes from the interaction of the power to maintain pills with some charter provisions—the large majority of which had been adopted *before* their antitakeover significance could have been recognized by shareholders—that prevent shareholders from getting access without undue delay to a vote on replacing a board that blocks an attractive offer. In particular, the combination of a poison pill and a staggered board, which exists in a majority of publicly traded firms, is especially powerful in providing boards with a veto power.⁸ Incumbents' advisors keep coming up with new ideas for obtaining or strengthening incumbents' veto power.⁹ The push to expand and protect board veto over corporate acquisitions has been much helped by state legislators and courts.

⁷ See Grant Gartman, *State Antitakeover Laws* § XX (Investor Responsibility Research Center 2000).

⁸ See Lucian Bebchuk, John Coates IV, and Guhan Subramanian, *The Anti-Takeover Power of Classified Boards: Theory, Evidence and Policy*, 55 *Stan L Rev* (forthcoming 2002). This work provides a theoretical account, and an empirical confirmation, of the powerful antitakeover force of staggered boards. It also reports that 58 percent of the firms in a sample of about 2,400 publicly traded firms had staggered boards. The discussion of staggered board in this paper, including the proposal discussed below for not allowing directors with a staggered board to maintain a pill after losing one election over a bid, are largely based on this work.

⁹ See, for example, *Quickturn Design Systems, Inc v Shapiro*, 721 A2d 1281, 1287–88 (Del 1998) (describing how the board of Quickturn first adopted a “dead hand” pill and subsequently replaced it with a “deferred redemption” pill).

This push has been accompanied by supporters of board veto putting forward a wide and impressive array of arguments for such veto. Supporters of board veto would like boards to have the power to block acquisition offers for a substantial period of time. Indeed, in the view of the most well-known and powerful defender of the board veto position, the best regime would have directors elected for five-year terms and given largely absolute power over acquisition offers made in the five years between elections.¹⁰

Part II presents the case against board veto. Whereas various scholars have opposed board veto power because of the agency problems between boards and shareholders, scholars taking this view have not attempted thus far to provide a comprehensive and detailed analysis of the full array of arguments marshaled by supporters of such veto. This paper seeks to fill this gap and to offer such an analysis. I begin by discussing the agency problems arising from such veto power and the empirical evidence indicating that these problems are likely to be substantial. To evaluate whether these agency problems are outweighed by some countervailing benefits, however, I then identify and assess each of the arguments that have been made over the years in favor of board veto. I examine each argument both at the level of theory and in light of all existing empirical evidence. As will be discussed, a significant amount of relevant empirical work has been done in recent years, and it enables a better assessment of the issues than was possible earlier.

I start with an argument made in favor of board veto that is based on an analogy to other corporate decisions. Boards have full power over other corporate decisions, and this arrangement is commonly viewed as working well. Therefore, supporters of board veto argue, in the absence of strong reasons to treat the takeover context differently, providing boards with the power to make decisions in the takeover context should be expected to be beneficial as well. There are strong reasons, however, to treat the takeover context differently.

To begin, the agency problem is more severe in the takeover context. Furthermore, in the takeover context we have the option, which is not viable or practical in many other corporate contexts, of letting shareholders make decisions. Indeed, the case for board power over other corporate decisions is not only consistent with, but is in fact reinforced by, the case against board veto in takeovers: The absence of veto power in takeovers provides a safety valve against management's straying from shareholders' interests in other corporate contexts.

Another argument made in favor of veto power is that, because capital markets are not informationally efficient, board veto is necessary to protect

¹⁰ See Martin Lipton and Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U Chi L Rev 187, 224 (1991).

shareholders during periods in which shares trade at “depressed” levels significantly below their fundamental value. But the presence of such pricing inefficiencies, I show, would only imply that companies should have complete freedom at any given point in time to choose whether to reject a premium offer and remain independent. This position would not imply by itself that boards, rather than shareholders, should make such decisions.

However, supporters of board veto argue that, because of directors’ superior information, shareholders would be better off if boards were to decide whether an offered price exceeds the target’s fundamental value. Not providing boards with veto power, however, hardly implies that directors’ special information would be unused. Boards could still communicate their information, or at least their recommendation, to the shareholders. When directors recommend rejecting an offer that shareholders otherwise would be inclined to take, shareholders would have to decide whether to defer to the directors’ view. In making this decision, shareholders would weigh both the possibility that directors might have superior information and the concern that they might have self-serving reasons for preferring independence. Shareholders would try to reach the best decision, give the circumstances of each case, on this question of whether to defer.

Thus, providing boards with veto power implies that, instead of letting shareholders decide whether to defer to directors’ view of the offer, deference would be mandated. In today’s capital markets, such paternalistic hands-tying is unlikely to benefit shareholders. Mandated deference should not be expected to produce on average better results for shareholders than letting them make the decision whether to defer. Furthermore, the existing evidence does not support the view that, when boards defeat offers, shareholders generally or on average receive a higher value, either in the short-run or at least in the long-run.

Yet another argument made in favor of board veto concerns its effects on premia in the event of an acquisition. Boards, it is argued, can use this power to extract higher premia for shareholders. Having a regime of shareholder voting and no board veto, however, does not imply that management cannot do substantial bargaining on behalf of the shareholders. Lawyers can and do bargain for their client, for example, even though they have no veto power and the client is free to accept settlement offers. Similarly, a regime based on shareholder voting and no veto power is fully consistent with significant bargaining by management on shareholders’ behalf for a long period of time, provided only that shareholders are content to have management continue bargaining and do not elect to take the bargaining mandate from management. If the board recommends rejecting an offer and letting the board try to obtain a higher value, shareholders would make a decision, in light of the circumstances of the case, whether such an “extension” would likely be in

their interest. Furthermore, whatever extra bargaining lever management might obtain from board veto might be used not to extract a higher premium but rather to obtain a better treatment for itself. Overall, the empirical evidence fails to identify any significant positive effect of board veto on takeover premia and, furthermore, does indicate that managers are willing to accept lower premia for shareholders in return for some personal benefits for themselves.

In addition to the arguments listed above, I also examine arguments based on the pressure that takeovers exert on managers to focus on short-term results, on the possibility of designing executive compensation schemes to neutralize the negative effects of board veto, and on inferences from charter provisions adopted by firms going public. My conclusion is that none of the arguments made in favor of board veto, nor all of these arguments combined, provides a basis for concluding that providing boards with veto power serves target shareholders.

Concluding that board veto is undesirable from the perspective of target shareholders, I turn to examine the question from other perspectives. In particular, I discuss whether the case for board veto would become stronger if the analysis (i) were to focus on the special interests of long-term investors, (ii) incorporated the effects of veto power on bidders and their shareholders (the perspective of aggregate shareholder wealth), or (iii) took into account the effects of veto power on stakeholders (the perspective of all corporate constituencies). I conclude that board veto is unwarranted when examined from any of these perspectives.

Because of the importance in the debate of arguments for board veto based on stakeholder interests, I pay significant attention to such arguments. Even assuming that stakeholders should get some protection in connection with acquisitions beyond the one accorded by their contracts, I argue, support for board veto would not follow; this veto would not be a good way to address such a concern. The overlap between managements' and stakeholders' interests is hardly such that management could be relied on to use its powers to serve stakeholders. Therefore, those genuinely concerned about providing extra protection to stakeholders in corporate acquisitions should focus on acquisitions in general, rather than on hostile acquisitions, and should seek arrangements tailored to address their concerns. Concerns about stakeholders thus do not point towards expanding the discretionary power of boards in the hope that this would somehow work to the advantage of stakeholders. The debate over board veto, I suggest, should not be viewed as making a choice between shareholders and stakeholders but rather as making a choice between more and less power to management.

Part II ends by discussing the implications of the analysis for the judicial review of defensive tactics. In other work I do some exploring of the best de-

sign, starting from a clean slate, of a regime of undistorted choice and no board veto¹¹. Here, however, I show how a move toward such a regime could be accomplished by courts taking as given the basic structure of existing doctrine. In particular, existing doctrine requires that the use of defensive tactics in general and poison pills in particular be proportionate, and the analysis below can inform how the requirement of disproportionably be interpreted. In particular, much move toward a reduction in board veto would be achieved by a doctrine that, at least in the absence of explicit shareholder authorization to the contrary, would not allow boards protected by a staggered that lose one election over an acquisition offer, to continue maintaining a poison pill.

Before proceeding, I wish to note two related issues that I will put aside. My focus will be on analyzing the nature of the optimal default arrangement concerning board veto on acquisition offers. Although I will discuss what inferences can be made with respect to this question from IPO charters, I will not examine here the question of the extent to which opting out of the default arrangement should be permitted and, if permitted, what should be required for such opting out to be valid.¹² Second, I will put aside the question, relevant for both the U.S. and Europe, of whether the provision of the default arrangement should be done at the federal or state level.¹³ Although these two questions are related and important, my subject can be fully analyzed with-

¹¹ See generally Bebchuk and Hart, Harvard Olin Paper 336 (cited in note); Lucian A. Bebchuk, *The Allocation of Power between Managers and Shareholders* (Working Paper, 2001) (on file with author) Lucian Arye Bebchuk and Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 Va. L. Rev. 111 (2001).

¹² Other work in which I discuss the extent to which opting out of corporate rules includes Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 Harv L Rev 1820 (1989); Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 Colum L Rev 1395 (1989); and, more recently, Lucian Bebchuk, *Asymmetric Information and Corporate Governance* (Working Paper, 2002).

¹³ I discuss this question in other work, including Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv L Rev 1435 (1992); Lucian Bebchuk and Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 Va L Rev 111 (2001); Lucian Bebchuk and Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 Va L Rev 993 (2001); Oren Bar-Gill, Michal Barzuza and Lucian Bebchuk, *A Model of State Competition in Corporate Law*, working paper (2001), available online at <<http://papers.ssrn.com/abstract=275452>>; Lucian Bebchuk and Alma Cohen, *Firms' Decisions Where to Incorporate*, Harvard Olin Discussion Paper No 351 (Jan 2002), available online at <<http://papers.ssrn.com/abstract=296492>>; Lucian Arye Bebchuk and Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition in Corporate Law*, forthcoming Yale L J; Lucian Bebchuk and Allen Ferrell, *Takeover Law and Regulatory Competition: A Reply*, XX Bus Law (forthcoming 2002).

out getting into them, and I thus will focus on whether, at least in the absence of appropriate shareholder authorization to the contrary, it would be desirable for boards to have veto power in corporate takeovers.

I. PREREQUISITE: ENSURING UNDISTORTED SHAREHOLDER CHOICE

A. *Ensuring Undistorted Choice via Voting*

One reason that could be given for granting boards a veto power is a concern that shareholders facing a takeover bid might be unable to exercise an undistorted choice. In the absence of any restrictions on bidders, shareholders might be pressured to tender. The pressure-to-tender problem is by now familiar to students of takeovers, and it can thus be described with brevity.¹⁴ In deciding whether to tender, each shareholder will recognize that its decision will not determine the fate of the offer. The shareholder therefore will take into account the scenario in which the bid is going to succeed regardless of how the shareholder acts. Whenever the expected value of minority shares in the event of a takeover is lower than the bid price, this scenario will exert pressure on the shareholder to tender. As a result, shareholders might tender, and a takeover might occur, even if most shareholders do not view a takeover as being in their collective interest.

The pressure to tender is most visible and conspicuous in the case of partial, two-tier bids. In *Unocal*, the landmark takeover case, the potential coercive effect of such a bid was held to pose a substantial threat that justified strong defensive measures.¹⁵ Whereas the pressure to tender is most visible in such cases, however, it is in no way limited to them. It can be shown to exist also when bids are for all shares, and when no second-step, low-value freezeout is expected, as long as the expected post-takeover value of minority shares in the event of a takeover is lower than the bid price.¹⁶

The approach that I favor for addressing the distorted choice problem is based on using a voting or vote-like mechanism. Under this approach, the problem is addressed by enabling each shareholder to express separately its

¹⁴ For a full account of this problem, see Bebchuk, 98 Harv L Rev at XX (cited in note 3); Bebchuk, 12 Del J Corp L at XX (cited in note 3). For a formal model of the problem, see Bebchuk and Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* at 25 (cited in note 6); Lucian A. Bebchuk, *A Model of the Outcome of Takeover Bids*, Harvard Law School Program in Law and Economics Discussion Paper No 11 (1985) (on file with author).

¹⁵ *Unocal Corp v Mesa Petroleum, Inc*, 493 A2d 946, 956 (Del 1985).

¹⁶ See Bebchuk, 98 Harv L Rev at 1717-33 (cited in note 4); Bebchuk, 12 Del J Corp L at 913, 917-31 (cited in note 4).

preferences with respect to the following two questions: (i) whether it prefers a takeover to take place; and (ii) whether it prefers that its shares be acquired in the event that a takeover takes place. The pressure-to-tender problem essentially results from the fact that even shareholders who wish to answer in the negative question (i) (that is, who prefer that a takeover not take place) might tender and thereby support the bid because of their interest in giving a positive answer to question (ii) to ensure that their shares are acquired in the event of a takeover.

A voting mechanism provides a “clean” way of enabling shareholders to express separately their preferences on issues (i) and (ii). Consider any procedure under which: (1) shareholders vote or otherwise express their preferences on whether a takeover should take place; (2) the bidder is permitted to gain control only if majority of the shareholders express their support for a takeover; and (3) in the event that the offer wins such majority support, all shareholders—regardless of whether they supported a takeover—receive a genuine opportunity to get their pro rata fraction of the total acquisition price. Under any such procedure, because voting against the offer would impose no penalty whatsoever on the voting shareholder in the event of a takeover, shareholders’ votes would solely reflect their preferences concerning whether a takeover should take place. As a result, the bid will gain the necessary vote of shareholder support, and a takeover will take place, only if most shareholders indeed view a takeover as beneficial.

B. Can Preventing “Structurally Coercive” Bids Ensure Undistorted Choice?

As I have said, having a vote-like mechanism in place would be the best way of ensuring undistorted choice. Before turning to discuss alternative versions of a voting requirement, however, I wish to consider briefly an alternative approach based on restricting the form that bids may take. In particular, some influential cases and commentators identified distorted choice with the presence of a bid that is “structurally coercive.”¹⁷ On their view, in the face of a bid that is “structurally noncoercive” — in particular, a cash bid for all shares with a back-end (that is, a planned freezeout for remaining shares) in cash at the same price as the bid price—shareholders can be expected to exercise undistorted choice.

Although I do not share the view that this approach can effectively solve the pressure-to-tender problem, I wish to stress at the outset that, for readers who do hold this view and favor this approach, Part II’s analysis of the case against veto power should still be wholly relevant. The analysis in that Part

¹⁷ *City Capital Associates Ltd Partnership v Interco*, 551 A2d 787, 797 (Del Ch 1988); Gilson and Kraakman, 44 *Bus Law* at 274 (cited in note 5).

suggests that, once a mechanism ensuring undistorted choice is in place, having a board veto is undesirable. If one favors ensuring undistorted choice by preventing structurally coercive bids and is also persuaded by Part II's analysis, then this person should support a regime combining this mechanism with no board veto.

Having made this point, let me turn to explain why ruling out structurally coercive bids does not ensure undistorted choice as effectively as would shareholder voting.¹⁸ Consider a shareholder that must decide at the present time whether to tender to \$100 a share bid that, in the event of success, is supposed to be followed in four months by a freezeout at \$100 a share. Supposing that the relevant discount rate of return for this shareholder is 6 percent a year – that is, 2 percent for four months – the freezeout consideration has a present value of \$98. Although the \$2 difference between the present value of the bid price and the freezeout consideration is small, and thus might appear at first sight of little practical significance, it will likely weigh heavily in the shareholder's considerations. The reason is that (i) the scenario in which the shareholder is going to be pivotal has a smaller likelihood than (ii) the scenario in which the offer is going to succeed regardless of what the shareholder does. And in considering the latter scenario (ii), a 2 percent difference is sufficient to make tendering clearly preferable; many financial decisions are influenced by such or even smaller differences.

In theory, distortions could be eliminated by ensuring perfect equality – rather than merely rough equality – between the values of the bid price and the freezeout consideration. If such perfect equality were ensured, and if the transaction costs of tendering were zero,¹⁹ then deciding shareholders would ignore the important scenario in which the bid is going to succeed regardless of their decision, since the outcome for them would be exactly the same regardless of how they act. Thus, undistorted choice can be obtained only under “knife's edge” conditions that are practically unattainable.

At first sight again, it might be thought that this problem can be solved by requiring that the freezeout price be equal to the bid price plus interest. Discount rates, however, are unobservable and likely to vary considerably among the target's shareholders. Thus, there would be no interest rate that

¹⁸ The argument below builds on Bebchuk, 98 Harv L Rev at 1740–42 (cited in note 4); Bebchuk, 12 Del J Corp L at 944–47 (cited in note 4).

¹⁹ Transaction costs are relevant because, if the bid consideration and the freezeout consideration were exactly equal, then holding out would be preferable for shareholders for whom tendering involves some non-negligible transaction costs (many retail investors). Assuming the bid is conditional on gaining control, not tendering would save these transaction costs in the scenario in which the bid is going to fail and shares are going to be returned, and not tendering would by hypothesis make no difference in the scenario in which the bid is going to succeed.

could be used to ensure for all shareholders equality between the values of the bid and the freezeout consideration. For all shareholders for whom such equality is not assured, decisions would be distorted—either in favor of tendering (in case the present value of the freezeout consideration is lower than the bid price) or in favor of holding out (otherwise). Thus, the practical inability of attaining the knife’s edge conditions of perfect equality would render the considered approach incapable of removing from shareholders’ decisionmaking the comparison between the bid price and the expected post-takeover value of minority shares. Because the scenario in which a shareholder is going to be pivotal has relatively small likelihood compared with the scenario in which the bid is going to succeed regardless of the shareholder’s decision, small deviations from perfect equality might distort outcomes in a big way.

In contrast, voting provides a robust way of ensuring that shareholders’ expressed preferences would be solely based on their judgment of how the acquisition price compares with the target’s independent value. Under the voting approach, in the scenario in which the bid is going to succeed regardless of a shareholder’s decision, a shareholder’s voting decision would not affect the shareholder’s interests, because all shareholders would have an opportunity to get their pro rata fraction of the acquisition price. This ensures that distortions would be always removed from the shareholder’s decisionmaking, enabling the shareholder to focus always on comparing the bid with the target’s independent value.

C. *Alternative Ways of Introducing Voting*

I have thus far spoken abstractly about the benefits of having a voting or vote-like mechanism. Choosing a particular version requires making a number of procedural choices, which implies that there are various versions to choose from. I explore elsewhere the considerations relevant for the optimal design of the voting procedure. In early work, for example, I put forward an arrangement under which tendering shareholders may tender approvingly or disapprovingly and the bidder may proceed only if a majority of shareholders tendered approvingly;²⁰ this arrangement might have the potential

²⁰ See Bebchuk, 98 Harv L Rev at 1747–52 (cited in note 4). An arrangement of this kind was incorporated into Israel’s new corporate code following a proposal by Professor Uriel Procacia (the code’s chief designer) and myself. See Lucian Bebchuk and Uriel Procacia, *Corporate Acquisitions*, 13 U Tel Aviv L Rev 71 (1988), reprinted in Uriel Procacia, *A New Corporate Law for Israel* (1989). Another “clean” version of a voting mechanism would allow merger proposals to be initiated and brought for a shareholder vote not only by the board but also by (a sufficient number of) shareholders. See Bebchuk and Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* at 24 (cited in

advantage that it requires shareholders to act no more than once. For the purpose of this project, however, choosing the particular parameters of an optimal voting procedure is not necessary. It might be useful, however, to give some concreteness to the idea of a voting mechanism by briefly noting some voting arrangements that are in place.

As noted in the Introduction, many states have control share acquisition statutes that practically make it necessary for a hostile bidder to win a vote in order to gain control.²¹ Under such statutes, a buyer of a majority block would not be able to vote these shares unless such voting is approved by a vote of other shareholders. This makes it not worthwhile to buy a large block of shares without first winning a vote; once a large block is acquired, other shareholders would have little reason to approve the buyer's having voting power, as such approval would effectively turn their shares from ones that have all of the voting power into minority shares. This arrangement thus greatly discourages bidders from purchasing a large block without first obtaining advance shareholder approval for their being able to vote the purchased shares. Under the statutes, bidders may ask for a shareholder meeting to vote on this matter, and the meeting must take place within a certain period, which in most states is fifty-five days, following such a request. Although the vote formally would be on whether the bidder would be able to use the voting power of shares acquired through its bid, the vote essentially would be a referendum on the offer.

Also, and perhaps most importantly for an analysis of the takeover landscape in the U.S., the development of poison pills made the winning of a vote a practical condition for a hostile takeover. In the presence of a poison pill, buying shares beyond a certain limit (which is commonly in the range of 10–20 percent) would be costly to an extent that would make the buyer regret its purchases. Because directors usually can maintain a pill as long as they are in office, a hostile takeover would require that the bidder replace the directors through a ballot box victory with directors that would redeem the pill. The voting, again, would not be on the offer formally but rather on the election of directors. But the vote practically would be a referendum on the offer; the voting on directors would determine the fate of the offer, would be understood as such, and would be determined by shareholders' judgments concerning the offer.

note 6); Lucian Arye Bebchuk, *The Allocation of Power between Managers and Shareholders*, working paper (Nov 2001) (on file with author).

²¹ See Gartman, *State Antitakeover Laws* § A-2 (cited in note 7).

D. Arrangements with Voting and No Board Veto

In the presence of a voting mechanism ensuring an undistorted shareholder choice, I argue, the board should not have veto power beyond the period necessary for exploring and preparing alternatives for shareholders' consideration. I will refer to such a regime as one of shareholder voting and no veto power. The absence of veto power implies, in particular, that directors should not be able to use their powers: (i) to block a bidder's access to a vote beyond the above preparatory period; (ii) to frustrate or distort the outcome of the vote; or (iii) to block a takeover that has gained the needed vote of shareholder support.

There are, again, particular procedural choices that must be made in designing such a regime. For example, how long should the preparatory period be? Should this period be set in general or be determined on a case-by-case basis? How should a vote be triggered? I examine these questions in other work, which explores the possible alternatives and the best design, starting from a clean slate, of such a regime.²² Below I will put aside such questions, because my focus is on the general policy comparison between a regime with and without board veto.

What I wish to emphasize, however, is that poison pills are not inherently inconsistent with a regime of voting and no board veto. As explained, the pill might serve merely as an instrument for requiring the bidder to win a vote of shareholder support. As long as the board cannot deny the bidder an access to such a vote for too long, and as long as the victory in such a vote would result in redemption of the pill, we would have a regime of shareholder voting and no board veto.

To illustrate, let us consider Wachtell, Lipton's second-generation pill. The first generation of pills, one of which was approved in *Moran*,²³ did not impede a buyer's gaining control, but only a second-step freezeout. In 1987, Wachtell, Lipton proposed to its clients adopting a "second generation" type of pill whose terms included a "flip-in" provision that made it prohibitively costly for hostile bidders to cross a 20 percent ownership threshold.²⁴ Because the *Moran* decision was partly based on the threat of abusive freezeouts, the designers of the new pill sought to "decrease concerns regarding judicial acceptance" of the flip-in²⁵ and to address "shareholder

²² See works cited in note 12.

²³ See *Moran v Household International, Inc*, 500 A2d 1346, 1357 (Del 1985).

²⁴ See generally Wachtell, Lipton, Rosen, and Katz, client memorandum, *A Second Generation Share Purchase Rights Plan* (July 14, 1987) (describing the features and rationale of the proposed new type of pill). See also Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U Pa L Rev 1, 69-71 (1987) (same).

garding judicial acceptance” of the flip-in²⁵ and to address “shareholder democracy and fiduciary duty arguments.”²⁶ To this end, the new pill’s designers added to its terms a procedure under which “qualified” bidders would be able to obtain a special shareholder meeting to vote within ninety to one hundred and twenty days from their request, and a vote of a majority of the outstanding shares against the pill (that is, in favor of the offer) would lead to the pill’s redemption.

Much water has gone under the takeovers bridge since 1987. In contrast to what designers of pills expected in 1987, the development of the principle of *Moran* by subsequent cases did not insist on the safety valve of shareholders’ always having an option to vote to redeem the pill. As a consequence, the special meeting procedure was dropped from the terms of subsequent generations of pills and is no longer in use. But the second-generation pill is worth noting as an example of a pill-produced regime of shareholder voting and no veto power. Had courts elected to require that special meeting procedures be included as a condition for pills’ validity, as pill designers had thought they might elect to do, the prevailing regime now would have been one of shareholder voting and no veto power.

Given that existing pills do not generally include provisions for a special meeting that could vote for redemption of the pill, board veto could be limited or eliminated by courts placing limits on how long a board can maintain a pill. As noted, a majority of the publicly traded firms have staggered boards, with a majority of such staggered boards adopted before the developments in takeover jurisprudence that made them so potent. If a board with a staggered structure could maintain the pill indefinitely, a hostile bidder would have to win two elections, one year apart, to gain control. As a result, staggered boards currently provide incumbents with a great deal of power to block unwanted bids. This veto power could be much limited by requiring boards that lose one election over a bid to redeem the pill. Such a requirement would prevent boards from using a staggered board-poison pill combination to block an offer that enjoys shareholder support beyond the next annual election.²⁷ How courts could move toward a regime of shareholder voting and no board veto, taking as given the existing structure of takeover doctrine, is a topic to which I shall return in Section III.G.

²⁵ Lipton, 136 U Pa L Rev at 70 (cited in note 24) (“[T]o decrease concerns regarding judicial acceptance, the new pill provides that, under certain circumstances, a special shareholders meeting will be held to determine whether the pill should be redeemed.”).

²⁶ See Wachtell, Lipton, Rosen, and Katz, *A Second Generation Share Purchase Rights Plan* at 3 (cited in note 24).

²⁷ This approach is put forward in Bebchuk, Coates, and Subramanian, 55 Stan L Rev (cited in note 8).

Finally, I wish to emphasize that having a regime of shareholder voting and no board veto does not at all imply that, in the event that a bidder emerges, shareholders would generally be forced to participate in voting and possibly have to do it more than once. Such a regime can be easily designed in such a way that shareholders would not have to vote as long as they are not interested in accepting the offer. Consider a situation in which the board may maintain a pill and in which, furthermore, the board may be removed once a bidder obtains written consents from a majority of the shareholders (or obtains in some functionally equivalent way a vote of approval from a majority of the shareholders). In such a case, if the shareholders do not wish to take the bidder's offer, the bidder's emergence and the presence of a regime with shareholder voting and no board veto would not require the shareholders to take any action; they simply would refrain from giving their written consents to the bidder. Thus, shareholders would have to vote only when if, and when, they conclude that the offer would be worth taking.

II. THE CASE AGAINST BOARD VETO

On the view that I label the "board veto" view, boards should have the power to block acquisition offers, at least for a significant period of time beyond what would be necessary for exploring and preparing alternative plans and communicating them to the shareholders. I already noted some of the arrangements that currently provide managers with substantial veto power. The ubiquitous staggered board does so whenever directors are permitted to maintain a pill as long as they remain in office. Similarly, when boards may adopt dead-hand pills or slow-hand (delayed-redemption) pills,²⁸ as they may for sure in some states and possibly in others, boards can completely block, or at least significantly reduce the chances of, a bid that otherwise would likely win.

My interest in this main part of the paper is not in the particulars of veto-providing arrangements but rather in the general question of whether a board veto regime is desirable. Supporters of board veto arrangements take the view that the best corporate law regime involves such a board veto. Expanding the use of board veto arrangements, they believe, operates to the benefit of both shareholders and society at large.

²⁸ Dead-hand pills, the most lethal, are permitted in Virginia, Pennsylvania and Georgia. See *Chesapeake*, 771 A2d 293 at 322. Slow-hand pills are allowed in Maryland. See James Hanks, *Something Old, Something New: Maryland's Unsolicited Takeovers Act*, 3 M&A Law 12-18 (1999).

Although the board veto view has other supporters,²⁹ it is most closely associated with Martin Lipton. As inventor of the “poison pill,” Lipton made a great practical contribution to incumbents’ ability to defend the corporate citadel. In his various writings on the subject, which span more than twenty years, Lipton puts forward a wide array of reasons for why incumbents should have substantial veto power over acquisitions.³⁰ Below I attempt to consider all of the arguments put forward by Lipton and other supporters of board veto.

A. *Alternative Normative Perspectives*

An important premise for any policy analysis is the normative objective in light of which outcomes are evaluated. What counts and what does not count as a benefit depends on the normative perspective used. An examination of the arguments of supporters of board veto reveals that more than one normative perspective has been used.³¹ Because I wish to examine the full range of possible arguments for board veto, I will examine the board veto question from each of the four different normative perspectives that have been invoked in the literature.³² It would be worthwhile to describe briefly at the outset each of these four perspectives.

²⁹ See, for example, the recent work of Margaret Blair and Lynn Stout, *A Team Production Theory of Corporate Law*, 85 Va L Rev 247, 305 (1999).

³⁰ These writings start with Martin Lipton’s 1979 article, *Takeover Bids in the Target’s Boardroom*, 35 Bus Law at 101 (cited in note 2) and conclude (thus far) with Martin Lipton and Paul Rowe, *Pills, Polls, and Professors: A Reply to Professor Gilson*, 27 Del J Corp L (forthcoming 2002). Some of the other important pieces in this series are Martin Lipton, *Takeover Bids in the Target’s Boardroom: A Response to Professors Easterbrook and Fischel*, 55 NYU L Rev 1231 (1980); Lipton, 136 U Pa L Rev at 69 (cited in note 24); and Lipton and Rosenblum, 58 U Chi L Rev at 224–52 (cited in note 10).

³¹ See Allen, Jacobs, and Strine, 69 U Chi L Rev at XX (cited in note 3) (observing that there are different “strands” in the board veto camp (referred to by the authors as “the entity model”)).

³² By examining the subject from these four normative perspectives, I attempt to respond to the challenge posed by the suggestion in Allen, Jacobs, and Strine that the participants in the takeover debate “seem to be talking past each other” because their arguments are based on fundamentally different objectives and normative perspectives. See 69 U Chi L Rev at XX (cited in note 3).

I used a similar strategy in Bebchuk, 95 Harv L Rev 1028 (cited in note 1), and in Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 Stan L Rev 23 (1982). These articles took issue with Easterbrook and Fischel’s arguments against any restrictions on takeovers, even those restrictions that would be necessary to facilitate auctions. I argued that auctions are desirable when evaluated either from the perspective of target shareholders or from the perspective of total share-

(1) *The perspective of target shareholders:* The rules governing defensive tactics are often analyzed from the perspective of target shareholders. From this perspective, the rules that should govern target boards are those that would best serve the shareholders of these companies. These rules are those that informed and rational shareholders of these companies would have wished to adopt *ex ante*. In defending veto power from this perspective, supporters of such power have argued that shareholders would be best served under a regime in which, in the event of a bid, boards would have substantial veto power.

(2) *The perspective of targets' long-term shareholders:* Supporters of board veto sometimes draw a distinction between short-term shareholders, which do not plan to hold shares for long and therefore are focused on short-term returns, and long-term shareholders, which plan to keep holding their shares and focus on long-run returns. Target boards should give greater weight, supporters of board veto sometimes argue, to the interests of the target's long-term shareholders.³³ These supporters also believe that there is some divergence of interest between these two categories of investors in the takeover context. Therefore, another perspective that I will use to evaluate board veto is that of targets' long-term shareholders.

(3) *The perspective of total shareholder wealth:* Another normative perspective is that of aggregate shareholder wealth, which combines the wealth of targets' shareholders and acquirers' shareholders.³⁴ The use of this perspective might be justified on grounds that most target shareholders hold diversified portfolios and therefore prefer rules that would maximize aggregate shareholder wealth rather than gains to targets.³⁵ Alternatively, the use of

holder wealth—the two perspectives that Easterbrook and Fischel invoked in their own work.

³³ See, for example, Lipton, 136 U Pa L Rev at 36 (cited in note 24) (“[T]hose who choose to invest for the long-term are surely deserving of management consideration.”). Compare Allen, Jacobs, and Strine, 69 U Chi L Rev at XXX (cited in note 3) (discussing the concern that a regime of shareholder choice would let “short-term” stockholders cause a sale of the corporation for a “one-time profit”).

³⁴ Allen, Jacobs, and Strine, 69 U Chi L Rev at XXX (cited in note 3), discuss this perspective and view it as potentially more favorable to board veto than the perspective of target shareholders. This perspective was also used in the early work of Easterbrook and Fischel. See, for example, Easterbrook and Fischel, 94 Harv L Rev at 1175 (cited in note 1) (“Even resistance that ultimately elicits a higher bid is socially wasteful [because] [a]lthough the target's shareholders may receive a higher price, these gains are exactly offset by the bidder's payment and thus by a loss to the bidder's shareholders.”).

³⁵ See Allen, Jacobs, and Strine, 69 U Chi L Rev at XXX (cited in note 3); Frank Easterbrook and Daniel Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 Stan L Rev 1, 7–9 (1982) (arguing that shareholders, who do not know whether their firm will be a target, a bidder, or a bystander, are best off under the legal or contractual rule that

this perspective might be justified on grounds that, in setting takeover rules, society should not seek to adopt the rules that target shareholders prefer but rather the ones that would maximize the total value of the corporate sector.

(4) *The perspective of all corporate constituencies:* Supporters of board veto have also argued that it would serve the interests of nonshareholder constituencies, such as employees, suppliers, host communities, and so forth.³⁶ Thus, another perspective from which veto power might be examined is that of the aggregate wealth of all corporate constituencies, including both shareholders and stakeholders. Even if board veto were not beneficial from the perspective of aggregate shareholder wealth, it might be argued, it would be justified from the broader perspective that takes into account also the interests of stakeholders.

Supporters of board veto have not taken a clear position on which perspective is the decisive one. Because they have not conceded that board veto is undesirable from any one of the possible four perspectives, they have not had to make such a choice. Invoking several normative perspectives provides them with fallback positions—even if board veto were identified as undesirable for target shareholders in general, they could retreat to the view that such veto would be justified from the perspective of long-term shareholders; and even if board veto were identified as for any significant group of target shareholders, they could still retreat to defending it on grounds of aggregate shareholder wealth or the aggregate wealth of both shareholders and stakeholders.

I will not attempt in this paper to resolve or discuss which normative perspective should guide the design of takeover rules. Rather, my thesis is that there is no good basis for the board veto position from *any* one of the above four perspectives. I begin by examining board veto in Parts II.B and II.C from the standard, conventional perspective of target shareholders: Part II.B discusses the costs of such power from this perspective; Part II.C then goes in detail over each one of the rationales that have been offered for board veto from this perspective. After concluding that board veto is not in the overall interest of target shareholders, I turn to examine in Parts II.E, II.F, and II.G whether the case for board veto becomes stronger if one evaluates it from the perspectives of long-term shareholders, aggregate shareholder

maximizes total shareholder wealth). For a critique of this basis for using the perspective of aggregate shareholder wealth, see Bebchuk, 35 *Stan L Rev* at 27–30 (cited in note 32).

³⁶ See, for example, Lipton, 35 *Bus Law* at 105–06 (cited in note 1); Lipton 136 *U Pa L Rev* at 36–39 (cited in note 24); Blair and Stout, 85 *Va L Rev* at 287 (cited in note 29). See also Allen, Jacobs and Strine, 69 *U Chi L Rev* at XXX (cited in note 3) (“Judges, presented with a takeover case are unavoidably aware that interests of more than stockholders are usually at stake”).

wealth, and the aggregate wealth of all corporate constituencies respectively; I find that it does not.

B. The Target Shareholders' Perspective: Costs of Veto Power

1. Ex post agency costs.

Although this problem is a serious one, it is conceptually simple and thus can be described with brevity. The takeover context is one in which managers' and shareholders' interests often diverge. Managers might lose their control and the private benefits associated with it. Thus, to use the language of *Unocal*, the takeover context confronts us with "the omnipresent specter that a board may be acting primarily in its own interests."³⁷

Thus, whenever a bid is made, the divergence of interest gives rise to potential for agency costs. First and most importantly, managers might elect to block a beneficial acquisition in order to retain their independence. Secondly, managers might use their power not to extract a higher premium for their shareholders but rather personal benefits for themselves. I will refer to these problems as "ex post" agency problems because they are ones that arise *after* a bid is made. I will discuss later ex ante agency costs, that is, adverse effects on incentives and behavior prior to the making of any bids.

Martin Lipton and Paul Rowe recently argued that the absence of legal cases condemning incumbents' standing behind pills is evidence that directors have in fact used their powers responsibly; the absence of such cases, they believe, indicates that the "pill has been used; it has not been abused."³⁸ But the absence of such court cases does not indicate whether shareholders have been hurt. Once judicial standards are established, incumbents can be expected not to deviate from them. Thus, absence of violations merely indicates that incumbents, helped by legal counsel, can predict what actions would stand judicial scrutiny.

Although the incidence of judicial condemnation does not provide a test for the presence of agency costs, there is evidence that these costs are significant. To start with, the evidence indicates that, in the event that incumbents use their veto power to defeat bids, shareholders end up worse off compared with the scenario in which the bid would have been accepted.

It is well documented that, when target managers defeat offers, shareholders on average experience a significant stock market loss. For example, James Cotter and Marc Zenner found that, when offers are defeated, share-

³⁷ *Unocal*, 493 A2d at 954.

³⁸ Lipton and Rowe, 27 Del J Corp L at XX (cited in note 30).

holders suffer a 21 percent decline in their stock price.³⁹ It might be objected, however, that incumbents' resistance should be evaluated by its effects on shareholders' wealth in the long-term rather than short-term. In a recent empirical study on staggered boards, John Coates, Guhan Subramanian, and I therefore studied how the defeat of bids hurt shareholders when evaluated from a long-term perspective.⁴⁰ We examined all the cases during the period 1996-2000 in which targets remained independent in the face of hostile takeover bids. We found that, evaluated thirty months after the bid's announcement, the shareholders of targets remaining independent were on average substantially worse off compared with the scenario in which the bid would have been accepted. To illustrate, in the period we studied, we estimated that the average return to target shareholders during the period of thirty months following the offer was 54 percent higher for the group of targets that were acquired than for the group of targets that remained independent.

Additional evidence of the agency problem is provided by studies examining the circumstances in which incumbents are likely to resist bids. An early study by Walkling and Long indicated that the probability of a hostile reaction by incumbents is negatively related to the effect of the acquisition on managers' financial interests, including the loss of their compensation.⁴¹ Subsequently, James Cotton and Marc Zenner found that managers are more likely to resist offers when they have smaller holdings (and thus when their interests overlap less with those of the shareholders).⁴²

Finally, the presence of ex post agency costs is also suggested by evidence that managers might be willing to trade off premia to shareholders for personal benefits. A recent study by Hartzell, Ofek, and Yermack found that target CEOs are willing to accept lower acquisition premia in transactions that involve an extraordinary personal treatment (such as special payments to the CEO at the time of the acquisition or high-ranking managerial posts in

³⁹ See James F. Cotton and Marc Zenner, *How Managerial Wealth Affects the Tender Offer Process*, 35 J Fin Econ 63, 86 (1994).

⁴⁰ See Bebchuk, Coates, and Subramanian, 55 Stan L Rev (cited in note 8) (Section IV.C).

Note that this evidence indicates that, even compared with a state of affairs in which all these companies would have been acquired, the instances of bid rejection and remaining independent produced on average significant losses to shareholders. The losses produced by defeating bids might have been even greater compared with a state of affairs in which the choice whether to reject would have been made by the shareholders. To the extent that shareholders would have rejected some bids in this state of affairs, those bids that were relatively less attractive would have been more likely to be rejected.

⁴¹ See Ralph A. Walkling and Michael Long, *Agency Theory, Managerial Welfare and Takeover Bid Resistance*, 15 Rand J Econ 54, 67 (1984).

⁴² See Cotton and Zenner, 35 J Fin Econ at 95 (cited in note 39?).

the buyer).⁴³ Another study by Wulf indicated that, in merger negotiations, CEOs are willing to trade off higher acquisition premia in exchange for better managerial positions in the merged firm.⁴⁴

2. *Ex ante* agency costs.

Board veto also produces agency costs *ex ante*, before any takeover attempts occur. Management generally acts against the background of the possibility that a takeover bid will be made. In the absence of a board veto, the takeover threat provides managers with an important source of incentives to serve shareholders. Better performance by management makes it less likely that a takeover bid will be made or that it will succeed.

Conversely, by eliminating or reducing the threat posed by a takeover, board veto provides managers with security that could produce significant agency costs. With veto power, managers might contemplate that, even if they do not perform well for shareholders, their veto power will enable them either to retain their control or, if they do not retain control, at least to extract a good deal for themselves. Either way, the presence of a veto power eliminates or much reduces any adverse effect that a takeover might otherwise have on managers' interests. Thus, the takeover threat will lose much of its ability to provide incentives to managers. As a result, veto power might thus lead to a reduction in incentives to curtail managerial slack, consumption of private benefits, empire-building and other actions that are beneficial or convenient for managers but costly to shareholders.

The evidence indicates that insulation from takeover threats does indeed have such adverse effects. Studies by Bertrand and Mullinathan, and by Garvey and Hanka found that stronger protection from antitakeover statutes

⁴³ See Jay Hartzell, Eli Ofek, and David Yermack, *What's In It for Me? Personal Benefits Obtained by CEOs Whose Firms Are Acquired*, NYU Working Paper at 21 (2000), available online at <<http://www.papers.ssrn.com/abstract=236094>>.

⁴⁴ See Julie Wulf, *Do CEOs in Mergers Trade Power for Premium? Evidence from "Mergers of Equals"*, University of Pennsylvania Working Paper (2001), available online at <http://knowledge.wharton.upenn.edu/show_paper.cfm?id=1009>. Some of the famous takeover cases nicely illustrate the weight that CEOs give in takeover negotiations to their managerial position in the merged firm. In *Paramount Communications, Inc v Time, Inc*, 571 A2d 1140 (Del 1989), one of the sticking points in the negotiations was which managerial team would be more dominant following the combination of Time and Warner. See *id.* at 1144 (recounting how, before the merger, the consensus among Time's board members was that "a merger of Time and Warner was feasible, but only if Time controlled the board of the resulting corporation"). In *QVC v Paramount*, 635 A2d 1245 (Del Ch 1993), Herb Wachtell argued for QVC that, in seeking to facilitate an acquisition with Viacom, Paramount's CEO was motivated by his desire to become CEO of Paramount/QVC. *Id.* at 1248 (noting "Mr. Davis's insistence that he become CEO").

causes increases in managerial slack.⁴⁵ Gompers, Ishii, and Metrick found that companies whose managers enjoy more protection from takeovers (as measured by a governance index taking into account both corporate arrangements and state antitakeover provisions) are associated with poorer operating performance—including lower profit margins, return on equity, and sales growth.⁴⁶

There is also evidence that insulation from takeover threats results in greater consumption of private benefits by managers. Borokhovich, Brunarski, and Parrino found that managers with stronger antitakeover defenses, and who thus have a greater degree of veto power, enjoy higher compensation levels.⁴⁷ Bertrand and Mullinathan obtained similar findings for managers that are protected by stronger antitakeover statutes.⁴⁸ Finally, Gompers, Ishii, and Metrick found that companies whose managers enjoy more protection from takeovers are more likely to engage in empire building.⁴⁹

C. *The Target Shareholders' Perspective: Arguments for Veto Power*

1. *Analogies to other corporate decisions.*

Before examining arguments that “start from first principles,” I wish to consider first a common and influential claim that is based on an analogy to other corporate law decisions. Board control, it is argued, characterizes corporate decision-making in general. Indeed, for most corporate decisions, management has not only veto power but the power to make the decision either way. When the corporation faces a choice, say, whether to make a major investment in a new plant or a new product, managers would have the

⁴⁵ See Marianne Bertrand and Sendhil Mullinathan, *Executive Compensation and Incentives: the Impact of Takeover Legislation*, NBER Working Paper No 6830 (1999), available online at <<http://papers.nber.org/papers/W6830>> (finding that the adoption of antitakeover statutes weakened managers' incentives to minimize labor costs); 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) (concluding that antitakeover statutes “allow managers to pursue goals other than maximizing shareholder wealth”).

⁴⁶ See Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, NBER Working Paper No 8449 (2001), available online at <<http://papers.nber.org/papers/w8449.pdf>>.

⁴⁷ See Kenneth A. Borokhovich, Kelly R. Brunarski, and Robert Parrino, *CEO Contracting and Antitakeover Amendments*, 52 J Fin 1495, 1515 (1997).

⁴⁸ See Bertrand and Mullinathan, *Executive Compensation and Incentives: the Impact of Takeover Legislation* (cited in note 45).

⁴⁹ See Gompers, Ishii, and Metrick, *Corporate Governance and Equity Prices* at 31–32 (cited in note 645).

power to make it, either way, generally without any intervention from either courts or shareholders. Why should we rely on managers for other corporate choices, so the argument goes, but not for decisions on takeovers?⁵⁰

This argument, to be sure, does not claim that deference to managers in other corporate contexts *compels* granting managers veto power over acquisitions. Rather, building on the long-standing and widely accepted role of boards in other corporate decisions, it seeks to use it to question the case for limiting boards' roles in takeovers. If one accepts that delegation to boards works well in other contexts, so the challenge goes, are there any good reasons to view the takeover context as sufficiently different?

In fact, there are important differences, which call for a different treatment, between the takeover context and that of corporate decisions such as the investment decisions noted above. To begin, the concern that managers' and shareholders' interests might diverge is greater in the takeover context. Because managers' control is at stake in the takeover context, managers' preferences in this context are likely influenced by their private interests. In contrast, a divergence of interest is much less likely to arise, and if it arises to be of great magnitude, in corporate contexts such as the considered investment decision. Therefore, given managers' common ownership of shares and options, as well as their general interest in making the shareholders content, managers will likely be guided primarily by the goal of enhancing shareholder value. They might err and thereby make wrong decisions. But their decisions are unlikely to be distorted by private interests strongly and commonly.⁵¹

Second, in other contexts, such as the investment decisions considered above, letting the shareholders of a publicly traded company make the decision is not a viable option. In contrast, in the takeover context, letting the shareholders ultimately make the decision is a viable and practical option. Experience indicates that proxy contests conducted over an acquisition offer draw heavy participation by shareholders. The question remains, of course,

⁵⁰ See Lipton, 35 Bus Law at 104 (cited in note 1) ("Takeover bids are not so different from other major decisions as to warrant a unique sterilization of the directors in favor of direct action by the shareholders.").

⁵¹ The reasoning in this paragraph is similar, I think, to the one underlying Vice Chancellor Strine's recent statement in *Chesapeake*: "It is quite different for a corporate board to determine that the owners of the company should be barred from selling their shares than to determine what products the company should manufacture." *Chesapeake Corp v Shore*, 771 A2d 293, 328 (Del Ch 2000). Strine cites, *id* at 328 n 79, the essay of Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 Bus Law 393 (1997) In this essay, Veasey, although sympathetic to the board veto view, nonetheless indicates that standard deference and delegation are inappropriate with respect to "ownership" or "enterprise" decisions.

whether shareholders would make good decisions, and we shall consider this question in the next Part. In the takeover context, however, letting the shareholders make the decision is an option that is viable in ways that it is not in other contexts.

Relatedly, deference to boards in the takeover context is not called for by courts' reluctance to make business decisions. In other corporate contexts, where letting the shareholders decide is not an option, complete deference to boards can be avoided only by relying on judicial scrutiny. Given courts' limited information, expertise, and resources, however, the business judgment rule rightly counsels courts against making the business decisions that would be necessary for effective scrutiny of the merits of board decisions. In contrast, in the takeover context, a regime of shareholder voting and no board veto does not require courts to make business decisions. Courts are expected only to protect shareholders' rights to make decisions in certain circumstances and to prevent managers from blocking such decisions.

Thus far, I have explained why, if we look at the takeover context and the investment context each in isolation from the other, the argument for board control is substantially weaker in the former context than in the latter. But there is an important interaction between (1) the case *for* board control in the investment context, and (2) the case *against* board control in the takeover context. Not only is (2) consistent with (1), but, furthermore, (2) strengthens and reinforces (1). One of the reasons why boards can be left with such large powers over business decisions is that the possibility of a takeover provides a safety valve and source of discipline.⁵² Thus, not having board control over takeovers in fact contributes to the case for board control in general corporate decisions.⁵³

2. *Inefficient capital markets.*

Supporters of the board veto view believe that boards would decide better whether any given offer is worth accepting. Consequently, it is argued, it would be better for shareholders if boards were to make the decision for them. The argument that boards would decide better has two variants. One variant, which I will take up first, is based on rejection of the efficient capital markets hypothesis and belief that stock prices might often deviate from fundamental values. The second variant, which Part II.C.3 will take up, is

⁵² See Gilson, 33 *Stan L Rev* at 848–52 (cited in note 1).

⁵³ While the above analysis suggests that the takeover context should be an exception to the general principle of board control, I do not wish to imply that it must be the *only* exception. I discuss the desirable scope of exceptions to board control in Bebchuk, *The Allocation of Powers between Managers and Shareholders* (cited in note 20).

based on incumbents' having private information concerning the target's value.

Let us start with the claim that board veto is called for by rejection of the efficient capital markets hypothesis.⁵⁴ On this view, board veto can address situations in which a company's price is trading at a "depressed" level below its fundamental value.⁵⁵ "[M]ust we accept (and make boards accept) short-term trading value as the sole reference point in responding to takeover proposals?" supporters of board veto ask.⁵⁶ A negative answer to this question, they believe, calls for a board veto.

There are indeed good reasons to doubt the extent to which market prices generally reflect well fundamental values. The efficient capital market hypothesis has been by now long questioned by a large body of work in financial economics.⁵⁷ The recent burst of the dot.com bubble has provided a vivid illustration that stock prices may deviate from fundamental values. As explained below, however, accepting that capital markets are not generally informationally efficient, which has been the consistent position of the Delaware courts,⁵⁸ does not imply that board veto is desirable.

To be sure, the stock market's informational inefficiency undermines the basic premise underlying the passivity approach of Easterbrook and Fischel, according to which a takeover at a premium over the pre-bid market price is bound to increase shareholder wealth and efficiency.⁵⁹ Such inefficiency also significantly weakens the case for the auctions approach; some of the likely causes of this inefficiency, such as limited arbitrage, might also suggest that auctions might not always fetch a price that equals or exceeds the target's independent value.

Acceptance of informational inefficiencies, however, is consistent with a regime of undistorted shareholder choice. In such a regime, targets of hostile bids will not be necessarily acquired for the highest price that would be offered for them in a market that might be temporarily depressed. Shareholders would vote down any premium offer if they believed that, although significantly above the target's temporarily depressed price, it falls below the

⁵⁴ See, for example, Lipton and Rowe, 27 Del J Corp L (2002) (cited in note 30) (equating opposition to defenses with support for the efficient market theory).

⁵⁵ See, for example, Lipton, 35 Bus Law. at 108 (cited in note 1).

⁵⁶ Lipton and Rowe, *Pills, Polls, and Professors* at 33 (cited in note ??).

⁵⁷ See, for example, Andrei Shleifer, *Inefficient Markets XX* (Oxford 2000).

⁵⁸ See, for example, *Smith v Van Gorkom*, 488 A2d 858, 875-76 (Del 1985) ("Using market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious, premise.").

⁵⁹ See Easterbrook and Fischel, 94 Harv L Rev at 1173-74 (cited in note 1).

target's fundamental value, which would be eventually reflected in market prices if the target were to remain independent.⁶⁰

That shareholders' decisions might discriminate in this way is nicely illustrated by comparing shareholders' reactions to the recent hostile bids for Shorewood and Willamette, two targets that were protected by a substantial array of defensive tactics.⁶¹ In both cases, the hostile bidders offered a substantial premium over the preceding market price of the target, though not over its historic price. In both cases, the boards rejected the offers as inadequate on grounds that the stock market was greatly undervaluing the company's shares. In the case of Shorewood, shareholders apparently shared the view that the premium price was below the target's value, and after the bid was made only 1 percent of the targets' shares were tendered to the bidder.⁶² In contrast, in the case of Willamette, shareholders took a different view, and the bid attracted 45 percent of the shares initially and, after the bidder raised the offer somewhat, 64 percent of the shares.⁶³

Thus, shareholders might sometimes accept, and might sometimes reject, claims that a premium offer is inadequate because the pre-bid market price was highly depressed. Thus, even if we do not accept short-term value "as the sole reference point in responding to takeover proposals," board veto does not necessarily follow. The question would still remain who should make the judgment of how the takeover proposal compares with the right reference point—boards or shareholders. Accepting that capital markets might be informationally inefficient does not by itself compel or suggest an answer to this question. To be sure, supporters of board veto might take on

⁶⁰ It might be objected that, if shareholders viewed the market price as depressed, they themselves would keep buying shares, and the price could not remain at its level. But this argument ignores risk-aversion and liquidity constraints on the part of the shareholders. More importantly, the critical question is not what shareholders' views were prior to the bid but rather what their views will be when making voting decisions. At this point, shareholders will be able to draw on the information produced by the very making of the bid, the communications and recommendations of the board, and other information produced during the takeover context. That shareholders of a target might by that time come to the view that the target's fundamental value exceeds the bid price is nicely illustrated by the Shorewood case discussed in *infra* notes 60–61 and accompanying text.

⁶¹ See generally, *Chesapeake*, 771 A2d at 296; Jim Carlton and Robin Sidel, *Willamette Agrees to be Bought by Weyerhaeuser*, Wall St J A3 (Jan 22, 2002).

⁶² *Chesapeake*, 771 A2d at 314.

⁶³ See Robin Sidel, *Weyerhaeuser Fails to Win Willamette Mandate*, Wall St J A4 (May 22, 2001); (reporting that 45 percent of Willamette's shareholders tendered into Weyerhaeuser's \$50 a share offer); *Weyerhaeuser Bid Wins 64% Support in Target Company*, Wall St J B8 (Jan 11, 2002) (reporting that the percentage of shares tendered increased to 64 following the raising of Weyerhaeuser's bid).

the additional position that boards would make such decisions better. This is the claim to which I shall now turn.

3. *Directors' superior information.*

a) *The threat of an inadequate offer.* Whether a takeover would benefit shareholders depends on how the offered acquisition price compares with the target's value in the event that it remains independent at least for the time being. This "independent value" of the target includes both the value of the possibility of remaining independent for the long haul and the value of the possibility of receiving higher offers later on.⁶⁴ Because managers might have superior information about the target, supporters of board veto believe that they would be in a better position to estimate the target's independent value. Accordingly, it is argued, shareholders' interests would be served by delegating the decision to their board.⁶⁵

That managers might sometimes be better informed has been long accepted by takeover law.⁶⁶ The Delaware courts have viewed as plausible and legitimate directors' concern that shareholders mistakenly view as adequate an offer that is, in fact, inadequate according to directors' superior information.⁶⁷ The danger of imperfectly informed shareholders' acceptance of an inadequate offer has been referred to, using a term coined by Ronald Gilson and Reinier Kraakman, as "substantive coercion."⁶⁸

b) *Does informational advantage warrant a board veto?* I agree that, indeed, managers often have private information, both hard and soft, that public investors do not possess. Managers also might have devoted more time and effort to assessing the body of information about the company that is publicly available. Managers' superior information might indicate to them that the target's independent value is lower or higher than the level estimated by the

⁶⁴ See Bebchuk, 98 Harv L Rev at 1700 (cited in note 4) (defining the target's independent value as including the value of the possibility of receiving higher offers in the event that the current offer is rejected).

⁶⁵ See, for example, Lipton, 35 Bus Law at 115 (cited in note 2).

⁶⁶ In *Paramount Communications, Inc v Time, Inc*, 1989 Del Ch LEXIS 77, *56 (Del Ch July 14, 1989), former Chancellor Allen remarked on managers that "[n]o one, after all, has access to more information concerning the corporation's present and future condition." Id at 49.

⁶⁷ See, for example, *Paramount Communications, Inc v Time, Inc*, 571 A2d 1140, 1153 (Del 1989); *Unitrin v American General Corp*, 651 A2d 1384, 1385 (Del 1994); *Moore v Wallace Computer*, 907 F Supp 1545, 1557 (D Del 1995). In each of these cases, the court expressed concern about shareholders' decisions being affected by their "ignorance or mistaken belief" as to the target's intrinsic value.

⁶⁸ Gilson and Kraakman, 44 Bus Law at 248 (cited in note 5).

target's shareholders. The case in which shareholders overestimate the target's value cannot by definition be grounds for considering board veto. But can the possibility of shareholders underestimating the target's value provide good basis for such a veto power? As I explain below, the answer is no.⁶⁹

Note first that, even accepting that directors might sometimes have better information for the purpose of comparing the bid price and the target's independent value, they do not have the *best incentives* for making the right decision. Thus, a regime with board veto moves decision-making to a party that might be better informed but might have worse incentives. Directors might use their veto power not (or not only) for the intended purpose of blocking inadequate offers but also to block offers that would be beneficial to shareholders. This concern is real and significant because the claim of offer inadequacy is one that directors can generally raise, and that would be hard to falsify, whenever they prefer their independence.⁷⁰ In contrast, if shareholders had decision-making power, they might sometimes be less informed, but they would never have a reason to reject an offer that they view as beneficial to shareholders.

The above discussion indicates that board veto would be unlikely to be desirable even if we assumed that directors' superior information would go totally unused in a regime of shareholder voting and no board veto. Such a regime, however, would not imply that directors' superior information would generally be wasted. It only would preclude directors from blocking offers on grounds that they have such information. But such information could and would likely be used as a basis for directors' communications and recommendations to shareholders.

To begin, following the making of an offer, directors can and often do provide shareholders with a great deal of new information as well as de-

⁶⁹ The analysis below responds, I think, to the concern expressed by Allen, Jacobs, and Strine, 69 U Chi L Rev at XXX (cited in note 3), that those opposed to board veto "seem to give little credit to the fact that directors have much greater access to information flows respecting business prospects and values." Fully accepting this fact, the analysis below shows that it does not undermine the case against board veto.

⁷⁰ As was observed by Vice Chancellor Strine: "[i]t is important to recognize that substantive coercion can be invoked by a corporate board in almost every situation." *Chesapeake*, 771 A2d at 327. Note that the raising of a false claim cannot be discouraged by fears that even if the claim is not demonstrably false when made, it will become so down the road. Suppose that managers block an offer of \$100 a share on grounds that the target's independent value is \$120 a share, and suppose that the market price three years down the road will be \$90 a share. Managers still will be able to defend their earlier estimate: The \$120 a share estimate was accurate at the time it was made, they will argue, but it was an expected-value estimate; the price after three years has fallen below this expected value because uncertainty has been resolved unfavorably.

tailed reasoning, sometimes backed by investments bankers' opinions, for the directors' estimate of how the offered price compares with the target's value. Such communications might close or significantly reduce whatever information gap existed between management and public investors prior to the offer (and might have continued to exist in the absence of the communications).

Of course, in some circumstances, managers might be unable to communicate the information on which they base their high estimate of value, say, because business considerations require secrecy⁷¹ or because the nature of the information makes it impossible to disclose it credibly.⁷² In such cases, directors can still communicate to the shareholders their estimate (or range of estimates) for the target's value and their recommendation to reject the offer.

In the face of such a communication from directors, rational shareholders can be expected to balance two considerations. On the one hand, they will recognize that directors might be better informed; that shareholders are imperfectly informed about the target's value hardly implies that they are unaware that this is the case. This consideration would weigh in shareholders' decision-making in favor of deferring to the directors. On the other hand, shareholders will also recognize possible problems with deferring to the directors, which would weigh against doing so. First, directors might have self-serving reasons for preferring independence. Furthermore, like other humans, the directors might make mistakes and might suffer from the cognitive dissonance tendency to view favorably both one's past performance and the positions that fit one's interests. As Chancellor William Allen wisely remarked in *Interco*: "[H]uman nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial."⁷³

In balancing these considerations, shareholders will take into account various circumstances of the particular case facing them. Among other things, shareholders might take into account the following factors: their own estimate of the target's value (if it is just below the bid price, for example, the risk of deferring to the board is small); how likely the managers are to have private information of substantial import for the target's value (which in turn

⁷¹ See, for example, *Shamrock Holdings, Inc v Polaroid Corp*, 559 A2d 278 (Del Ch 1989). In this case, the target's largest asset was a patent litigation claim. The court accepted that disclosures about this claim might compromise the target's bargaining position in the litigation. *Id* at 290.

⁷² In some cases, managers have argued that information cannot be passed on effectively to shareholders because they would have difficulty comprehending it or would get confused. See, for example, *Chesapeake*, 771 A2d at 332 (discussing the concern expressed by Shorewood with respect to "the risk of shareholder confusion").

⁷³ *City Capital Associates Partnership v Interco*, 551 A2d 787, 796 (Del Ch 1988).

might depend on the nature of the company's business); and the estimated magnitude of management's divergence of interest (the more shares the managers themselves hold, for example, the smaller the likely divergence of managers' and shareholders' interests).

It is worth noting that in a regime with no board veto, managers that view the target's independent value as significantly higher than the bid price might elect to take steps that would credibly signal that their recommendation is indeed based on their genuine estimate of the target's value. For example, managers could do so by committing themselves, in the event that the bid fails, to spend some of their own funds to purchase from the company *at the bid price* a certain number of shares and hold them for a certain period of time. Such an investment would be profitable if and only if the target's independent value exceeded the bid price. Accordingly, a commitment to make such an investment would send a signal that managers genuinely view the target's independent value as exceeding the bid price. When managers may use a board veto to block the offer, they will see no reason to signal using such commitments. But they might elect to use them under a regime with no board veto when they believe remaining independent would be indeed beneficial.⁷⁴

In any event, after balancing the considerations for and against deferring to the directors, rational shareholders might sometimes conclude that deference would be best overall, on an expected value basis, and might sometimes reach the opposite conclusion. Of course, shareholders might not always get it right. But given that their money is on the line, shareholders naturally would have incentives to do the tradeoff correctly.⁷⁵

In contrast, a board veto regime mandates deference to the directors as a general rule. A board veto regime and a shareholder voting regime would produce different outcomes only in those cases in which shareholders would elect not to defer if the decision were left with them. Thus, to prefer a board

⁷⁴ It is worth connecting this point to the recent observation made by Vice Chancellor Strine that current doctrine allows managers to make fundamental decisions for the company's owners, "yet the directors bear no risk if they erroneously block a premium offer and the stock price drops." *Chesapeake*, 771 A2d at 328. While current doctrine does not require or encourage taking such risks, a shareholder voting regime might induce managers to take some such (profitable) risks—in the way outlined above—when they genuinely believe that the offer is inadequate.

⁷⁵ Note that in deciding whether to defer, shareholders will be in the same situation as many parties who must decide whether to defer to an agent that has greater expertise. Because we expect such parties to have incentives to trade off the costs and benefits of deference as well as possible, we generally believe that such parties would be better off if they were allowed to make the decision rather than required to defer to the expert agent.

veto regime, one would have to believe that, due to ignorance of their imperfect information or irrationality or hubris or some other reason, shareholders would be making the wrong choice in most of these cases. That is, one would have to believe that in most of the cases in which shareholders would have decided not to defer if they were left with the choice, deference would in fact serve them better. If shareholders' decisionmaking on whether to defer were indeed so flawed, then the paternalistic approach of tying their hands and mandating general deference to boards would be indeed warranted.

Although targets' shareholders are often less informed than management about the target's value, there is little reason to view shareholders as unaware of this state of affairs or as likely to ignore it out of hubris, irrationality, or otherwise. Target shareholders do not seem to be a group for which paternalism is warranted. As the United States Supreme Court stated in *Basic Inc v Levinson*, management should not "attribute to investors a child-like simplicity."⁷⁶

The substantial presence of institutional investors makes paternalistic mandating of deference especially unwarranted. Institutions are likely to be aware of the informational advantage that directors might have, and they appear capable of making reasonable decisions on whether deferring to the board would be best overall. Some institutional investors rely on their own analysis and some rely at least partly on proxy-advisory firms such as Institutional Investors Services, which devotes resources to researching questions put to a vote and then makes recommendations to institutions.⁷⁷ Clearly, there is little reason to believe that the decisions of institutional investors on whether to defer would be so poor that mandating deference would be preferable to letting them make such decisions.⁷⁸

Finally, voting shareholders can hardly be regarded as a group that is excessively reluctant to defer to managers. Indeed, the normal patterns of corporate voting indicate that shareholders, including institutions, com-

⁷⁶ *Basic, Inc v Levinson*, 485 US 224, 234 (1988), quoting *Flamm v Eberstadt*, 814 F2d 1169, 1175 (1987).

⁷⁷ See, for example, *Northrop Grumman Gains ISS Endorsement for TRW Special Meeting*, PR Newswire (Apr 18, 2002) (reporting that ISS, the "Nation's leading independent proxy advisory firm, endorsed a vote in favor of allowing Northrop Grumman's bid for TRW to proceed")

⁷⁸ In *Chesapeake*, Vice Chancellor Strine rhetorically asks: "If stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation has been afforded them?" *Chesapeake*, 771 A2d at 328. I would replace the second clause in this question with "why are they not presumed competent to decide whether to defer to managers' recommendation to reject the offer after an adequate time for management communications and shareholder deliberation?"

monly display a great deal of deference to management's views. Thus, if anything, there are grounds for concern that voting shareholders might be excessively deferential. But that is, of course, not a reason to mandate deference. When circumstances would lead shareholders to overcome the tendency to defer to management, imposing deference on them would be unlikely to be beneficial.⁷⁹

In assessing the arguments for and against board veto, William Allen, Jack Jacobs, and Leo Strine wonder "whether shareholders have sufficient information and appropriate incentives to determine, equally or more competently than directors, whether the corporation should be sold."⁸⁰ On the view put forward above, however, the important question is not who can judge better whether the company should be sold but rather who should decide whether deference should be given to the more informed but possibly conflicted directors. Shareholders have the best incentives to make this decision in a way that would serve their interests, and they should be permitted to make it.

c) *Some evidence.* It is worth noting that the case against mandated deference is supported by the existing evidence. When target managers defeat offers, shareholders experience on average a significant decline in stock value,⁸¹ a pattern that is consistent with the proposition that mandating deference makes shareholders worse off.

To be sure, supporters of board control can rightly object that this evidence does not respond to their claim, because it refers to short-term results. On their view, investors' possible under-estimation of the target's long-term value is the very reason for board control, and shareholders' short-term losses thus do not rule out the possibility that the defeat of offers by incumbents ultimately does pay off. As already noted, the staggered boards study done by Coates, Subramanian, and I examined long-term returns and found no such long-term payoff. To the contrary, we found that thirty months after the bid announcement, the shareholders of targets that remained independent obtained on average a significantly lower value than they could have obtained had the board agreed to be acquired.⁸²

⁷⁹ Compare Lucian Arye Bebchuk and Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 Va L Rev 993, 995–96 (2001). In this work, we defend a proposal to allow shareholders to vote to opt into a different takeover regime against a critique by Choi and Guzman. Responding to Choi and Guzman's claim that voting shareholders display deference to managers, we argue that such deference implies at most that shareholders might use their voting power too little but not that they should not have this power.

⁸⁰ Allen, Jacobs, and Strine, 69 U Chi L Rev at XX (cited in note 3).

⁸¹ See Cotton and Zenner, 35 J Fin Econ at XX (cited in note 39).

⁸² See Bebchuk, Coates, and Subramanian, 55 Stan L Rev (forthcoming 2002) (cited

d) *Judicial screening of inadequate offer claims.* In response to the above analysis, it might be suggested that board veto should not be permitted when directors simply assert that the offer is inadequate but should be permitted when managers provide a particularized and detailed analysis indicating that the target's value is substantially higher than the bid price. This approach was put forward in an influential article by Gilson and Kraakman.⁸³ Recognizing the potential for abuse from allowing unlimited board veto based on mere assertions of offer inadequacy, Gilson and Kraakman suggested allowing such veto only when such assertions are judged (by a court) to be sufficiently substantiated and weighty. On their view, requiring such a particularized and substantial showing would screen out the instances in which board veto would be undesirable.

Chancellor Allen's famous opinion in *Interco* indeed subjected claims of offer inadequacy to judicial scrutiny. In that case, Allen did not permit a board to veto an offer of \$74 a share on grounds that such veto would enable the incumbents to pursue a business plan that an investment banker estimated would produce a value of "at least" \$76 a share. Confronting these numbers, Allen found the threat of offer inadequacy to be too mild to justify a board veto.⁸⁴ He left open, however, the possibility that the threat of substantive coercion could justify a veto in other circumstances, such as a case in which the company's investment banker suggested a value greatly exceeding the offer price.

Consider a "screening" rule under which courts permit a board veto if: (1) directors provide a particularized analysis—say, in the form of an investment banker opinion—of their estimated target value in the event of bid rejection; and (2) this estimated value or range of values is substantially higher than the offer price. Imposing such limits on managerial claims of offer inadequacy clearly would eliminate some (and possibly the worst) cases of abuse. However, in my view, this rule still provides an unnecessary "safe harbor" for offer inadequacy claims. It would be better still to let shareholders rather than courts engage in the screening of managers' claims of offer inadequacy.⁸⁵

in note 8).

⁸³ See Gilson and Kraakman, 44 *Bus Law* at 271 (cited in note 5).

⁸⁴ *Interco*, 551 A2d at 799.

⁸⁵ Evaluating the overall approach suggested by *Interco*, and Gilson and Kraakman, I view it as too lax in the respects discussed in this Part and as insufficiently restrictive in the respects discussed earlier. As discussed in Part I.B, I do not accept the Allen-Gilson-Kraakman view that a cash offer with a back-end at the same price enables undistorted shareholder choice; in my view, such an offer can still produce collective action problems, and undistorted choice should be ensured by requiring the bidder to win a shareholder vote. In any circumstances in which undistorted shareholder choice is as-

Consider a target that was trading at \$70 a share and received a hostile bid of \$100. Suppose that management subsequently put together an alternative business plan, and that the company's investment banker provided an opinion giving an estimated range of \$100 to \$120 a share (in present value terms) for the value that the target will have if it remains independent. Should blocking of the offer by the board be permitted (as the considered screening rule would do)?

Note that, in a regime of shareholder voting and no board veto, the \$100 bid would not necessarily win. The shareholders might be persuaded by the board's recommendation and the investment banker opinion backing it and might vote to reject the offer. In the absence of a board veto, however, voting shareholders might also decide not to accept directors' recommendation to remain independent. With due respect to investment bankers opinions', their estimates are hardly money in the bank.⁸⁶ There is substantial room for discretion in financial estimates, and two analysts who use standard and acceptable methodologies may reach very different estimates.⁸⁷ Furthermore, the investment banker hired by management might have an incentive to please management as long as it would not have to bear reputational costs; thus, the banker would have an incentive to come out with the highest estimate that can be justified by standard and acceptable methodologies.⁸⁸

Compared with a regime of shareholder voting and no board veto, the screening rule would produce different outcomes only in those cases in which shareholders otherwise would elect to accept the bid notwithstanding

sured, however, the Allen-Gilson-Kraakman willingness to accept some substantive coercion claims as justifying board veto is, in my view, unwarranted.

⁸⁶ For a detailed analysis of the problems involved in relying on investment bankers' opinions, see Lucian Ayre Bebchuk and Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?*, 1989 Duke L J 27. See also *Interco*, 551 A2d at 799 ("[I]t is incontestable that the Wasserstein Perella value is itself a highly debatable proposition.").

⁸⁷ See Bebchuk and Kahan, 1989 Duke L J at 29-37 (cited in note 86). See also *Interco*, 551 A2d at 799 (discussing the big difference between the estimates offered by the investment banker hired by the target's management and the one hired by the plaintiff in the case).

⁸⁸ Note that there is a form of investment banker backing that voting shareholders would find quite credible. Suppose that the investment banker in the considered case not only opined that the target would have a value of \$120 to \$130 in the event of remaining independent but also made a commitment to purchase, in the event that the target remains independent, a substantial number of shares for \$120 a share. Such a commitment might well get substantial weight in shareholders' decision-making. As long as the banker simply puts forward an estimate of \$120 to \$130 dollars a share, however, the possibility that rational shareholders will elect not to rely on this estimate is a realistic one.

the managers' recommendation and the bankers' opinion. In such cases, however, why should deference to the directors' and bankers' opinion be imposed on shareholders, as the screening rule would do? Essentially, a regime of shareholder voting and no board veto does not imply that there would be no screening of the board's inadequacy claims. Such a regime also involves such screening, but *shareholders* would be the ones doing the screening. The factors that courts would weigh under the screening rule might well be ones that would also guide the shareholders' screening decisions. The critical point, however, is that there is no reason to have the courts rather than shareholders screen boards' claims of offer inadequacy.

Thus, although the screening rule seems, at first sight, consistent with the tendency of courts to defer to business decisions made by market participants, it is not. If courts were to decide when directors have a sufficiently substantiated case that remaining independent would be worthwhile, they would be substituting their judgment on this question for that of the shareholders. Given that courts do not have any clear advantage over shareholders in assessing the strength of offer inadequacy claims, courts should not take such decisions away from shareholders.⁸⁹

4. *Bargaining by management.*

a) *Premia obtained with and without board veto.* Thus far, I have focused on the possible benefits of board veto in those cases in which it would lead to target independence. I now turn to claims that such power might have beneficial effects on those cases in which acquisitions take place by increasing premia in these acquisitions. Even if the increased likelihood of independence produced by board veto were undesirable, it might be argued, board control could still be beneficial overall because of its effect on premia.

Management's bargaining is possibly beneficial, it is argued, because target shareholders are dispersed and thus unable to bargain. If management is given some veto power, it could fill the gap and act as a single bargaining agent on behalf of the shareholders. Therefore, so the argument goes, board veto enables managers to bargain and extract a higher price—and thus a larger fraction of the surplus produced by the acquisition—than shareholders would obtain otherwise.⁹⁰ Note that an increased premium at the expense of

⁸⁹ *Interco* itself warns of "the danger that . . . courts—in exercising some element of substantive judgment—will too readily seek to assert the primacy of their own view on a question upon which reasonable, completely disinterested minds might differ." 551 A2d at 796.

⁹⁰ See, for example, René M. Stultz, *Managerial Control of Voting Rights, Financing Policies and the Market for Corporate Control*, 20 J Fin Econ 25 (1988). See also *Interco*, 551 A2d at 798 ("[A]n active negotiator with power, in effect, to refuse the proposal may be

the acquirer would not count in an evaluation from the broader perspective of aggregate shareholder wealth. This perspective will be considered, however, in Part II.E; for now, we are evaluating board veto from the perspective of target shareholders, and for them, higher premia do count as benefit.

There are reasons, however, to doubt the presence, or at least the significance, of the bargaining advantage that a board veto regime is claimed to have. To begin, a regime of shareholder voting is consistent with substantial bargaining by management on behalf of the shareholders. Such a regime would only imply that, after the time necessary for shareholders to have an access to a vote passes, shareholders would have the power, if they so choose, to take the bargaining mandate from management. Thus, the difference between a shareholder voting regime without a board veto and a board veto regime is only that the latter grants management an irreversible mandate to bargain whereas the former gives management a mandate to bargain that is reversible.⁹¹

Consider a principal who has an agent conducting some negotiations on its behalf. Even if the principal keeps the power to take the mandate away from the agent, as is often the case, the agent can bargain on the principal's behalf. Lawyers, for example, bargain on behalf of clients, sometimes ferociously, even though clients are generally free, if they so choose, to accept an offer from the other side against their lawyer's recommendation. That clients are free to do so, however, hardly implies that they would generally elect to do so. Clients might and often do refuse to accept any offer not recommended by their lawyer.

In a regime of shareholder voting and no board veto, when a board takes the view that it would be desirable not to accept the offer on the table and keep bargaining, shareholders would weigh various considerations. They might defer to the board and take no action to remove management's bargaining mandate and accept the offer that is on the table. But they also might sometimes decide to take away the bargaining mandate and end the bargaining if they conclude that management's recommendation is likely due to self-serving reasons or to cognitive bias. In making such explicit or implicit decisions, shareholders would take into account what they know about the particular circumstances of the case.

able to extract a higher or otherwise more valuable proposal.”).

⁹¹ Note some similarity between the argument in Part II.C.4 that a voting regime is consistent with managers' contributing bargaining skills and the argument in Part II.C.3 that a voting regime is consistent with management's contributing its informed estimates. In both cases, my claim has been that a voting regime does not require forgoing all that management has to offer. Rather, such a regime mainly gives shareholders a choice whether to accept management's claims that it has better information or that it will be able to obtain more value through bargaining.

To be sure, it is theoretically possible that it would be the optimal strategy for shareholders to tie their own hands and give management an irreversible mandate to bargain. But it is far from clear that this is the case. Indeed, in other contexts in which principals send agents to bargain on their behalf, principals commonly grant their agents only a reversible mandate. They generally do not deprive themselves of the power to take the mandate away from the agent should they later on conclude that this would best serve their interests.

Furthermore, in examining the question whether an irreversible bargaining mandate is the optimal strategy in the particular context of corporate takeovers, we should take into account that this context is one afflicted by significant agency problems. Given the agency problems, an irreversible mandate might have two adverse effects. First, management might use an irreversible mandate not to extract a higher premium but rather to prevent a takeover altogether. Under a regime with a reversible mandate, shareholders would be able to limit such an abuse either by taking the bargaining mandate from management at some point or by refraining from doing so only if management constrains itself by committing to a price it would accept if offered.⁹²

Second, managers might use an irreversible bargaining mandate not to block an acquisition altogether, and not to extract a higher premium for shareholders, but rather to extract some significant private benefits for themselves. For example, managers might use their power to bargain for an attractive role in the post-takeover entity. Concessions made by the bidder toward management's personal interests might come at the expense of the maximum value that the bidder would be willing to offer shareholders.

b) Some evidence. The discussion above suggests that, at a theoretical level, it is unclear whether a board veto should be expected to increase substantially, or even at all, the acquisition premia paid to target shareholders. Given that the question cannot be fully resolved at the level of theory, let us turn to the evidence.

Supporters of board veto argue that the evidence shows that such veto has a substantial positive effect on premia.⁹³ They rely on early studies by

⁹² Consider our example, and suppose that the acquirer's current offer is \$120 a share. If managers are concerned that shareholders might take away the bargaining mandate from them because of shareholders' concerns that the managers might be seeking an indefinite delay, managers might state that they would agree to a price of \$140 if offered. Note that a commitment by managers to accept a \$140 a share bid would serve as a counter-offer to the bidder.

⁹³ See, most recently, Lipton and Rowe, 27 Del J Corp L (cited in note 30) (noting that "premiums paid to firms with pills were 42 percent higher than the market price of the acquired firm's shares five days prior to the initial offer, while companies that did

Georgeson & Co. that find that targets with poison pills obtained significantly higher premia in acquisitions.⁹⁴ Robert Comment and William Schwert, in a more systematic study, also found an association between pills and premia.⁹⁵

As recent work by Coates shows, however, the findings of the above studies provide no basis for inferring that the presence of pills produces higher premia due to the bargaining power provided by pills.⁹⁶ Because every company can install a pill overnight, having the pill already installed does not affect the power that management would have to block a hostile bid should it occur. Both companies with and without pills effectively have pills in place. Thus, the difference in premia between those two types of companies could not have resulted from the bargaining advantage of pills. The difference must have reflected whatever differences led firms to make different choices whether to install a pill or keep it on the shelf.

Because companies with a pill installed do not stand out in terms of managers' power to block bids, they do not enable testing the impact of defenses on premia. In contrast, as noted, effective staggered boards do offer managers especially strong defenses, and they thus provide a way for such testing. In our study of staggered boards, Coates, Subramanian, and I found that, controlling for other company and bid characteristics, managers armed with effective staggered boards obtained increases in premia that were small and statistically insignificant.⁹⁷ Our analysis indicates that, even if further work does find statistically significant benefits of effective staggered boards in terms of higher benefits, these benefits would be unlikely to be of the magnitude that could give significant support to the case for board veto.

There is also evidence that, in using their bargaining power, managers sometimes advance their interests at the expense of shareholders' premia. As noted earlier, recent studies found that target CEOs are willing to accept lower acquisition premia in transactions that involve an extraordinary per-

not adopt pills received an average premium of only 30 percent").

⁹⁴ See Georgeson & Company, Inc, *Poison Pill Impact Study* (Mar 31, 1988); Georgeson & Company, Inc, *Poison Pill Impact Study II* (Oct 31, 1988).

⁹⁵ See Robert Comment and G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J Fin Econ 3 (1995).

⁹⁶ See John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 Tex L Rev 271, 337 (2000); John C. Coates IV, *Empirical Evidence on Structural Takeover Defenses: Where Do We Stand?*, 54 U Miami L Rev 783, 794-96 (2000). For an acceptance of Coates' critique by well-known practitioners, see R. Franklin Ballotti and J. Travis Laster, *Professor Coates Is Right. Now Please Study Stockholder Voting*, 54 U Miami L Rev 819, 835-37 (2000).

⁹⁷ See Bebchuk, Coates, and Subramanian, 55 Stan L Rev (cited in note 8).

sonal treatment, such as special payments to the CEO at the time of the acquisition or high-ranking managerial posts in the buyer.⁹⁸

Finally, before turning to arguments for board veto based on ex ante effects, it is worth noting that, in the staggered board study discussed earlier, we tried to estimate the overall effect of board veto on the expected returns to target shareholders following the making of a bid. As noted earlier, we found that effective staggered boards produced substantial costs by increasing the likelihood of remaining independent and produced small and statistically insignificant benefits in terms of premia. Putting the various effects together, we estimated that, during the 1996–2000 period of our study, effective staggered boards reduced the expected returns of target shareholders by 8–10 percent.⁹⁹

5. *Dangers of short-term focus.*

Thus far, I have concluded that, given that there is a bid on the table, shareholders' interests would not be well served by a board veto power. But this does not end our inquiry. It remains to explore whether board veto power would be beneficial by virtue of its ex ante effects on managers' incentives and behavior.

Supporters of board control and takeover defenses have suggested that the threat of hostile takeovers forces managers to focus on short-term results and thereby discourages investments, such as research and development, that would bear fruit only in the longer run.¹⁰⁰ Indeed, during the corporate governance debates of the 1980s, supporters of board veto argued that the short-term bias produced by takeovers was one of the reasons for why the United States economy was performing less well than Germany and Japan, where corporate managers were largely insulated from unsolicited offers.¹⁰¹ This particular concern about the consequences of takeovers is presumably no longer with us, but the basic claim underlying it should be taken seriously.

At the level of theory, there is no question that when managers' inside information is not fully observable to public investors, concern about short-

⁹⁸ See Hartzell, Ofek, and Yermack, NYU Working Paper at 21–22 (cited in note 43); Wulf, U Pa Working Paper at 28 (cited in note 4).

⁹⁹ See Bebchuk, Coates, and Subramanian, 55 *Stan L Rev* (cited in note 8). Lipton, 69 *U Chi L Rev* at XX (cited in note 30) argues that the recent takeover of Willamete demonstrates that staggered boards provide big bargaining advantage.

¹⁰⁰ See Lipton and Rosenblum, 58 *U Chi L Rev* at 205–14 (cited in note 9); Lipton, 35 *Bus Law* at 115–16 (cited in note 2).

¹⁰¹ See Lipton and Rosenblum, 58 *U Chi L Rev* at 218–22 (cited in note 10).

term results might distort managers' decisions. It is worth noting, however, that the direction of the distortion is ambiguous and depends on the type of information that is unobservable to investors. Jeremy Stein developed models in which the level of investment in long-term projects is unobservable, an assumption that seems especially fitting to investments of time and effort by management.¹⁰² In these models, should a takeover bid occur, shareholders deciding on it would not be able to observe the level of investments in long-term projects. As a result, the threat of an unsolicited bid discourages investment in such projects.

Another model, developed by Lars Stole and myself, analyzes the case in which the level of investment in long-term projects is observable but its quality or expected profitability is not.¹⁰³ This assumption might well fit most of the cases of capital investments in long-term projects made by firms. Under this assumption, the threat of unsolicited offers leads to *excessive* investment in long-term projects. Should a control contest arise, shareholders will be able to observe such investments. Furthermore, a higher level of investment will signal managers' confidence in the profitability of this investment, and this signaling effect leads to excessive investment.

In any event, whichever direction distortions are expected to take in any given set of circumstances, the prospect of a takeover bid undoubtedly can, in theory, distort the level of long-term investments. For designing legal policy, however, the important question is whether these distortions are of sufficient magnitude to justify the granting of board veto power. Neither the theory nor the available empirical evidence on the subject provides a basis for believing this to be the case. The evidence on this issue can be described as mixed, with ambiguous results with respect to the sign of the effect of board veto on R&D expenditures.¹⁰⁴

Furthermore, even assuming that board veto does have beneficial ex ante effects on investments in long-term projects, it must be taken into account that such veto power also has negative ex ante effects. As discussed in Part II.B, board veto has significant ex ante costs. By removing or weakening the potential disciplinary force of the takeover threat, board veto might increase

102 See Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q J Econ 655 (1989); Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J Polit Econ 61 (1988).

103 See Lucian Ayre Bebchuk and Lars A. Stole, *Do Short-Term Managerial Objectives Lead to Under- or Over-investment in Long-Term Projects?*, 48 J Fin 719 (1993).

104 See William N. Pugh, Daniel E. Page, and John S. Jahera, Jr., *Antitakeover Charter Amendments: Effects on Corporate Decisions*, 15 J Fin Rsrch 57 (1992); Mark Johnson and Ramesh P. Rao, *The Impact of Antitakeover Amendments on Corporate Financial Performance*, 32 Fin Rev 659 (1997); Lisa K. Meulbroeck, et al, *Shark Repellents and Managerial Myopia: An Empirical Test*, 98 J Polit Econ 1108 (1990).

managerial slack, empire-building, consumption of private benefits, and so forth. Furthermore, as discussed earlier, there is evidence that these ex ante costs are pervasive and potentially significant.

Thus, there is little basis for believing that the ex ante effects of board veto are positive overall, even though this possibility cannot be ruled out. More importantly, there is no basis for expecting these ex ante effects to be positive to such an extent that they outweigh the significant negative ex post effects of board veto that have been discussed earlier. Indeed, as I now turn to note, all the evidence that is available on the overall effect of veto power on shareholder value supports the conclusion that this overall effect is negative.

To begin, Gompers, Ishii, and Metrick found a significant association between companies with a higher antitakeover index and lower stock market valuation (as measured by Tobin's Q).¹⁰⁵ According to their study, throughout the 1990s, companies with a higher index had a lower Tobin's Q, with the effect becoming more pronounced as the decade proceeded.¹⁰⁶

Furthermore, there is evidence that the passage of the strongest antitakeover statutes—the ones most capable of significantly enhancing managers' veto power over unsolicited offers—was accompanied by a significant decline in the share value of the companies incorporated in these states. Massachusetts companies significantly declined in value when Massachusetts adopted a statute making staggered boards the default arrangement under state law.¹⁰⁷ Companies incorporated in Pennsylvania or Ohio significantly declined in value when these states passed statutes preventing hostile bidders from making any “short-term” profits.¹⁰⁸ In general, the overwhelming

¹⁰⁵ See Gompers, Ishii, and Metrick *Corporate Governance and Equity Prices* at 34 (cited in note 46).

¹⁰⁶ This evidence is consistent with early evidence found by Morck, Shleifer, and Vishny on the association of managerial entrenchment with lower Tobin's Q. See Randall Morck, Andrei Shleifer, and Robert W. Vishny, *Alternative Mechanisms for Corporate Control*, 79 *Am Econ Rev* 842 (1989).

¹⁰⁷ See Robert Daines, *Do Staggered Boards Affect Firm Value? Massachusetts and the Market for Corporate Control*, working paper (2002) (on file with author); L. Mick Swartz, *The Massachusetts Classified Board Law*, 22 *J Econ & Fin* 29 (1998).

¹⁰⁸ For studies documenting the negative impact of the passage of the Pennsylvania statute, see L. Mick Swartz, *The 1990 Pennsylvania Anti-Takeover Laws: Should Firms Opt Out of Anti-takeover Legislation*, 11 *J Acct, Audit, & Fin* 223 (1996); Jonathan M. Karpoff and Paul H. Malatesta, *State Takeover Legislation and Share Values: The Wealth Effects of Pennsylvania's Act 36*, 1 *J Corp Fin* 367, 368 (1995); Samuel H. Szewczyk and George P. Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310*, 31 *J Fin Econ* 3 (1992). For a study documenting the negative impact of the passage of the Ohio statute, see Michael Ryngaert and Jeffrey Netter, *Shareholder Wealth Effects of the 1986 Ohio Antitakeover Law Revisited: Its Real Effects*, 4 *J L, Econ, &*

majority of event studies on the adoption of state antitakeover statutes found either no price reactions or negative price reactions.¹⁰⁹

6. *Executive compensation to the rescue.*

The preceding discussion in this Part has paid much attention to the potential divergence of interest between managers and shareholders in the face of a takeover. It can be argued, however, that the agency problems produced by a board veto regime could be addressed by an appropriate design of executive compensation schemes. If such schemes were designed to reward managers sufficiently in the event of an acquisition, so the argument goes, they would neutralize managers' private interests in preventing a takeover. Indeed, in a recent insightful paper, Marcel Kahan and Edward Rock suggest that executive compensation schemes have already sufficiently developed in this way to produce a healthy and well-functioning acquisitions market.¹¹⁰ On their view, even though board veto power (which they do not endorse) might be undesirable by itself, the compensation schemes that market participants have adopted provide a countervailing force, neutralizing any adverse effects that the presence of veto power would have otherwise, and secure a good equilibrium.

I agree that, given the introduction of veto power, appropriate executive compensation schemes can improve matters. But even though such schemes can ameliorate the negative effects of board veto power, there is reason to doubt that they have eliminated these effects or, indeed, that they could have done so.

Let us start with the ex post problem of ensuring that given that a bid is on the table, managers use whatever veto power they have in the interest of shareholders. It is quite difficult, if not impossible, to design executive compensation schemes so that managers' and shareholders' interests would overlap and that managers could be relied on to exercise their veto power in shareholders' interests.

Org 373, 383–83 (1988).

¹⁰⁹ See, for example, Jonathan M. Karpoff and Paul H. Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J Fin Econ 291 (1989) (reporting that forty second-generation statutes adopted in twenty-six states had, on average, a -.294 percent impact on stock prices). For surveys of these many studies, see Roberta Romano, *The Genius of American Corporate Law* 60–75 (AEI 1993); Gartman, *State Anti-takeover Laws* § XX (cited in note 7).

¹¹⁰ See Kahan and Rock, 69 U Chi L Rev at XX (cited in note 3). For an early work on the potential benefits of golden parachutes and other acquisition-related benefits in addressing potential managerial opportunism, see Charles R. Knoebler, *Golden Parachutes, Shark Repellents and Hostile Tender Offers*, 76 Am Econ Rev 155 (1986).

Consider managers confronted with a takeover bid, and suppose that, at this time, the private costs to the managers of losing their control is C . Suppose also that according to the managers' compensation arrangements, the loss of control would provide a monetary benefit of G to the managers. Clearly, as long as G is lower than C , managers' private interests would favor maintaining independence, and we would face the danger of managers' using their veto power to block beneficial acquisitions.

This conclusion, however, does not imply that optimal incentives could be secured by ensuring that G is sufficiently high in all cases. If G is pushed to a level higher than C , managers' incentives would be distorted in favor of selling the company.¹¹¹ Could one take the view that managers' incentives to sell can never be excessive? Certainly not in an inquiry exploring whether a board veto could be justified. Such an inquiry must start from the premise that not all premium acquisitions would be beneficial to shareholders; otherwise, there clearly would be no point to having a board veto.

Thus, for a compensation scheme to induce optimal decisions by managers facing an offer, the scheme must produce in each and every case that emerges a monetary acquisition benefit G that would exactly equal C . That seems exceedingly difficult to do. To begin, even if G were to be determined on an ad hoc basis ex post, given the circumstances in place, difficulties would arise from the fact that C is hardly observable. Furthermore, ex ante, when compensation schemes are set, and when the particular circumstances that would arise in the future are still uncertain, setting the scheme in a way that the produced G would always equal whatever value C would take under the circumstances appears impossible.¹¹²

Indeed, the evidence that has been discussed above indicates that compensation schemes have not solved thus far the agency problems arising from managers' veto power. Consider, for example, the findings of the study by Coates, Subramanian, and myself that, during the period 1996–2000, managers facing hostile bids and armed with ESBs used them to reduce the

¹¹¹ The possibility that compensation arrangements that reward acquisitions might lead to distorted managerial choice in favor of acquisitions is also noted by Ehud Kamar, *Managerial Change-in-Control Benefits and Takeovers* at 1–3, working paper (2002) (on file with author).

¹¹² The analysis above indicates that even if boards were setting compensation schemes at arm's length with sole concern for maximizing shareholder value, boards would be unable to design schemes that would fully align the interests of managers and shareholders in the face of a takeover bid. It is worth noting, however, that there are reasons to question whether compensation schemes are generally set to maximize shareholder value. See generally Lucian Arye Bebchuk, Jesse M. Fried, and David I. Walker, *Power and Rent Extraction in the Design of Executive Compensation*, 69 *U Chi L Rev* XX (2002).

likelihood of an acquisition without producing significant countervailing benefits in terms of higher premia. These findings are inconsistent with the view that executive compensation schemes have eliminated managers' preference for remaining independent. This also applies to the findings in the studies by Wulf and by Hartzell, Ofek, and Yermack that managers bargaining in the past decade were willing to accept lower premia when the transaction was accompanied by favorable personal treatment.¹¹³ Again, these findings are inconsistent with the view that executive compensation schemes have produced an alignment of interests between managers and shareholders in the context of takeovers.¹¹⁴

Turning from *ex post* to *ex ante*, compensation schemes cannot in any way eliminate the potential adverse *ex ante* effects of board veto, as Kahan and Rock themselves recognize.¹¹⁵ To induce managers not to oppose a takeover *ex post*, compensation schemes would have to provide managers with monetary benefits in the event of a takeover that would eliminate or sharply reduce the adverse effect of a takeover on managers' private interests. Such compensation schemes would eliminate, however, the disciplinary effect of a takeover. With managers not expecting to be hurt in the event of a takeover, the prospect of a takeover would no longer provide managers with *ex ante* incentives to avoid poor performance that would raise the likelihood of a takeover.

In sum, although compensation arrangements can improve matters, taking *as given* the presence of board veto, such arrangements cannot neutralize its adverse effects. Kahan and Rock might be correct in suggesting that such arrangements might present the best outcome that shareholders could have obtained in the past decade given the difficulty of changing takeover arrangements. Our interest here, however, is in identifying the best set of takeover law arrangements. The possibility of using compensation schemes to neutralize some of the adverse effects of a board veto can make such a re-

113 See note 97 and accompanying text.

114 Kahan and Rock point to the large volume of acquisitions as evidence that compensation schemes have produced their hoped-for benefits. Kahan and Rock, 69 U Chi L Rev at XX (cited in note 3). Although this aggregate data indicates that such schemes might well have had some beneficial influence, it certainly does not establish that such schemes have eliminated the potential distortions arising from managers' veto power. Among other things, such aggregate data does not tell us whether all the targets that should have been acquired were acquired (and the other data discussed above suggests that they might not have been). It also does not tell us whether the targets that were acquired were bought by the right buyer, for the right price, and with the right arrangements for managerial succession.

115 See Kahan and Rock, 69 U Chi L Rev at XX (cited in note 3).

gime less detrimental, but it hardly recommends such a regime as the one that would best serve the interests of shareholders.

7. *Inference from IPO Charters*

Having concluded that a direct examination of the merits of board veto does not provide a good basis for supporting it, I turn to consider whether its desirability can be inferred from the choices that firms going public have been making. Recent empirical evidence, which has attracted much attention, indicates that firms going public during the past decade have not designed their charters to eliminate board veto.¹¹⁶ To start with, no firm is known to have adopted a charter provision that eliminates or curtails the power of the board to maintain a poison pill. Secondly, the majority of firms going public adopted charters provisions, such as ones that establish staggered boards or prevent shareholders from calling a special meeting or acting by written consent, that make it difficult for shareholders to replace the board quickly. Researchers examining this pattern have raised the possibility that the adoption of such provisions resulted from imperfections in the IPO process.¹¹⁷ Researchers have also raised the possibility, however, that this adoption was due to—and thus was evidence of—the positive effects of board veto on shareholder value.¹¹⁸

According to a widely held view, firms at the IPO stage have powerful incentives to adopt arrangements that serve shareholders; and the adoption of arrangements at this stage provides, therefore, evidence of their optimality. Whether, when, and to what extent this proposition is valid is a large question that I discuss elsewhere¹¹⁹ and that does not need to be resolved for

116 Robert Daines and Michael Klausner, *Do IPO Charters Maximize Firm Value?: Antitakeover Protections in IPOs*, 17 J L, Econ, & Org 83 (2001); John Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 Cal L Rev 1301 (2001); Laura Casares Field and Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, J Fin (forthcoming Oct 2002), available online at <http://www.afajof.org/Pdf/October_02/FieldKarpoff.pdf>.

117 See, for example, Daines and Klausner, 17 J L, Econ, & Org at 86 (cited in note 116); Stephen J. Choi and Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 Va L Rev 961, 985–86 (2001).

118 See Stephen J. Choi and Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 Va L Rev at 985–86 (cited in note 117); Daines and Klausner, 17 J L, Econ, & Org at 84–85 (cited in note 116); John Eloffson, *What If They Gave a Shareholder Revolution and Nobody Came?: Poison Pills, Binding Shareholder Resolutions and the Coase Theorem* at XX, working paper (2002) (on file with author); Jonathan R. Macey, *Takeover Law and Regulatory Competition: A Reply to Bebchuk and Ferrell*, VOLUME Bus Law (forthcoming 2002).

119 I discuss how inefficient IPO provisions might result from inaccurate pricing in

our purposes. For these purposes, it is sufficient to observe that, even assuming this proposition to be valid in general, the evidence with respect to charter provisions facilitating board veto is sufficiently mixed and conflicted to make the inference under consideration unwarranted.

To start with, throughout the past decade, shareholders of existing companies have been generally unwilling to vote in favor of amending the charter to include provisions making replacement of the board more difficult. Once firms realized that shareholders are unwilling to vote for such charter amendments, boards all but stopped proposing such amendments. From 1988 to 1998, the annual number of such proposals dropped by 90 percent.¹²⁰ Furthermore, shareholders' opposition to such arrangements has also been reflected in the large and growing support given to precatory resolutions to dismantle existing staggered boards.¹²¹ All this is clearly the opposite of what is predicted by the view that investors favor charter provisions that facilitate board veto.

Secondly, while no firm is known to have adopted in the '90s a charter provision that takes from boards the power to maintain pills indefinitely – a power given to boards by developments in case law and state statutes in the late '80s and early '90s – firms also did not generally adopt charter provisions that provided boards with such power prior to these developments.¹²² During the '80s, it often appeared uncertain, if not in some cases unlikely, that boards would ultimately be given broad permission to maintain pills. Nonetheless, although boards were actively seeking to enhance takeover protections, pill-authorizing (or functionally equivalent) charter provisions generally were not adopted.

Consider Delaware firms. Between the invention of the pill in 1982 and the *Moran* decision in 1985, there was uncertainty as to whether the Delaware

Lucian Arye Bebchuk, *Freedom of Contract and the Corporation: An Essay on the Mandatory Role of Corporate Law*, Harvard Law School Program in Law and Economics Discussion Paper No 46, (1988) (on file with author); and Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 Colum L Rev 1395, 1406 (1989). I discuss how problems of adverse selection and signaling might lead to inefficient IPO provisions, including ones providing excessive protection from takeovers, in Lucian Arye Bebchuk, *Asymmetric Information and Corporate Governance*, working paper (Apr 2002) (on file with author).

¹²⁰ See VOLUME Institutional Rsrch Center Corp Gov Bull PAGE (1998).

¹²¹ The average shareholder vote in favor of such proposals was 52.7 percent in 2000. See Michael Klausner, *Institutional Shareholders' Split Personality on Corporate Governance: Active in Proxies, Passive in IPOs*, Stanford Law and Economics Olin Working Paper No 225 at 3 (2001), available online at <<http://papers.ssrn.com/abstract=292083>> (visited on April 17, 2002).

¹²² See, for example, Elofson, *What If We Gave a Shareholder Revolution and Nobody Came?* at XX (cited in note 118).

courts would permit the use of pills at all. *Moran* permitted the use of pills but left quite open the possibility that boards would be required to redeem pills in various circumstances, and *Interco* made the possibility of court-ordered redemption of pills a real one. It was only with the *Time* decision in 1990 that boards could have gained confidence that they would be given a broad and open-ended power to maintain pills. Still, prior to 1990, Delaware firms had not been adopting, either when going public or through charter amendments, pill-authorizing (or functionally equivalent) charter provisions.

A similar point can be raised with respect to firms incorporated in states other than Delaware. In most states, the validity of pills was in doubt until the passage of pill endorsement statutes in the late '80s.¹²³ Still, prior to the adoption of these statutes, firms incorporated in those states generally did not adopt, either when going public or through a charter amendment, pill-authorizing (or functionally equivalent) charter provisions.

The absence in the '80s of proposals for amending charters of existing firms to include such charter provisions was presumably due to the expectation that shareholders generally would not vote for such proposals. For this reason, boards and their advisers placed their hopes on the validation by courts or legislators of pills that managers unilaterally adopted. Managers lobbied state legislatures to adopt pill endorsement statutes instead of lobbying shareholders to approve functionally equivalent charter amendments, presumably because managers did not expect shareholders would approve such measures.

Could supporters of board veto dismiss the above patterns by saying that shareholders' unwillingness to vote for certain charter provisions reflects their preferences less well than their willingness to purchase shares at IPOs of firms with such charter provisions? Even if IPO choices were assumed to provide better evidence, there would still be the need to explain why firms going public between 1982 and 1990 did not include pill-authorizing (or functionally equivalent) charter provisions in their IPO charters. Thus, even if we were to put aside evidence based on voting decisions and focus solely on IPO choices, the evidence on how board veto is viewed by investors would be rather mixed.

It follows that it is not at all possible to infer from IPO choices that board veto is generally the arrangement favored by shareholders. Not being able to infer the optimal arrangement from such evidence, we should seek to identify it through direct examination. And the examination conducted in this Part has shown that shareholders' interests likely would be best served by a regime of shareholder voting and no board veto.

¹²³ See Gartman, *State Antitakeover Laws* § XX (cited in note 7).

D. *The Perspective of Long-Term Shareholders*

Because supporters of board veto have stressed the interests of long term investors, those that choose to invest in the target for the long haul, it is worth considering whether a case for such veto can be made from the perspective of such investors. To examine this question, we should first note that most of the preceding discussion in this Part is equally applicable when we focus solely on the interests of long-term shareholders.

There is one factor, however, that could be evaluated differently from the perspectives of long-term and short-term investors and thus needs to be considered here. Recall the argument that directors may use their power to block offers when they, but not investors, recognize the target's fundamental value to exceed the bid price. In such cases, it might be argued, defeat of the offer might have a negative effect on shareholder wealth in the short-run but would deliver value in the long-run as the market would ultimately recognize the target's true value. Therefore, in such cases, the board's power to block offers would benefit those shareholders that would stay with the company long enough but not short-term shareholders that would sell before the defeat of the offer would deliver value.

Thus, if it were the case that shareholders of targets whose directors defeat bids and remain independent benefit in the long-run from such resistance, this pattern would have provided support for a board veto from the perspective of long-term shareholders. As discussed in Part II.C.3, however, the evidence indicates that, when directors defeat bids and remain independent, target shareholders on average lose not only in the short-run but also in the long-run. Accordingly, the perspective of long-term shareholders cannot provide a basis for a board veto regime.

E. *The Perspective of Aggregate Shareholder Wealth*

I now turn to examine the perspective of aggregate shareholder wealth. From this perspective, it is necessary to take into account the effects of board veto not only on targets' shareholders but also on bidders' shareholders. Does this "broadening" of perspective strengthen the case for a board veto? As explained below, the answer is no. To the contrary, if anything, such inclusion of the interests of bidders' shareholders would only make a board veto regime relatively *less* attractive.

Examining the set of cases in which bidders make offers, board veto primarily affects two groups of cases: (i) cases in which the target is acquired but the presence of board veto affects the premium for which it is acquired; and (ii) cases in which the target is not acquired due to the presence of board veto but would have been acquired in the absence of such veto. Let us exam-

ine in turn how the evaluation of each of these two effects will be influenced by taking into account also bidders' interests.

Consider the first group of cases, where a board veto does not prevent a takeover but only influences the acquisition premium. Supporters of such veto argue that it operates to increase the premia captured by target shareholders in these cases. This potential benefit was taken into account in Part II.C's discussion of the target shareholders' perspective. From the perspective of overall shareholder wealth, however, extracting a higher premium from the bidder is by itself merely a transfer. Thus, a switch to the perspective of aggregate shareholder wealth removes from consideration, rather than enhances, this potential benefit of board veto. To be sure, as I explained earlier, there are reasons to doubt whether, compared with a regime of shareholder voting and no board veto, a board veto regime enjoys a significant bargaining advantage. Clearly, however, excluding potential bargaining benefits, as is required by a switch to the perspective of aggregate shareholder wealth, cannot be expected to help the case for board veto.

Similarly, considering the second group of cases in which the effect of board veto is to preventing an acquisition, this effect of board veto hardly benefits bidders. Rather, this effect denies bidders an acquisition they were seeking. Again, incorporating the interests of bidders into the objective to be maximized does not help the case for board veto.¹²⁴

Indeed, the above analysis is consistent with a line of work that suggests that, in the context of corporate control contests, the arrangement that would be optimal for shareholders is one that restricts takeovers and proxy contest victories by outsiders more than what would be optimal once the interests of control seekers are taken into account.¹²⁵ Thus, once we conclude that a

¹²⁴ Could it be argued that preventing acquisitions sought by bidders would be in fact in the interests of bidders' shareholders because of the evidence that bidders' shareholders do not benefit much if at all from acquisitions? Even if one takes such a negative view on acquisitions in general, it hardly follows that it would be desirable to give targets' boards veto power in order to save bidders' shareholders from their empire-building managers. Such board veto, of course, would not help bidders' shareholders in the more numerous cases in which targets' boards agree to be acquired. One concerned about possible empire-building by acquirers' managers should focus on other ways for addressing this problem.

¹²⁵ See Lucian Arye Bebchuk and Luigi Zingales, *Ownership Structures and the Decision to Go Public: Private Versus Social Optimality*, in Randall K. Morck, ed, *Concentrated Corporate Ownership* 55 (Chicago 2000); Lucian Arye Bebchuk and Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 Cal L Rev 1071, 1129-34 (1990); Sanford Grossman and Oliver Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 Bell J Econ 42, 54-57 (1980). For this reason, the perspective of aggregate shareholder wealth is one that can be expected to be used by those seeking to reduce restrictions on takeovers. Thus, it is not surprising to find it invoked by

board veto regime is not desirable from the perspective of target shareholders, it is not surprising that taking bidders' interests into account cannot provide a basis for supporting such a regime.

F. *The Perspective of Stakeholders*

Supporters of board veto also argue that it enables managers to prevent acquisitions that would impose harms on stakeholders—nonshareholder constituencies such as employees, suppliers, or debtholders.¹²⁶ Indeed, a majority of the states enacted statutes allowing managers responding to a takeover bid to take into account the interests of stakeholders.¹²⁷ More generally, claims about stakeholder interests have been much used by supporters of board veto in their fight for takeover defenses in the political arena, in the courts, and in the court of public opinion.

Acquisitions, whether hostile or friendly, might sometimes adversely affect the interests of stakeholders. Employees might be laid off, creditors' debt might become riskier, suppliers might lose a valuable business partner, communities might lose a corporate headquarters or corporate operations, and so forth. It is desirable, so the argument goes, to have in place some mechanism that would ensure that stakeholders' interests be taken into account in deciding whether to have a takeover and that these interests would be protected if a takeover does take place. On this view, having such a mechanism in place would not only benefit stakeholders but also would be *ex ante* in the interest of shareholders; specifically, it would encourage *ex ante* investments and participation on the part of stakeholders.¹²⁸

Critics of this view have argued that, although takeovers could in theory impose substantial harm on stakeholders, the evidence indicates that such

Easterbrook and Fischel, 94 Harv L Rev at 1161 (cited in note 1), who used it in arguing for their rule of passivity using this perspective. Criticizing at the time Easterbrook and Fischel's view that higher premia should not count as a benefit, Lipton characterized this argument as one that "courts—and target shareholders—would find . . . both peculiar and unpersuasive." Lipton, 55 NYU L Rev at 1235 (cited in note ??).

¹²⁶ See, for example, Blair and Stout, 85 Va L Rev at 253 (cited in note 29); Lipton, 35 Bus Law at 130–31 (cited in note ??).

¹²⁷ See Gartman, *State Antitakeover Laws* §§ A-6 to A-7 (cited in note 7). The committee drafting the Revised Model Business Corporation Act, however, decided that directing directors to consider the interests of nonshareholder constituencies is undesirable.

¹²⁸ See Blair and Stout, 85 U Va L Rev at 304–05 (cited in note 29); Andrei Shleifer and Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in Alan J. Auerbach, ed, *Corporate Takeovers: Causes and Consequences* 33 (Chicago 1988); John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders, and Bust-Ups*, 1988 Wisc L Rev 435; John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 Mich L Rev 1 (1986).

losses are not very common and, furthermore, are small in magnitude relative to shareholders' gains when they do occur.¹²⁹ More importantly, critics have argued that the law generally should not provide protection to stakeholders beyond what is called for by their contracts with the corporation. On this view of the critics, protection of stakeholder interests should be left to the contracts between them and the corporation or to nonlegal sanctions.¹³⁰ Given this line of response, it is unsurprising that some observers view the board veto question as one of shareholders versus stakeholders.¹³¹

Below I will assume for the purpose of discussion that (i) takeovers often impose significant externalities on stakeholders (possibly employees in particular), and (ii) it is desirable to have some mechanism in place that protects stakeholders in the case of acquisitions. As I explain below, even under these assumptions, the case for board veto hardly follows. That is, fully accepting for the purpose of our discussion the importance and desirability of protecting stakeholders in acquisitions, I will show that a board veto is a rather poor and unfitting way to go about it, and that this objective thus cannot provide a basis for a board veto regime.

1. *Expanding board discretion to benefit stakeholders.*

To begin, it is worth observing that there is no assurance that, if directors are given veto power, they would exercise it to protect stakeholders. In theory, one could consider permitting boards to block offers that shareholders would like to accept only if such blocking would protect stakeholders to such an extent that the overall welfare of all corporate constituencies would be maximized. Courts, however, would be unable to enforce compliance with such a principle.

Indeed, courts are reluctant to review the merits of board decisions—even to determine whether they serve the much narrower and well-defined interest of shareholders. For this reason, those opposed to board veto are not seeking to limit it by having courts review board decisions, but rather to replace it with shareholders' making the key decision. Clearly, if directors were instructed to maximize the joint welfare of all corporate constituencies, courts would be unable or at least unwilling to enforce compliance with such a principle. As Oliver Hart observed, a prescription to management to take

¹²⁹ For a review of the evidence, see Ronald Daniels, *Stakeholders and Takeovers: Can Contractarianism be Compassionate?*, 43 U Toronto L J 297, 317–25 (1993); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J Reg 119, 133–43 (1992).

¹³⁰ An excellent discussion of the problems can be found in Daniels, 43 U Toronto L J at 340–349 (cited in note 128).

¹³¹ See Allen, Jacobs, and Strine, 69 U Chi L Rev at XX (cited in note 3).

the interests of all constituencies into account “is essentially vacuous, because it allows management to justify almost any action on the grounds that it benefits some group.”¹³²

Supporters of board veto indeed do not assume or imply that directors would *have* to use their power in ways that would protect stakeholders and that courts would review whether this is done. Indeed, lest there be any confusion that courts are expected to ensure directors’ taking of stakeholders’ interests into account, drafters of state constituency statutes used (in all cases but one) language that authorizes (rather than requires) directors to take into account the interests of other constituencies.¹³³

In sum, supporters of board veto wish to give boards *discretion* whether to block a takeover with the aspiration and hope that they would use their discretion to protect stakeholder interests. In examining how likely this is to happen, we should examine the extent to which the interests of those granted the discretion are likely to overlap with the interests of the stakeholders that are supposed to benefit from this discretion.¹³⁴

2. *Are boards good agents of stakeholders?*

Recall the agency problem that played an important role in analyzing board veto from shareholders’ perspective—that, in the takeover context, managers are likely to be influenced by their private interests. Even though managers’ holdings of shares and options create in general some alignment of managers’ and shareholders’ interests, the takeover context is one in which managers’ interests are likely to diverge from those of shareholders.

Do we have good reasons for expecting managers to be better agents of stakeholders than they can be expected to be of shareholders? To begin, note that, on most corporate decisions, managers’ interests are actually more likely to be aligned with those of shareholders rather than stakeholders. Whereas management usually has a significant fraction of its wealth in the form of shares and options, it does not usually have much of its wealth tied to bondholder or employee wealth. And managers’ private interests in the

¹³² Oliver Hart, *An Economist’s View of Fiduciary Duties*, 43 U Toronto L J 299, 303 (1993).

¹³³ See Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 Bus Law 2253, 2261–63 (1990).

¹³⁴ Some supporters of board veto list “managers” as a constituency whose interests should be taken into account. See Blair and Stout, 85 Va L Rev at 297 (cited in note 29). One can safely assume that the expanded discretion under consideration would ensure that the interests of this particular constituency be taken into account. But such an assumption cannot be made with respect to other constituencies.

takeover context cannot be counted to produce a good alignment of their interests with those of stakeholders.

To be sure, some correlation between managers' and stakeholders' preferences might arise because some acquisitions might be a threat to managers (who might lose their private benefits of control) and also to employees (who might lose their jobs) or creditors (who might be harmed by an increase in leverage). But this correlation of interests is likely to be rather limited; managers' and stakeholders' interests are likely to overlap occasionally but not in general.

There might well be acquisitions that would be beneficial to stakeholders—say, when an acquisition by a large and rich buyer would improve opportunities for employees—but that management might well disfavor for self-serving reasons. Conversely, there might well be acquisitions that would disadvantage stakeholders but that management, at least if it is offered a sufficiently good deal for itself, would favor. Finally, in cases in which the acquisition is likely to occur ultimately, it is doubtful that management would use whatever veto power it has to bargain for better terms for stakeholders rather than, say, for itself or even for shareholders.¹³⁵ In sum, given the lim-

¹³⁵ Blair and Stout, who support in general giving boards discretion in order to protect corporate stakeholders, recognize the risk that directors will not use their discretion for the intended purpose: “[T]o say that directors are *free* . . . is not the same thing as saying they *will*. If directors are despots, why should they be benevolent?” Blair and Stout, 85 Va L Rev at 315 (cited in note 29). These authors go on to suggest three aspects of law and culture that are likely to encourage directors to do the right thing. First, Blair and Stout say, directors have an interest in doing their job well if they enjoy and want to keep their job. *Id.* Although this argument might be valid outside the takeover context, it is inapplicable to the takeover context, where directors’ desire to keep their jobs is a major basis for concern that they might not use their discretion appropriately. Second, Blair and Stout say, corporate law encourages directors to serve shareholders and stakeholders well by limiting severely their ability to serve their own interests. *Id.* at 315–16. Again, this argument is not applicable to the takeover context in which the directors’ interests are by definition strongly implicated.

The third factor listed by Blair and Stout is that of corporate cultural norms of fairness and trust, reinforced by reputational sanctions and the selection to boards of trustworthy individuals. *Id.* at 316. I doubt that this factor is a sufficiently strong force to ensure desirable use of discretion in the takeover context. Apparently, the norm that directors should not impose great financial losses on their shareholders was not sufficient to prevent Time’s directors from defeating Paramount’s bid and thereby imposing great loss on their shareholders. It is far from clear that cultural norms can induce management to ignore its self-interest in a context in which managers’ private interests are very much at stake and in which acting in self-interest can always be defended as aimed at protecting shareholders or some other constituency. Indeed, cognitive dissonance might lead managers that would benefit from remaining independent to develop a genuine (even if mistaken) belief that their stakeholders would be well served by such inde-

ited overlap between managers' and stakeholders' interests, there is no basis to expect that board veto would translate into an effective protection of stakeholders.

3. *bThe tenuous link between stakeholder protection and board veto.*

Protection of stakeholders is not an end that the board veto regime can serve well. If one is genuinely concerned about protecting stakeholders from being harmed by corporate acquisitions, then one presumably should seek a mechanism that (i) would apply to all or most of the transactions that might have the undesired effects, and (ii) would reasonably target and address these effects. A board veto is not such a mechanism, on both counts.

First, a concern about the effect of acquisitions on stakeholders should clearly not limit itself to, or even focus on, hostile takeovers. Such takeovers, which constitute a rather limited fraction of all relevant corporate transactions, are not especially or disproportionately ones that can be expected to harm stakeholders. Layoffs, for example, might result not only from hostile acquisitions but also from negotiated acquisitions of a company or of a division, or from a change of course following a proxy contest victory by challengers, or from decisions by incumbents to shut down plants.¹³⁶ Whereas hostile takeovers are important for an analysis focusing on how power is allocated between managers and shareholders, and on managers' incentives to serve shareholders, arrangements designed to protect stakeholders in corporate transactions have no reason to focus on hostile takeovers.

Furthermore, focusing on those cases in which the board veto arrangement does affect outcomes, its effects on outcomes would have little overlap with those desirable for stakeholders. If we seek to protect stakeholders, why do so by giving discretionary power to agents that have their own, very different interests and somehow hope for the best? One truly concerned with stakeholder interests should seek remedies that are tied more systematically to the problems to be addressed. For example, one concerned about harms to employees from acquisition-related layoffs might consider rules that would give such employees various procedural and substantive rights in the event of such layoffs,¹³⁷ or that would provide employees or their representatives

pendence.

¹³⁶ Or from internal decisions to restructure. See, for example, Harry DeAngelo and Linda DeAngelo, *Union Negotiations and Corporate Policy: A Study of Labor Concessions in the Domestic Steel Industry of the 1980's*, 30 J Fin Econ 3, 10-15 (1991) (providing a detailed account of the huge cost to employees caused by steel companies' decisions during the 1980's to reduce capacity).

¹³⁷ See Ronald Daniels, *Mergers and Acquisitions and the Public Interest: Don't Shoot the Messenger*, in Leonard Waverman, ed, *Corporate Globalization through Mergers and Ac-*

some say in corporate decision-making in general or in plant closings or layoffs in particular,¹³⁸ or greater judicial willingness to supplement formal contracts with implied and good faith terms.

Examining whether a mechanism for extra protection of stakeholders is necessary and, if so, which of the above or other approaches would be best, is clearly beyond the scope of this paper on board veto in corporate takeovers. For our purposes, however, it is important to recognize that, if one were concerned with protecting employees rather than finding reasons for board veto, then it would be far better to address this concern not by board veto but rather by some approach tailored to it and applicable whenever it arises. Any such approach would likely yield more benefits to employees, with less harm to the legitimate interests of target shareholders, than granting boards veto power in the hope that they would use it to protect employees.

In sum, the connection between board veto and the goal of protecting stakeholder interests is rather tenuous. And, indeed, the push for constituency statutes seems to have come from those seeking not to protect stakeholders but rather to enhance management power. Although acquisitions with their effects on stakeholders have been part of the corporate landscape for a long time, such statutes came into being only after the rise of hostile bids created a threat to management power. Furthermore, the majority of state constituency statutes were adopted as part of a larger wave of antitakeover statutes aimed at impeding hostile acquisitions.¹³⁹ In any event, whatever motivated the adoption of constituency statutes and board veto arrangements, they cannot be reasonably justified as a mechanism for protecting stakeholders.

4. *Protecting stakeholders or protecting managers?*

I have discussed in detail the arguments based on stakeholder interests because of their importance in the debates on takeovers and in the politics of takeovers. Once the interests of nonshareholder constituencies are intro-

quisitions XX (Calgary 1991) (discussing policies to address such issues, including plant closure legislation, mandatory successorship rights, and mandatory bargaining); Joseph William Singer, *The Reliance Interest in Property*, 40 Stan L Rev 611, 740-43 (1988) (discussing rules governing severance payments, advanced notice, and rights of first refusal in connection with plant closings).

¹³⁸ See generally Lawrence Mitchell, ed, *Progressive Corporate Law* (Westview 1995).

¹³⁹ An examination of the data on state antitakeover statutes indicates that, out of the thirty-one states that have a constituencies statute, all but four also have another type of second-generation antitakeover statute. See Gartman, *State Antitakeover Laws* § XX (cited in note 7).

duced, the growing opposition of institutional investors to takeover defenses no longer has the weight that it would have otherwise. Once stakeholders are brought in, such investors can be viewed as just one constituency that is not entitled to have a dominant say on a question that affects other constituencies whose interests should be protected, on the board veto view, by the board.

Thus, support for board veto can be presented as a rejection of the view that only shareholders count in favor of the view that stakeholders, especially employees, count too. Supporters of board veto would like us to accept that, if stakeholders are to count, then boards should have veto power to be able to act as the stakeholders' champion. By casting boards as the champion of stakeholders, supporters of board veto have been able to boost significantly the perceived legitimacy and appeal of their position. And they have sought to cast the debate over board veto as a debate between a narrow, shareholder-centered view of the corporation and a broad, enterprise view of the corporation.¹⁴⁰

The arguments made in this Part question this account of what is at stake in the board veto debate. Concluding that employees and other stakeholders must receive some protection beyond the one accorded by their contracts hardly leads to endorsement of board veto. Boards are unlikely to be good agents of stakeholders in takeovers, at least under the existing structure and rules for board selection and operation. Support for board veto thus should not be viewed as support for protecting employees and stakeholders but rather as support for enhancing the power of boards and managers.

The debate over board veto, then, does not confront us with a choice between shareholders and stakeholders, with managers as the champion of the latter. Rather, the choice is between shareholders and managers, with stakeholders as bystanders. This is what is at stake in the board veto debate.

G. Implementation within Existing Case Law

I now turn to consider briefly implications of the analysis for takeover case law. As I said, there are different institutional arrangements that can produce a regime of shareholder voting and no veto power, and in other works I do some exploring of the possible alternatives and the best design, starting from a clean slate, of such a regime.¹⁴¹ Here, however, I focus on ex-

¹⁴⁰ Compare Allen, Jacobs, and Strine, 69 U Chi L Rev at [pincite](cited in note 3). In reflecting on the debate over board veto, they view it as partly involving choice between a shareholder-centered view of the corporation and a broader, "entity" perspective that incorporates the interests of stakeholders.

¹⁴¹ See generally, Bebchuk and Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* (cited in note 6); Lucian A. Bebchuk, *The Allocation of Power between*

aming how the analysis could inform the future development of takeover law taking *as given* the existing structure of takeover doctrine.

Delaware law on takeover defenses, which the law of many other states follows, has established principles that allow boards to adopt and maintain poison pill plans. This law, however, also includes principles prescribing a proportionate use of defensive measures and attaching a great importance to the shareholder franchise and to providing a safety valve against potential abuse of poison pills. The considerations identified by my analysis can usefully inform and guide the implementation and development of these principles. In particular, the analysis leads me to propose that, at least in the absence of explicit charter provisions to the contrary, courts should be guided by the following principles in reviewing takeover defenses:

(1) *Maintaining Pills to Protect Voting*: Subject to the conditions below concerning access to and consequences of shareholder voting, the board should be permitted to maintain a poison pill in the face of a takeover bid even if the bid is “structurally non-coercive.”

(2) *Access to Elections*: After a bid is made and a period reasonably sufficient for the board’s exploring and preparing alternatives for shareholder consideration passes, maintaining a pill would be consistent with fiduciary duties and thus permissible only if, within a period as short as reasonably practical, either: (a) shareholders would have or would be given an opportunity to vote to replace some or all of the directors (whether in a regularly scheduled meeting, a special meeting, or through written consents); or (b) shareholders would have (by the terms of the rights plan) or would be given by the board an opportunity to vote to have the pill redeemed.

(3) *Redemption of Pills following Electoral Defeat*: When directors of a company with a staggered board lose one election fought over an acquisition offer, they should not be permitted (absent compelling corporate justification) to continue maintaining a pill.

Furthermore, dead-hand pills, delayed-redemption pills, or any other pill terms that, in the aftermath of electoral defeat by incumbents, make it impossible, costly or difficult to redeem the pills should be prohibited.

(4) *Protecting the Shareholder Franchise*: In the face of an unsolicited takeover bid, board decisions that might frustrate or distort the outcome of shareholder votes that will affect the fate of the offer should be subject to the highest judicial scrutiny. Specifically, boards should not be permitted (absent compelling corporate justification) to adopt defensive bylaws

Managers and Shareholders (cited in note 20); Lucian Arye Bebchuk and Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 Va L Rev 111 (2001).

that either: (a) impose supermajority requirements on the adoption of shareholder bylaws; or (b) reverse shareholder bylaws.

Some of the above proposals are mild, whereas others are likely to be controversial. Some of them are quite close to existing case law, whereas others might require some limited change of course. But they are all ones that would be consistent with, and indeed advance, the goals of ensuring that defenses are proportional to the threat posed and that the shareholder franchise is well protected. They all also would move arrangements toward a regime of shareholder voting and thereby operate to enhance shareholder value and to improve corporate governance and the allocation of corporate assets.

CONCLUSION

Supporters of board veto in corporate takeovers have long argued, with much influence on legislators and courts, that boards should have substantial power to block acquisition offers. This paper has attempted to analyze the full array of arguments that supporters of board veto have marshaled in its defense. Examining all of these arguments both at the level of theory and in light of the substantial body of evidence that has accumulated over the years, I have concluded that a board veto regime is undesirable. This conclusion is reached when the subject is analyzed from either the perspective of target shareholders or from any of the other normative perspectives that have been invoked. Once mechanisms to ensure undistorted shareholder choice are in place, boards should not be permitted to block offers beyond the period necessary for exploring and putting together alternatives for shareholder consideration. All those with interest in corporate governance -- be they public officials, investors, or students of the subject -- should recognize the substantial costs and limited benefits of veto power. The case against board veto in corporate takeovers is a strong one.