PROPERTY RIGHTS IN ASSETS and RESISTANCE TO TENDER OFFERS*

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Abstract

This Article employs a bargaining model to show that resistance to tender offers--even where such resistance is unlikely to facilitate the creation of an auction market for the target firm's shares--may be beneficial to shareholders. Defensive tactics by target firm management are likened to bargaining by agents for the owners of other assets that are traded in thin markets. This paper shows that under such cirmcumstances, bargaining/resistance enables sellers to garner a greater share of the gains from exchange and thereby enhances the value of the assets being traded by providing asset owners with greater initial incentives to make value enhancing investments in the asset.

Next the Article examines the argument that even if defensive tactics enhance the value of the firms that employ them such tactics should be banned because they impose external costs on other firms by reducing the monitoring done by potential bidders. The Article applies the Buchanan and Stubblebien model of externalities to show that the mere presence of external effects does not by itself justify intervention. Potential target firms that stand to gain from increased monitoring by prospective bidders can "purchase" such increased monitoring by

making credible promises to potential bidders not to engage in resistance. The ability of target firm shareholders to forgo some increment of the control premium for their shares in exchange for enhanced monitoring by prospective bidders provides a complete answer to the claim that all defensive tactics should be banned due to third party effects. Finally, the Article concludes by observing that if individual firms are unable to make credible individual promises to refrain from resisting takeover attempts, the solution is to change the contracting rules governing these firms so as to permit them to constrain themselves if they prefer to do so.

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I. INTRODUCTION

The recent spate of highly-publicized hostile tender offers has prompted questions about the proper reaction of target-firm management to a takeover bid. Traditionally, the law has not constrained management's ability to resist acquisition. To the contrary, courts recognize not just "a large reservoir of authority" in management to respond to takeover bids, but "an obligation to determine whether the offer is in the best interests of the firm and its shareholders" and resist if it is not.[1]

Particularly since the publication of an influential article by Frank Easterbrook and Daniel Fischel,[2] however, the wisdom of allowing managerial resistance has been challenged. All else equal, resistance by any target firm reduces the bidder's net expected returns. Consequently, it is argued, potential future targets would receive greater monitoring by bidders, and so face greater likelihood of an advantageous takeover, if resistance were impermissible. In addition, it is urged, managers could not be trusted to seek a proper level of monitoring even if it were attainable, as agency problems are

apparently insurmountable when mangers' jobs are on the line. The Easterbrook-Fischel school therefore would ban managerial resistance to tender offers.

The opposition to managerial resistance is troubling. In the paradigm market, sellers (or their agents) are permitted to reject initial offers and bargain for a higher one, although sellers sometimes elect voluntarily not to exercise this ability. One can hardly bargain if one cannot reject an offer. The no-bargaining proposal for shares thus raises fundamental economic issues of considerable significance outside the corporate sphere. The questions posed can be answered only with a more general understanding of the functions of property and bargaining rights for assets traded in "thin" markets. Such an understanding is our objective.

In Section II we show that the market for corporate control has the same attributes as other markets where bargaining--resistance--is the norm. In such markets, important effects arise from allowing asset owners (including corporate shareholders) to bargain freely. Bargaining garners a greater share of the gains from exchange for sellers, and so enhances owners' initial incentives to make value-maximizing investments in an asset.

The logical structure of our argument in Section II can be summarized point by point.

(1) The ability to bargain is tantamount to the right to resist relinquishing an entitlement;

(2) the expected strength of future bargaining rights

affects the magnitude of the present investment one is prepared to make to enhance the value of an entitlement, with stronger bargaining rights implying greater willingness to invest;

(3) bargaining over an exchange of entitlements is symmetric, so that strengthening the bargaining position of one party (here, bidders) is identically a weakening of the bargaining position of the other party (targets); and hence

(4) the proposed no-resistance rule may indeed augment investment in search by prospective bidders, but it does so at a cost--it will simultaneously retard investments by prospective targets.

Ordinarily, one does not expect that owners of property rights will benefit if those rights are weakened. For a weakening of rights to benefit the owner, there must exist some market failure that cannot be overcome by voluntary contract. It is alleged that bargaining creates just such a failure in the market for corporate control. Targets' resistance to takeover bids, it is claimed, imposes external costs on other firms because they receive less monitoring from bidders.

In Section III, we examine this supposed market failure. We point out that external effects are ubiquitous, but only a subset merit legal intervention. Several additional criteria, theoretical and empirical, must first be satisfied.[3] Yet in the present debate about tender offer resistance, few of those

criteria have been recognized or investigated empirically. The necessary conditions to justify intervention to eliminate an externality are stringent. It is by no means obvious that those conditions are met where resistance to tender offers is concerned.

If our argument through Section III is accepted, then the wisdom of the Easterbrook and Fischel proposal is seen to hinge on several uninvestigated magnitudes. Of particular interest is the increased bidder search that would follow implementation of a no-resistance rule as compared to the decreased target investments. Because a priori the gain from increased search need not exceed the loss from decreased target investment, the reserved judicial response that has greeted the no-resistance proposal is in fact appropriate.

Logically, then, Sections II and III are the lynch-pins of our argument. In Section IV, we focus directly on one of the necessary conditions to justify intervening against an externality, the requirement that the costs of private internalization exceed the costs of public intervention. We point out that

(1) mechanisms exist that permit an individual target implicitly to alter its own bargaining rules, thus achieving the level of monitoring each target desires for itself;

(2) targets have an incentive to make such alterations as long as increased bidder investments add greater value than the value of target investments lost; and

(3) consequently, the cost of firms' achieving the level of monitoring each desires (i.e., of avoiding any externality from other firms' resistance) seems modest.

When these private contract costs are contrasted with the costs of a mandatory no-resistance rule, therefore, such a rule is inadvisable. Voluntary contract seems able to cope with any losses arising from the perceived externality. Admittedly, some owners may prefer a binding no-resistance policy to attract greater attention from bidders. If so, they can announce and credibly bond a promise constraining resistance, thus achieving contractually their preferred level of monitoring and bidding. Few, if any, firms do this. Consequently, as one ordinarily would expect when the law weakens property rights, asset owners would be harmed by legal compulsion to adopt a no-resistance rule.

In Section V we consider the agency cost objection to permitting resistance to tender offers. Initial entrepreneurs going public maximize their personal gains by maximizing the net present value of the firm, i.e., by considering both the costs and the benefits of various control techniques available to the public firm, including use of managerial agents. As in any realm of management decisions, an agency "problem" will seem to exist in corporate control matters if analysts focus solely on the cost side. But use of agents, even in the context of corporate control, has its benefits. The proper response to agency costs, as with any cost, is not to eradicate them: that can be done only

by eliminating the use of agents, and so the benefits as well. The appropriate response is to structure agency contracts optimally, so as to optimize the benefits net of costs. There is considerable evidence that firms facing the likelihood of agency costs, wherever they are encountered, do just that.

We conclude by noting that new law may indeed be called for here, but it is not that proposed by Easterbrook and Fischel. Instead, new law may be desirable to enhance the ability of private parites to internalize the effects of any relevant externalities in the market for corporate control. The distinction between this proposal and that of Easterbrook and Fischel is the distinction between option and compulsion.

II. BARGAINING AND PROPERTY RIGHTS IN ASSETS

Bargaining over the price of assets is a familiar prelude to exchange. In real estate, a seller could state a price as part of the contract with his selling agent that the seller would then be bound to accept. But the seller does not, preferring to list a figure normally understood to be higher than he would insist on to sell, then haggling with potential buyers over the actual transaction price. The seller of a painting does list his reservation price in the contract with his auctioneer-agent, but the auctioneer neither opens nor (ordinarily) closes bidding at that price. Bargaining with prospective customers again determines who will own the asset. Rules that countenance negotiation have evolved for art, real estate, and other assets. These rules are protected by law: a prospective buyer could not

bid a price for such assets and then demand that they be sold at that price.

In other words, owners of assets typically are protected by property rules rather than liability rules. Owners are permitted to bargain over asset prices, rather than forced to accept a price determined without interaction with the buyer.[4] Contractual rules that countenance bargaining are found in almost all markets involving non-fungible goods or services.[5] This raises a point of more general economic significance. Where markets are "thin," (i.e., where the number of potential purchasers is small and there is no pre-existing market price at which reasonable quantities of the asset can be purchased) parties to any exchange typically bargain as bilateral monopolists to establish the price. Bargaining is costly, yet it dominates other rules for exchange in thin markets. Why, then, is bargaining the rule in virtually every thin market?

A. The Role of Bargaining in a Theory of Property Rights

Thick markets are characterized by frequent transactions of nearly homogeneous units. At any moment there is a "standard price quotation" for each of the traded items in terms of the other(s), which saves transaction costs. But items transacted in thin markets are not divisible or numerous enough to ensure that everyone values them equally at the margin. Because a different value is then placed on an item by different persons, bargaining occurs whenever they attempt to trade.

It is possible to transact in thin markets without

bargaining. If bargaining costs are high relative to the costs of other procedures for exchanging entitlements, an efficient legal system will dispense with "property protection of entitlements," which endow traders with the bilateral vetos necessary for bargaining to occur. Instead, transactions will be governed by "liability protections," which enable one party unilaterally to take an entitlement. Compensation will be determined "objectively," or at least through a process not under the control of either party.[6] Ordinarily, liability remedies merely make whole the first party to lose his entitlement, meaning that all gains from trade go to the taker.[7]

By bargaining, each party tries to maximize his share of the gains from trade, net of bargaining costs. Bargaining consumes resources, and would be socially inefficient if it accomplished nothing but this short-run division of gains from any given trade. But in two distinct ways, bargaining is productive in the long run because it increases the magnitude of the gains to be partitioned. First, it assures that the traded items are worth more in other hands (i.e., that gains from trade exist). Liability rules cannot ensure the Pareto efficiency of exchanges because subjective value is poorly measurable and so may not be fully compensated.[8] Bargaining guarantees that no exchange occurs unless subjective values are recognized. This is an important function of bargaining, but it is not our focus. Rather, we focus on the second role of bargaining, that of enhancing the subjective and objective value of the items to be exchanged.

While consummating any given trade, division of the gains is a zero-sum activity, without allocative consequences. But ability to capture a greater portion of gains from trade tomorrow increases a party's incentive to augment the value of the asset today.[9] Creation (and destruction) of an asset's value is a continuous process. The size of the gains to be divided in the current period is determined by the myriad investment and other decisions made by asset owners before coming to the bargaining table. Restricting either party's ability to negotiate will decrease the returns from value-increasing efforts by that party, and so will curtail such investments by the disabled party. The ability to bargain for an exchange is tantamount to a right to try to maximize the benefits of investments one makes in the asset.[10]

B. Value Creation by Target Firms

Exchanges of one particular asset, blocks of corporate shares, illustrate the role of bargaining in thin markets. When transacting relatively small numbers of a publicly-traded corporation's shares, one deals in one of the thickest of markets. Hence, there is no bargaining, because by definition bargaining cannot alter relative prices in thick markets; there is no point to incurring bargaining costs if there are no benefits. Indeed, one rarely identifies the trading partner; every potential partner values the marginal share at the market price, so a partner's identity is irrelevant. But in the exchange of large blocks of shares, bargaining often occurs

(i.e., bargaining costs are voluntarily incurred), evidence that the block market is thinner and individual valuations differ at the margin. The market for controlling blocks is thinner still, and so costly bargaining is even more frequently observed. The market thins as the block of shares grows larger because larger blocks confer greater ability to direct the corporation's behavior, a power most investors could not properly exploit, and so do not want.[11]

Bargaining over share blocks, as with any other asset, allocates the gains from the transaction, and has consequences for the initial creation of valuable assets. A no-resistance rule would diminish the incentive that firm owners have to create initial value. There are two ways that a liability rule would diminish total wealth. First, whatever investments firm-owners make in anticipation of realizing the returns through future exchange must fall. Second, inability to resist (bargain about) a takeover would diminish certain types of specific investments whose returns hostile acquirers could expropriate.

1. Wealth Creation through Takeovers

From the beginning, the theoretical takeover literature has focused almost exclusively on the value-increasing contributions of acquirers in ferreting out inept or dishonest management.[12] Were all gains created this way, perhaps a no-resistance (i.e., liability) rule for protecting target-firm entitlements would be appropriate, because the rule would provide the maximum incentive to bidders to make value-increasing investments by giving the largest feasible portion of the gains to bidders, hence the

fewest to targets.

But if targets also make value-increasing investments, either at the time of a takeover or earlier, the desirability of mere liability protection depends on the elasticity of value creation by each side with respect to the rewards realized. A no-resistance rule would be efficient only if bidders created all the gains in takeovers and targets none. The empirical literature is resolutely agnostic about the source of gains from takeovers.[13] Given that the source of gains from takeovers varies substantially from one transaction to another,[14] a no-resistance proposal seems unjustified at best.

Even adopting a short-run perspective of the takeover process, it is clear that bidders do not create all the gains. Firms do not always sit back and wait to be taken over. Some go looking for a bidder.[15] Indeed, one good way for managers to enhance their positions is to point out the undervalued nature of their firm to bidders, who will value the ability to discern such circumstances. When the firm is undervalued because assets should be reallocated out of the firm, insiders doubtless know of that at least sometimes, and work toward a remedy. By the same token, acquirers often do not actively search for targets, but merely hold themselves out passively as willing to entertain overtures from prospective targets.[16] Targets would have little incentive to inform potential bidders of their undervalued shares if the bidders received most of the consequent gain. And finally, there now exist firms that specialize in matchmaking,

i.e., in locating and facilitating corporate pairing between two other firms.[17] Because these matchmakers do not make acquisitions themselves, they must profit by taking a portion of the gains from putting the other two firms together.

In short, while corporate acquisitions entail investments in search, it is not just bidders who invest. There is simply no reason, then, to award all the gains to bidders as a general rule. If different parties can create value in the asset being transferred, the optimal rule would create incentives for all to increase value until the marginal return to each from its efforts equaled its marginal opportunity cost.

Adopting a longer-run perspective, the importance of the target firm's own investments is even greater. The opportunity arises every day for a firm to make value-creating investments, the full returns from which often will be realized, if at all, only in the future, possibly through a takeover. Firms sometimes are in a position to create value by making initial investments that others are better able to develop, and so plan from the start to be acquired by another. For example, many computer software companies plan to be taken over if they successfully innovate even one important new software package. This expectation enables them to concentrate on technical innovation and ignore subsequent marketing, which is of no value unless and until a technical advance has been completed. Much small-time research in other fields follows a similar pattern.[18] The same process typifies much large-scale real estate development[19] as well as personal investments in real estate,

where homeowners hesitate to make improvements unless they can "get their money out" when they sell.

In other words, takeovers are not discrete events that begin at the moment the first bid materializes. All firms are "in play" from the day they are created, and the possibility of a takeover later only spurs greater efforts by innovators now. The more attractive the post-takeover asset configuration foreseen, the more effective the spur.

Forming a new company with the intention of being taken over is like planning to "go public" once the success of the company is manifest. Both techniques permit financing of untested projects by an entrepreneur adept at judging projects' potential while freeing him from post-innovation management, a duty for which an entrepreneur may be poorly qualified. That fledgling companies anticipate the likelihood of going public is clear from contracts signed when the company is formed specifying who will pay the costs of the initial public offering.

Even entrepreneurs who do not intend their firms to become targets nevertheless foresee some probability that their firm will fail to achieve its principal goals. The potential for being acquired or for selling off assets provides insurance in such an event.[20] If the insurance pay-off were reduced by a shift from property to liability protection, some risky ventures would never be initiated at all.

Additionally, reduced rewards from secondary asset uses would shift the form of initial investments. Those ventures

still undertaken after insurance pay-offs were reduced would involve assets more highly specialized to their primary objective, and hence less suited to uses elsewhere.[21]

2. Protecting Existing Quasi-Rents of Human Capital

Aside from increasing targets' shares of the gains from trade, there is another way that bargaining (resistance) increases investments in potential targets. Bargaining makes takeovers less likely in cases when there are no gains, only transfers, at stake.

In their daily operations, firms face two sorts of risk, systematic variations and firm-specific ones. Coping with each sort of risk requires different managerial skills. Adapting to the former requires generalized skills readily marketable elsewhere. But as Demsetz and Lehn have explained,[22] firm-specific variations require investments in firm-specific human capital that is not readily transferable. Individuals will make such investments only if the expected rewards exceed their best alternative by enough to provide a normal return.

Yet investments that are specific to assets owned by others place the investor at risk of opportunistic behavior by those others.[23] As long as the individual realizes at least as much as can be had in the best alternative, the invested human capital will remain, even if the returns are expropriated. The best alternative, of course, offers no premium for the firm-specific investment. Long-term guarantees may control the potential for opportunism by one party, but contracts that guarantee an individual's income invite shirking, i.e., opportunism by the

other party.[24]

Consequently, those making firm-specific human capital investments sometimes defend against potential opportunism by taking control of the asset to which their investment is specific.[25] In the corporate context, those who specialize for the benefit of the firm often acquire a substantial block of shares in that firm. This implies a higher concentration of shareholding in firms benefitting from more firm-specific human capital, a prediction confirmed empirically.[26]

In effect, not all shares are equal. Controlling shareholders will divert greater rewards per share to themselves than to other shareholders. This is not thievery, but part of an implicit contract to induce investments in firm-specific human capital of general benefit to the firm and hence to all shareholders. The thick public market in shares will be populated only by "ordinary" shareholders, while controlling shareholders will sell their larger blocks more rarely and only for a higher price. The daily "market price" quoted on the telex is lower than the reservation value that controlling shareholders place on their block, because the price at which they will sell includes a premium that must be determined through bargaining.[27]

Yet each share typically has the same voting power. If establishing property rights were costless, those shareholders with more at stake doubtless would also have a more potent voice. Larger individual holdings in any firm imply the higher

costs of diminished portfolio diversification,[28] so controlling shareholders still might own only a minority of the voting potential. The individual's optimal risk of having firm-specific capital expropriated thus is positive, as reducing risk by increasing control is costly. Hence, "controlling" shareholders are usually only semi-controlling. But the free-rider situation created by widely-dispersed share ownership normally affords (semi-) controlling shareholders sufficient protection from human capital expropriation by fellow shareholders.

This opens an avenue through which an outside bidder (for once, the term "raider" is appropriate) can profit. If defensive tactics are barred, a hostile bidder can overcome the free-rider problem among incumbent shareholders and expropriate the full value of controlling shareholders' quasi-rents. The situation is similar to an eminent domain taking, where asset owners are paid only the "objective" or market value of what is taken. Owners who attach a higher subjective value to the asset taken will not be paid full value. Property-rule protection of the asset, forcing would-be takers to negotiate with owners, would guarantee that full compensation was paid. A liability rule permits the "taker" (the government in an eminent domain proceeding, the "raider" in a takeover) to acquire property for less than full value.[29]

Controlling shareholders can limit this risk by including provisions in the corporate charter or by-laws permitting resistance to hostile takeovers. In effect, they will minimize the overall cost of potential quasi-rent expropriation by mixing

(costly) diversification-reducing but control-increasing tools with (also costly) takeover-resisting measures. As before, this is beneficial to all shareholders because it induces appropriate investments in firm-specific capital in the first place.[30]

The interests of controlling shareholders, who own large percentages of residual claims, are highly correlated with the interests of the firm as a whole, and hence other shareholders' interests. To the extent that the correlation is not perfect, noncontrolling shareholders discount the price they pay for shares initially. To restrain that discount when seeking original or additional capital, controlling shareholders have an incentive to deny themselves any ability to resist takeovers not beneficial to the firm as a whole. Through the lower initial share price, the noncontrolling shareholders are compensated for any remaining costs of permitted resistance.

Other situations may present similar opportunities for "raiders." In addition to quasi-rents from human capital, returns to other valuable assets may be expropriable. Suppose that management has discovered changes in firm structure or activities that will enhance the value of the firm, but has not made the information public. An outside bidder who discovers the information could acquire shares from shareholders who are ignorant of the changes. To limit losses to an outside bidder, shareholders would want management to resist any takeover until the changes have been effectuated and the shares rise in price.[31]

There is an unwarranted presumption in much of the

takeover literature that outside entrepreneurs employed by bidding firms can know something important that the market does not, but that inside entrepreneurs employed by a target cannot. If that were true, there would be no insider trading. But whenever firms invest in valuable information that cannot be made public, an opportunity exists for an outsider who learns of the information, or reporduces it redundantly. In that case, shareholders will want management to protect the returns to them from information that they have paid for.

C. Search Rates for Targets

The issue of appropriate property rights in target firms' shares can be approached from another perspective. The search for undervalued targets, like the search for new ideas, is costly. When several different claimants to a profitable idea or asset emerge, some scheme for allocating the property right must also emerge. One allocation is first-come-first-served.

But various authors have all shown that establishing property rights by first possession ordinarily results in premature capture.[32] Moving resources to higher-valued uses "as fast as possible" is undesirable. Speed is costly. Rapid search consumes more resources per unit of discovery than does leisurely search.[33] Hence, attempting maximum speed for replacing poor management, or reallocating corporate resources for any other reason, is ill-advised. Finding better managers too soon makes them too expensive; found too soon, management is only "better" in an engineering, not economic, sense.

The search for targets consumes resources, which have

valuable alternative uses. Resources will be diverted too soon if title to the entire increase in a corporation's value arising from reallocating control can be established only by racing to the firm before it is reached by a competitor. Well-defined property rights control the race by forcing contenders to deal with an owner or agent capable of implementing an internally consistent plan of action.[34] Weakening a particular property right, ability to bargain, would open a "common" to be claimed by the first arrival.[35] Facing no resistance, first bidders are more likely to be the only bidders, since no defense can be used to elicit competing bids.

III. EXTERNALITIES FROM MANAGERIAL RESISTANCE TO TENDER OFFERS

The preceding section illustrated various ways that the ability to bargain is advantageous when assets, including blocks of corporate shares, are traded in "thin" markets. Bargaining awards a greater share of the gains from trade to the seller, and so is a desirable practice whenever sellers are at least partly responsible for searching out exchange partners. But more important, the ability to bargain gives owners of assets greater incentives to enhance their value even prior to an exchange. It also facilitates defeat of takeover bids that do not represent value-maximizing exchanges, but only transfers from those who make valuable firm-specific investments. Because these individuals rightly value their position in the firm more highly than do a majority of shareholders, inability to bargain for a

better deal would discourage the firm-specific investments in the first place.

These advantages would explain why bargaining is the norm in most "thin" markets, and why the law typically does not impose liability rules there that would prevent negotiation. Nevertheless, Easterbrook and Fischel have argued that the law should outlaw managerial bargaining over takeovers by banning management resistance to takeover bids.[36] The Easterbrook-Fischel model is well known, and needs but little summary here. In effect, they argue, the market for corporate control is different, for two reasons.

First, the expectation of target-firm resistance acts as a disincentive to bidders, who therefore monitor all firms in the market less. Reduced monitoring by bidders means that other firms pay for any given target's resistance, creating an externality that allegedly requires a legal no-resistance rule for correction. This externality would arise even if target shareholders themselves, acting in their own interest, resisted takeover bids. But typically it is management that resists in the name of its shareholders. This, Easterbrook and Fischel claim, makes resistance undesirable for a second reason: managers resist, not only when resistance benefits their shareholders, but when it wrongfully safeguards management jobs. Thus, resistance not only creates externalities costly to other firms, but exemplifies managerial agency costs that are costly to the target itself.

In this section and the next two, we consider both these

objections to bargaining over corporate assets. Neither phenomenon necessarily accompanies takeover resistance, we show. But even if externalities and agency costs were substantial problems, they would not necessarily justify a legal ban on bargaining. Even in the presence of some relevant externality or considerable agency problem, the ability to bargain still has the various value-enhancing advantages discussed in Section II. Even if these problems exist, therefore, whether they justify a no-resistance rule is an empirical question: if the benefits of the value-increasing features of bargaining discussed above exceed the costs of the externality and agency problems, there still is no good reason to ban resistance.

A. The Externality Problem

Easterbrook and Fischel argue that application of a common-law business judgment rule to condone resistance, even when resistance benefits target shareholders, would be wrong.[37] Overwhelming evidence shows tender offers benefit target-firm shareholders.[38] But resistance results in some bids being foiled, with shareholders losing the takeover premium. Moreover, they claim, "[e]ven resistance that ultimately elicits a higher bid is socially wasteful."[39]

There are two sources of alleged waste. First, the target-firm's gains from resistance are transfers from bidding firms, creating no new wealth, but the resistance itself consumes real resources. This is just a bargaining cost, however, neither more nor less troublesome in the takeover context than in any other

thin market. Second, and more important, resistance by the target firm imposes an external cost on other firms, whose managers are monitored less by potential takeover bidders:

> [The] "externality" arises when a target's management resists a tender offer. The resulting increase in the prices paid for target firms will generally discourage prospective bidders for other targets; when the price of anything goes up, the quantity demanded falls. Changes in the incentives of bidders affect the utility of monitoring by outsiders, and that affects the size of [other firms' managerial] agency costs and in turn the pre-offer price of potential targets' stock.[40]

In other words, the externality arises because resistance by one target reduces the returns to monitoring by perspective bidders, and thus "there is too little monitoring and investors' wealth falls."[41] To end the externality they perceive, Easterbrook and Fischel advocate legal intervention to prohibit a target-firm's management from using any defensive tactics.[42]

The proposed no-defense rule has met resistance in the legal community. Courts refuse to apply it[43] and commentators disagree with portions of the analysis.[44] For example, it has been noted that although resistance consumes real resources, it also avoids the transaction costs of subsequent transfers if the first bidder is not the highest-valuing user of the target-firm's resources.[45] The debate has also focused on elasticities, i.e., on just how many bids are lost because firms can resist.[46] On the more fundamental externality point, however, there has been only acquiescence.[47]

B. Relevant vs. Irrelevant Externalities

"Externality" is a slippery concept, one less often used to elucidate a supposed "problem" than to justify government

intervention to "solve" it.[48] In general equilibrium the actions of one person affect everybody else by definition. The efficiency issue is not whether any third-party impact takes place--that is inevitable--but whether the appropriate marginal conditions still hold. Many externalities are solely pecuniary ones: they change prices but do not raise efficiency concerns as long as prices still equal marginal cost.[49] The problematic case arises only when prices and costs diverge, creating a non-pecuniary (or "technological") externality.

Although Easterbrook and Fischel do not distinguish them, there are really two distinct externalities connected with resisting takeovers in their model. One, fewer bids for targets, is merely pecuniary. This allegedly undesirable effect of resistance comes about because of the "resulting increase in the prices paid for target firms," meaning that "the quantity demanded falls."[50] This is a classic pecuniary externality. Bidders are aware of the possibility--indeed, the virtual certainty--that their first bid will not be accepted, and at the margin adjust the amount of search and bidding they undertake to reflect the higher price of takeovers. Resources will be used differently, but no inefficiency arises. The pecuniary externality is real enough, but does not justify legal intervention on efficiency grounds.

Their second externality arises because bidders adjust monitoring of potential target firms as takeover premiums rise. Admittedly, this externality is non-pecuniary, but that is not

the end of the analysis. Several conditions still must be met before a publicly-interested legal system will intervene to correct even a non-pecuniary externality.[51] Most obviously, the actions of one party must affect other parties who have little or no influence over the decisions of the first. Second, the impact on the affected parties must induce an alteration in their behavior.[52] Easterbrook and Fischel imply that these first two conditions for legal intervention are met, which is concededly plausible.

But these two necessary conditions are not sufficient. To justify intervention that would reduce the level of an activity, an externality must be an external cost, meaning that the affected parties would want the level of activity reduced.[53] It is unclear in the corporate context whether takeover resistance by one target is in fact a cost, meaning that other potential targets would want less of it. True, resistance decreases gains of bidders at the moment of takeover, which assuredly would reduce bidder search given a level of corporate investment. But as Section II noted, in the more dynamic setting an ability to resist enhances target gains from a successful takeover and so increases the amount of investment in place at any moment. All else equal, the increased population of potential targets increases bidder incentive to search by raising the likelihood that a bidder can locate a target of sufficient attraction.[54]

There is no apparent reason to believe that the first impact dominates the second, or vice versa. The issue is empirical. If the first dominates, the externality is indeed an external cost,

and shareholders in potential targets will want the resistance of other targets weakened. But if the second effect dominates, the externality is a relevant external benefit, and shareholders will prefer that the ability of other targets to resist be strengthened. And if the first and second impacts are essentially offsetting, the externality is irrelevant and need not be considered further.

Still a fourth condition necessary to justify legal "correction" of a relevant external cost requires that the cost of correction be less than the losses arising from the externality itself.[55] In other words, the parties must be missing gains from trade because of some condition remediable by legal authority. By focusing solely on the benefits perceived from a no-resistance rule, Easterbrook and Fischel imply that the costs of correcting externalities due to resistance are negligible, even non-existent.[56] But as we noted in Section II, there are losses arising from control of the externality at issue through the use of a no-resistance rule, because initial investment incentives are altered. In effect, the technique suggested for controlling the perceived externality, no resistance, has external effects of its own. Still other costs have been noted by other commentators.[57] Because no determination has yet been made of whether the costs of the original externality exceed or fall short of the costs of the externality created by removing the first, one must fall back on intuition to determine support or opposition for a no-resistance

rule -- an uncomfortable resolution at best.

The final condition necessary to justify legal intervention to correct a Pareto relevant externality is high private costs of internalization relative to the costs of public control.[58] Logically, government solutions to problems cannot be optimal if private solutions are cheaper. We next argue that this final necessary condition seems not to be met. Private internalization of any relevant externality seems available at modest cost. If so, a no-resistance rule is inappropriate even if all the other necessary conditions for government intervention are met, which is a problematic supposition in its own right.

IV. PRIVATE SOLUTIONS TO THE "PROBLEM" OF TAKEOVER RESISTANCE

If resistance generates Pareto-relevant, non-pecuniary externalities, they will be internalized when property rights are well defined and transaction (contracting) costs low.[59] The common law has defined for target firms unambiguous property rights to resist tender offers. That leaves the other issue: whether other potential targets, the alleged victims of the externalities created by target-firm resistance, can achieve contractually the level of bidder monitoring they prefer. If they can, they avoid the impact of any external effect that would otherwise exist. If potential targets that want to can credibly bond themselves not to resist a tender offer, outside bidders in the market for corporate control will not reduce their level of scrutiny and monitoring. In that event, government intervention cannot be justified.

The monitoring of targets by bidders is not free, and firms that get more of it will pay for the increase. A no-resistance rule, giving more of the expected takeover gain to bidders, is one way to pay for more monitoring. A firm selects the level of scrutiny by selecting the price of being acquired. No-resistance means a lower expected price and so increased scrutiny. If a firm can credibly promise not to resist a takeover, it cannot be affected by other targets' resistance, and there cannot be any relevant externality.

Those who would ban defensive tactics because of alleged externalities implicitly assume that prospective targets cannot promise not to resist, or that bidders will not believe targets' promises. But intra-firm contracts and third-party bonding through the formal rules of the organized stock exchanges allow firms to choose the level of resistance, and thus of monitoring, they are willing to pay for. There is, in short, no inevitable externality, pecuniary or technological.

A. Shareholder Agreements

The obvious place for shareholders to invoke a ban on defensive tactics is within the firm itself. In theory, shareholders could use their firms' articles of incorporation to specify the types and amounts of defensive tactics their managers could use. But there are two potential difficulties with such intra- firm contracts, pre-bid agency problems created by unfaithful managers and post-bid opportunism against bidders by shareholders.

1. Pre-Bid Agency Problems

With widely dispersed ownership, no one shareholder will find it worthwhile to draft and obtain adoption of corporate charter changes. If changes are to be made, they must originate with management. Easterbrook and Fischel argue that since managers want to keep their jobs, they are unlikely to draft or support charter amendments or changes in by-laws that encourage tender offers.[60] But other contractual devices--phantom stock plans, stock option plans, and "golden parachute" contracts--can align the interests of managers and shareholders in the event of a hostile tender offer.[61] Indeed, as Easterbrook and Fischel recognize in another context. "Publicly held corporations have developed a wide range of governance mechanisms that align managers' interests more closely with those of investors."[62]

Such internal arrangements are admittedly costly, but so is any way of inducing monitoring. At the other extreme, shareholders might do no internal monitoring and instead rely on increased monitoring from outside bidders. But as noted above, more outside monitoring must be purchased by foregoing takeover premia so as to promise greater gains to outside bidders. Contractual devices like golden parachutes merely substitute costly internal monitoring mechanisms for costly external monitoring by bidders. There is no reason to think that internal monitoring is always more costly, particularly recognizing that internal devices are approved by shareholders themselves.

But suppose arguendo that as takeovers loom, job-conscious managers can frustrate passage of amendments to the articles of

incorporation that are in shareholders' interests. That does not dispose of the issue. At the time of an initial public offering of securities there is no agency problem, because there is no separation of ownership and control. At this juncture shareholders would pay lower prices for the public offerings of firms that did not bar defensive tactics, if shareholders unambiguously would be benefitted by a no resistance rule. Agency problems evolve subsequently due to the costliness of foreseeing all plausible eventualities in a changing environment[63]. But if non-resistance unambiguously maximizes the present expected value of a corporation, there should be no initial difficulties of foresight with respect to that particular aspect of corporate governance. The founding shareholders of a corporation have a strong incentive to install internal governance rules that investors consider optimal. If it were indeed value maximizing to do so, fledgling firms would install stringent rules prohibiting defensive tactics before hiring outside managers. They would install provisions that would make it hard to alter the anti-defensive rules. But ordinarily they do none of these things.

2. Post-Bid Shareholder Opportunism

An objection to the notion that initial charter provisions can limit the resistance that bidders will expect arises from the ability of shareholders opportunistically to change their charter after a takeover becomes anticipated. Post-bid resistance is profitable. Any firm can adopt and announce a policy forbidding

defensive tactics, but target shareholders can revoke the earlier policy and create an auction market after a bid is launched. That prospect would harm shareholders of all firms if bidders could not distinguish firms likely to resist a bid from those that are not.[64] If bidders cannot distinguish, perhaps new law is called for, but only to ensure that firms honor their promises to refrain from resistance, not to bar all resistance.

But that point seems moot. Firms can credibly bind themselves not to resist. Time is of the essence in struggles for corporate control. Shareholders can insert one provision in their charters to forbid all defensive tactics (or a specified subset) and another to prevent any changes in the charter until a specified period has passed. Such provisions would protect bidders from shareholder opportunism unless bidders must reveal their intentions far in advance of their takeover move.[65]

Even without such delaying provisions, the structure of the corporate governance process itself prevents shareholders from making rapid changes in their articles of incorporation. Changes require a shareholder vote,[66] which takes time, particularly if shareholders are widely dispersed. Furthermore, the mechanisms of soliciting proxies are controlled by federal rules[67] which again create delay. These delays provide prospective bidders with additional assurance that firms banning defensive tactics cannot change those articles before a transfer of control occurs.

We do not claim that these bonding mechanisms are "perfect," i.e., costless. But again, as with internal monitoring devices

and the control of externalities, the cost of bonds must be compared to the costs of alternatives. It may be that a legal rule would provide enforcement of firms' no-resistance promises more cheaply than private bonding would. If so, the appropriate legal response is to enforce voluntarily offered target promises, not compulsorily to ban all resistance. If firms are truly better off eschewing resistance, such a legal rule would allow them to choose credible no-resistance policies. If shareholders do wish to allow bargaining, however, the rule would not preclude this possibility. Such a rule entails no risk, that is, of firms' losing the benefits of bargaining detailed in Section II, as would the Easterbrook-Fischel proposal simply to ban resistance.

B. Third-Party Bonds

When doubts exist about contractual reliability outside the corporate control market, third party bonding to assure performance often resolves them.[68] Similarly, there is no apparent reason that bonding could not be used in the corporate context to ensure that firms that promise to refrain from resisting outside bids will keep their promises. An explicit or implicit no-resistance bond could be posted with a third party fiduciary, its value exceeding the expected gains from resisting once a bid materializes; the bond would be forfeited if the firm breaches the promises it makes. If credible mechanisms exist to bond shareholders to their promised responses to takeover bids, firms can choose the level of bidder monitoring they want by

adjusting the contractual level of resistance.

State laws barring resistance by target firms comprise one possible sort of third-party bond. It is often suggested that state corporation statutes, reflecting inter-state competition for charter revenues, furnish the most efficient rules of corporate governance.[69] If so, some state(s) could enact no-resistance rules, and firms desiring to bond themselves to those rules could incorporate there. By subjecting themselves to suit if they violate the statute, firms would bond themselves not to resist. Thus, the observed failure of states to adopt a no-resistance rule suggests that firms do not demand bonding.[70]

If for some reason bonding through state law is insufficient, the organized stock exchanges could serve as third-party guarantors of firms' promises of no-resistance. The exchanges have incentives to devise rules maximizing listed firms' values.[71] A firm will select the exchange with the best rules for that firm's circumstances as its forum for trading.

Originally, simply listing on the New York Stock Exchange (NYSE) provided prospective bidders with assurance that the firm would not violate the Exchange's rules. In the days before computers and sophisticated computer technology, the NYSE was a natural monopoly. Firms that flouted exchange rules were delisted and lost access to this central marketplace, with a consequent fall in the firm's share prices. The long-term prospective loss of liquidity from delisting imposed costs on shareholders that reduced the attraction of short-term gains from violating exchange rules.

Thus if firms could have gained by having enforceable no-resistance rules, the NYSE should have had them. Long before federal regulation of securities trading, the NYSE required independent auditors, certain timely disclosures, and specified shareholder voting rights for listed firms.[72] But the NYSE has never had anything like a general anti-resistance rule. Only two NYSE rules conceivably could be construed as discouraging defensive tactics, and these also serve purposes unrelated to takeovers. Listed firms must obtain shareholder approval before issuing new stock exceeding 18 percent of the value of the outstanding stock,[73] and dual classes of voting stock have not been allowed.[74] But the most common sorts of resistance -- shark repellants, greenmail, and the like -- have never been subject to the NYSE prohibition or even limitation. The absence of past or present NYSE rules forbidding defensive tactics seems inconsistent with the argument that the anticipation of resistance to a takeover decreases a firm's market value.

There are indications that technological innovations have raised the ex ante costs of bonding through listing on the NYSE. Today, with cheap electronic communications available to everyone, the NYSE faces competition from the over-the-counter market and other exchanges. The presence of these rivals has diminished the value of the bond that NYSE listing once represented to prospective bidders.[75] Although the emergence of rival markets might explain why no exchange has adopted rules forbidding defensive tactics, it is significant that the NYSE

never adopted rules forbidding resistance when it had little fear of losing listings.

But despite the modern competition among them, the exchanges still represent separate legal entities with standing to sue, a standing that is not contingent on the contracting partner remaining listed on that exchange. The emergence of rival exchanges means only that firms no longer automatically bond themselves to obey the rules of specific exchanges. Exchanges are parties that can sign legally enforceable bonding contracts with firms. A firm still could voluntarily bond itself by signing a contract with an exchange specifying a sum that the firm will forfeit if it resists a hostile bid for control.[76] The bond would extract gains that a target might realize from defensive tactics. If shareholders value such bonds, exchanges themselves would benefit from serving as guarantors or bonders, by providing a service of value to its listing firms and so being able to share in any of the resulting gains.

Because target firms could post bonds with exchanges, firms that desire more outside surveillance by potential bidders can purchase it, though two transactions (listing and bonding) may now be required where one sufficed earlier. Once again, external bonding admittedly is costly--like any other device to obtain the level of monitoring the firm wants. The point is that institutions with an incentive and ability to bond target's promises already exist, and that the costs of writing effective and enforceable bonds appear to be slight, compared to the obviously costly alternative of banning valuable resistance. If

Easterbrook and Fischel are correct that future target firms are systematically the victims of present targets' resistance, it is remarkable that none of the entities with an interest in the problem has done anything at all to solve it.

C. Firm Variety and Legal Default Rules

The amount of resistance the firm chooses, relying where necessary on bonds to bolster its pledges, determines the amount of external monitoring it receives. Firm owners combine this external monitoring with internal governance mechanisms of their own, given the relative prices of external and internal devices, to achieve the optimal set of monitoring inputs overall. But different firms will demand different amounts of monitoring, since they have managers with different attributes, industrial structures posing different problems, and different organizational practices. Likewise, for any given level of monitoring, different firms will find it optimal to mix different amounts of the various monitoring inputs available.[77]

A principal disadvantage of a no-resistance rule is its inflexibility in the face of varying firm demands for different amounts of monitoring and different ways of producing it.[78] A no-resistance rule forces at least some firms to buy more outside monitoring than they want. There is no such thing as <u>the</u> efficient amount of external monitoring inputs across firms with varying characteristics and different demands for monitoring, any more than there is a single optimum amount of labor or capital across all firms in all industries. Railroads have different

capital-labor ratios than do dry-cleaning establishments. Similarly, different firms will prefer different combinations of external and internal monitoring inputs.

Casual empiricism verifies this phenomenon. Shareholders in many firms have agreed to restrict payment of greenmail, or have refused to install poison pill provisions in their charters. Others have made a contrary decision.[79] Internally, many firms have stock option plans and golden parachute agreements, but others do not.

In the face of such diversity in use of monitoring inputs, the law's attempts to correct supposed imperfections must be cautious. The corporation is itself a set of contracts linking shareholders, directors, managers and others.[80] The role of corporate law thus is enforcement of the explicit terms of the contracts, plus the more difficult task of supplying terms to cover contingencies that the contracting parties did not explicitly contemplate in the contracts. As Easterbrook and Fischel note, corporate law should supply standard-form terms of the sort that contracting parties would want for themselves.[81]

Assigning this role to the law does not determine which legal institution will be responsible for filling in corporate contracts. Judges can supply missing contractual terms case by case. Or the legislature can lay down a single rule to cover all defined contingencies. Each system has its benefits and costs. Judicial resolution of controversies permits consideration of the particularities of each case, but may be more time consuming. Legislative action may consume less time, but establishes a

single rule that will apply to all situations, regardless of the particular facts of the case.

The desirability of legislative default rules diminishes, however, as the number and variability of plausible choices available to the contracting parties increases. When, as in the takeover setting, there are dozens of internal and external monitoring choices available, and thus many thousands of possible input combinations, the likelihood that an appreciable number of firms would choose zero amounts of many of those inputs is practically nil. Yet that is what a no-resistance rule would accomplish, prohibiting firms from purchasing any combination of inputs that did not maximize outside monitoring. That rule would force an appreciable number of firms to purchase more external monitoring (which would induce less internal monitoring) than they would prefer. It is unlikely, that is, that many shareholders would write the sort of contract that Easterbrook and Fischel's no-resistance rule would impose upon them.

As a standard-form contract for shareholders, the Easterbrook-Fischel proposal has a second defect, one that goes beyond forcing all firms to accept the same missing term when they fail to provide for some contingency. It would also override the express terms of charter provisions, employment agreements and so on even if those contracts explicitly attempt to allow managerial resistance to takeovers. Easterbrook and Fischel's rule is not a default option, around which firms can contract if they please. Rather, it mandates a set level of

resistance--zero--regardless of the level shareholders have chosen. If enacted, then, a no-resistance rule would effectively tear up those charter provisions authorizing the resistance that shareholders themselves have agreed to.

No legal rule in this area can be optimal unless it is an option. Firms that wish to avail themselves of the option can thereby lower transaction costs vis-a-vis drafting and negotiating specific provisions in their contracts. But not all firms will find the legal prescription that is chosen appropriate. The ability of firms to opt out of the law by contracting around costly legal rules when lower-cost private alternatives are available must be a feature of any efficient standard-form contract.

Default options, like everything else, have their costs. In the takeover context, they may create uncertainty among bidders about what resistance rules a particular target has in force. But institutions like stock exchanges make it their business to minimize these costs. Moreover, firms that adopt no-resistance rules thereby increase the potential gains available to bidders in order to attract increased takeover attention. These firms then have every incentive to let bidders know what they have done, and bidders have every incentive to search for that information.

Of course, permitting firms to contract around legal rules means that courts will sometimes be called upon to interpret and enforce contracts. But a rule requiring managerial passivity in the face of a takeover bid also requires costly interpretation

and enforcement, as Easterbrook and Fischel concede. "[M]any legitimate business decisions could have the effect of making the corporation less attractive to the bidder and thus could be called resistance....Distinguishing resistance from passivity will be simple in some cases and hard in others."[82]

Nor does it follow that corporate contracting should be ignored in the takeover context because some forms of resistance (poison pills, greenmail) were unknown at the time contracts were written. Legislatures are no more able to provide rules about things that do not exist than are the original entrepreneurs. Whatever statutory language a legislature might choose to proscribe takeover defenses is equally available to firms themselves if they want to use it.

V. AGENCY COSTS

Whether or not important externalities attend takeover resistance, Easterbrook and Fischel believe resistance is undesirable because management will defend to save their jobs, not to benefit their shareholders.[83] Indeed, to Easterbrook and Fischel the very existence of tender offers evidences agency problems in target firms. Combinations between firms could occur through friendly mergers, which are claimed to dissipate fewer real resources than hostile tender offers.[84] When a bidder resorts to a tender offer, Easterbrook and Fischel argue, target-firm managers are revealed to have been protecting themselves by refusing to facilitate a beneficial merger alternative for

shareholders.

Empirically, mergers remain by far the most prevalent form of inter-firm combination, while tender offers are a comparative rarity.[85] This observation suggests that significant agency costs do not typify the takeover process, even by Easterbrook and Fischel's standards. It is noteworthy also that for Easterbrook and Fischel agency costs seem to be a significant problem only for tender offers. As Easterbrook has reported elsewhere, overwhelming empirical evidence in various aspects of corporate governance shows that faithful managers are rewarded while the faithless are punished.[86] Shareholders apparently do monitor and do devise corporate governance mechanisms that impose costs of agency on agents themselves.[87] In advocating a no-resistance rule, Easterbrook and Fischel do not explain why tender offers are unique.

Especially curious is Easterbrook and Fischel's preference for mergers to avoid agency costs. The scope for agency costs is no less in friendly mergers than it is in hostile tender offers. Managers of firms acquired in friendly mergers often receive substantial lump-sum payments from the acquiring firm or, alternatively, job guarantees for themselves prior to submitting the proposal to shareholders.[88] Moreover, management typically does not accept the first bid from the prospective partner. Rather, it "resists" by bargaining for a better deal before submitting the offer for shareholder consideration. In negotiating merger terms, target-firm managers seem to extract much if not all the available gains from the combination, leaving

the bidding firm with only a competitive rate of return.[89] Such hard bargaining presumably decreases the interest of other bidders in seeking merger targets, which again means less monitoring throughout the economy. If mergers are preferable to hostile tender offers, why is managerial resistance appropriate for the former but not the latter?[90]

We do not deny that resistance (in the face of either merger offers or tender offers) can sometimes be used opportunistically by management.[91] But as we pointed out in Section II, the ability to resist also can convey long-run benefits to shareholders. Whenever use of a tool, such as resistance, creates both costs and benefits for shareholders, shareholders will want to optimize its use, not eradicate its use.

VI. CONCLUSION

The foregoing has analyzed the role of bargaining in the context of alternative structures of property rights, and has applied that analysis to bargaining for corporate control. Bargaining is the hallmark of exchanges in thin markets. It is no accident that maximizing the value of assets often requires investments that owners cannot expect to be accurately valued by "objective" techniques, but only by negotiation. By definition, they involve more asset-specific risk whose management requires asset-specific investments in human capital. That capital can be expropriated unless bargaining is permitted.

It would be astounding if social product could be increased

by weakening well-defined rights to property currently trading or tradeable at modest cost. An externally-imposed rule substituting liability for property protection benefits neither side. It reduces the incentive to create value in potential targets. It causes too many bidders to search too much, too soon. There are good reasons why such a rule is not observed in other thin markets, even those where sellers commonly use agents and those where the good-faith efforts of the agents are costly to measure.

There is nothing special about corporate control that would justify such a rule for tender offers. In baseball, putting a player on revocable waivers creates the same sort of externality as that decried by Easterbrook and Fischel. If a claim is made for the player on waivers, the team owning his contract can revoke the waivers and either keep the player or begin bargaining with the team that filed the claim. The bidding team has spent real resources evaluating the player relative to its own circumstances, and the ability to revoke the waivers may well reduce the amount of evaluation and the number of bids. Yet that system is an explicit and mutually agreed to part of the rules of major-league baseball; presumptively therefore is it optimal for baseball teams as a group.

Unfettered asset owner discretion over future bargaining strategies has not been shown to be inferior to a mandatory no-resistance rule. Target firms can contract for any level and type of monitoring for which they are prepared to bear the real and unavoidable resource costs. If they wish, they may bond

through both internal and external means any no-resistance promise they make to potential bidders. The externality problem is a mirage. Imposing a single rule on firms with varying demands for outside monitoring would itself create inefficiencies where none now exist.

If the legal structure will not enforce voluntary commitments not to resist, then the appropriate legal change is one to enforce such promises, not one to require them. Admittedly, judicial ability to interpret voluntary commitments is neither costless nor perfect. But to require costless perfection of a policy is to succumb to the Nirvana fallacy. The appropriate standard is not perfection but a real-world alternative. Against that standard it is difficult to imagine how voluntary commitments can be more costly to enforce than are compulsory ones.

Management had a lesser role in tender offers before the Williams Act established mandatory waiting periods during which tenders cannot be completed. The delay now required gives target managers greater opportunity to employ a variety of defensive tactics (e.g., poison pills, greenmail, share repurchases and so forth) to fend off first and even subsequent bids. By lengthening the period over which tender offers are outstanding, the Williams Act may have weakened implicit commitments not to resist. But if so, repeal or modify the Williams Act, rather than add a new layer of immobilizing constraints.[92]

As noted at several junctures here, resolution of all

aspects of the controversy over resistance, particularly the externality issue, cannot be done at a purely theoretical level; some empirical judgments are required. Neither the proponents nor the opponents of managerial bargaining have provided quantitative evidence to support their position. But surely, given that low-cost private contractual solutions are available to solve any externality, and given that practically all other thin markets have evolved exchange rules allowing bargaining, the burden of persuasion must be on those who would ban bargaining. Likewise, given that firms differently situated inevitably want different bargaining rules and are observed to impose different rules on themselves, opponents of bargaining must shoulder the burden of showing why these private contractual solutions are undesirable and how a single rule for all firms can be an improvement.

FOOTNOTES

*The authors are all associate professors at Emory University, teaching either in the Economics Department or the School of Law. Macey is currently Visiting Professor at the University of Virginia Law School; McChesney is Visiting Professor and John M. Olin Fellow in Law and Economics at the University of Chicago Law School. We received valuable comments from Henry Butler, William Carney, Frank Easterbrook, Daniel Fischel, David Friedman, Charles Goetz, Clifford Holderness, Roger Meiners, Richard Posner, David Schap and Alan Schwartz; from participants in presentations made at the University of Chicago, Cornell University, Emory University and the University of Virginia; and from participants in presentations made at the 1986 Western Economic Association Meetings and the Conference on the Economics of Corporate and Capital Markets Law at Harvard University. As we hope is clear from these lengthy acknowledgements, the abundant citations below and the lengthy reference list appended to our paper, we have benefitted considerably from the many economists and lawyers who have addressed many of the topics we consider here. Distinguishing individual marginal products, as always, is difficult.

1. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 953-54 (Del. 1985).

2. Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of A Target's Management in Responding to a Tender Offer, 94 Harv. L. Rev. 1161 (1981) (hereinafter Proper Role). For elaboration of the basic model see Frank H. Easterbrook & Daniel R. Fischel, Auctions and Sunk Costs in Tender Offers, 35 Stan. L. Rev. 1 (1982) (hereinafter Auctions).

3. Buchanan & Subblebine, Externality, 29 Economica 371 (1962).

4. Guido Calabresi & A. Douglas Melamed, Property Rules, Liability Rules and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089 (1972).

5. Examples of other markets that exhibit similar bargaining rules are plentiful. In purchasing new automobiles, customers frequently obtain bids from one dealer and use them to bargain

for lower prices from other dealers. Most ironically perhaps, managerial positions themselves (and academic positions, for that matter) are not offered on a take-it-or-leave-it basis, but are subject to considerable bargaining about salary, perquisites, duties, and so forth, with bids from one prospective employer being used in negotiations with others.

6. Calabresi & Melamed, supra note ____.

7. Oi, The Economics of Product Liability, 4 Bell J. Econ. 3 (1973); Veljanovski, The Employment and Safety Effects of Employer's Liability, 29 Scot. J. Pol. Econ. 256 (1982); Haddock & Spiegel, Property Rules, Liability Rules, and Inalienability: One View of the Edgeworth Box, 1 Proc. Eur. Assn. for Law & Econ. 45 (1984); Rose- Ackerman, I'd Rather Be Liable Than You: A Note on Property Rules and Liability Rules, 6 Int'l Rev. of Law & Econ. 255 (1986).

8. E.g., Muris, Cost of Completion or Diminution in Market Value: The Relevance of Subjective Value, 12 J. Legal Stud. 379 (1983); Rea, Nonpecuniary Loss and Breach of Contract, 11 J. Legal Stud. 35 (1982).

9. This is a central paradigm in several strains of economic literature, particularly those analyzing alternative property rights. E.g., Demsetz, Toward a Theory of Property Rights, 57 Am. Econ. Rev. 347 (Papers & Proceedings 1967); Gordon, The Economic Theory of a Common Property Resource: The Fishery, 62 J. Pol. Econ. 124 (1954). For a summary of the empirical literature, see DeAlessi, The Economics of Property Rights: A Review of the Evidence, 2 Research in Law & Econ. 1 (1980).

DeAlessi summarizes in particular the link between ownership rewards and investment that is of concern here.

> To the extent that resource rights are held in common, individual choices regarding the output to be produced, the production techniques to be used, the characteristics (amount, type, and time profile) of the investment to be undertaken as well as the time horizon and the intensity of production will be affected[.] Thus, since the individual lacks exclusive rights to the output of any investment he might make on the commonly owned resource, the less incentive to invest this way.

DeAlessi, at 6 (citation omitted). For recent recognition of this paradigm in the corporate takeover context, see Bebchuk, Comment: The Case for Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028, 1049 (1982); The Case for Facilitating Competing Tender Offers: Reply and Extension, 35 Stan. L. Rev. 23, 42-43 (1982).

10. Bargaining costs thus resemble information costs. The individual's incentive to incur such costs arises solely from an interest in obtaining the best deal, much of it at the expense of the trading partner. In the short run, the process largely results only in transfers between trading partners. But the long-run implications are more important, because the process affects the future availabilities and values of the traded item.

11. The divergence of a block's value from the product of quoted share price times the shares in the block is constrained by the transaction cost of assembling or dispersing a similar-sized block piecemeal. Even if there are enough shares held outside blocks to enable one to assemble a block of specified size, assembling a block will not be a perfect substitute for

purchasing one. For example, the concentration of voting power will differ. Moreover, block assembly requires more interaction with the market than does block purchase, and so assembly increases the number of third parties "tipped" about one's activities and hence decreases the maximum gains from trade attainable.

12. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110 (1965).

13. E.g., Jensen, Agency Costs of Free Cash Flow, Corporate Finance and Takeovers, 76 Am. Econ. Rev. Papers and Proceedings 323, 328 (1986) (there are "approximately a dozen theories to explain takeovers, all of which I believe are of some relevance").

14. Jensen and Ruback note that "[v]arious sources of gains to takeovers have been advanced," but that the studies showing gains from takeovers "cannot distinguish between these alternative sources of gains." Jensen & Ruback, The Market for Corporate Control: The Scientific Evidence, 11 J. Fin. Econ. 5, 23-24 (1983). They remark that it "would be surprising to find that all the gains...are due to a single phenomenon such as elimination of inefficient target management." Id. at 25.

15. The amount of search a party will undertake is a positive function of the expected rewards. This is a fundamental aspect of the economics of information. Stigler, The Economics of Information, in The Organization of Industry 171 (1961); G. Stigler, The Theory of Price 1-4 (3d ed. 1966); Mortensen, Property Rights and Efficiency in Mating, Racing and Related

Games, 72 Am. Econ. Rev. 968 (1982). As Stigler notes, when assets are "unique," i.e., traded in thin markets, "sellers can also engage in search...in the literal fashion that buyers do." Economics of Information, at 175. For mention of this point in the takeover context, see Bebchuk, Comment: The Case for Facilitating Competing Tender Offers, supra note __, at 1049; The Case for Facilitating Competing Tender Offers: A Reply and Extension, supra note __, at 38-39; Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1693, 1776 (1985).

16. The following advertisement ran last year in the Wall Street Journal: "Acquisitions Wanted. Ocilla Industries, Inc., a publicly traded OTC-National company with a significant cash position, is seeking acquisitions meeting the following criteria:...Brokers inquiries welcome and brokers will be fully protected. Please call or write...." Wall St. J., May 27, 1986, p. 62, col. 4.

17. E.g., Sterngold, "Wall Street's Army of Insiders," N.Y. Times, May 18, 1986, p. F1, F8 ("Merger teams originate many deals on their own today, rather than waiting for a client to ask for help, because they need a constant flow of transactions to keep the large staffs profitably employed."); Petre, "Merger Fees that Bend the Mind," Fortune, Jan. 20, 1986, p. 21 (investment bankers increasingly involved in acquisitions because they "devise clever strategems and think up new kinds of transactions"). Gupta, "Intermediaries Play A Bigger Role in

the Venture Business," Wall St. J., Sept. 11, 1986, p. 1, col. 5.

18. One group specializes in putting together new Ph. D.'s to create new research firms, then selling the firms to pharmaceutical companies. Boland, "A Lot of Happy People," Financial World, May 13, 1986, p. 108.

19. For example, a real estate venture recently issued a prospectus stating as "Investment Objectives" the following: "to acquire,...hold and ultimately dispose of" various real estate properties.

20. The insurance function of subsequent acquisitions and sales is seen in the movie and television business. Frequently, movie-makers and investors organize to make a picture, intending to sell the product to a distributor. Fortune, February 17, 1986. If the distributor fails to make money in the theaters, he will pull the film back and sell it instead for use in the home video market. Sherman, "A TV Titan Wagers," Fortune, May 12, 1986. Similarly, many television series produced for prime time fail to make money there. But increasingly, it is possible to resell them for syndicated re-run and reduce losses, or even make money on the venture. Id.

In general, the process of reclaiming failed ventures, managing them back to profitability and then selling them off has become highly specialized. Practitioners are known as "turn-around venture capitalists," or "vulture capitalists." See Stevens, "Lots of Business," Financial World, Jan. 22, 1986, p. 32.

21. Holding all else equal, an owner clearly will prefer to make investments that maximize returns if the firm's experience turns out as the owner expects. Just as clearly, the owner will prefer investments that are adaptable, in case the firm's experience turns out other that expected. Consequently, an investment that offers greater returns and greater adaptability will always be preferred over investments offering less of each. If an entrepreneur can sensibly select from a range of alternative investments, the less adaptable options will have to offer higher returns to be attractive, and more adaptable investments will offer lower returns. If the advantages of adaptability are curtailed (through a no-resistance rule, for example), on the margin entrepreneurs will shift investments undertaken toward those with higher expected returns but lower adaptability.

22. Demsetz & Lehn, The Structure of Corporate Ownership: Causes and Consequences, 93 J. Pol. Econ. 1155 (1985). See also Demsetz, The Structure of Ownership and the Theory of the Firm, 26 J. Law & Econ. 375 (1983) (hereinafter Structure of Ownership); and Demsetz, Corporate Control, Insider Trading, and Rates of Return, 76 Am. Econ. Rev. Papers & Proceedings 313 (1986).

23. Klein, Crawford & Alchian, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J. Law & Econ. 297 (1978). See also O. Williamson, Markets and Hierarchies--Analysis and Antitrust Implications: A Study in

the Economics of Internal Organization (1975), and Alchian, Decision Sharing and Expropriable Specific Quasi-Rents: A Theory of First National Maintenance Corporation v. NLRB, 1 Sup. Ct. Econ. Rev. 235 (1982).

24. If there is no danger that the trained employee would quit, initial investment in specific human capital will be borne entirely by the firm, through wage rates in excess of realized marginal products during an initial training period. G. Becker, Human Capital 18-29 (1964). After the investments have been completed, the firm reaps the return on its investments by paying wages equal to those available elsewhere, which are below the employee's now enhanced marginal product within the firm to which his human capital is specific.

If the turnover rate is not zero, however, the situation is different.

> If a firm had paid for the specific training of a worker who quit to take another job, its capital expenditure would be partly wasted, for no further return could be collected. Likewise, a worker fired after he had paid for specific training would be unable to collect any further return and would suffer a capital loss. The willingness of workers or firms to pay for specific training should, therefore, closely depend on the likelihood of labor turnover.

Id. at 21. Becker notes that the likelihood of a quit is not fixed; it depends on wages, so a firm contemplating specific human capital investments in its employees might "offer employees some of the return from training. Matters would be improved in some respects but worsened in others, for the higher wage would make the supply of trainees greater than the demand, and rationaing would be required." Id. at 22. Moreover, the

magnitude of investment would not be pursued to the proper margin. "The final step would be to shift some training costs as well as returns to employees, thereby bringing supply more in line with demand. When the final step is completed, firms no longer pay all training costs nor do they collect all the return but they share both with employees. The shares of each depend on the relations between quit rates and wages, layoff rates and profits, and on other factors not discussed here." Id. (footnotes omitted).

The firm-specific human capital embodied in a firm's top executives often is unique. At any moment particular individual executives will be uniquely qualified to perform particular managerial tasks. The situation is akin to a bilateral monopoly, and a well-timed strategic threat to withhold the services of the executive can leave the firm in an extremely disadvantaged bargaining posture. Consequently, in such instances the interests of shareholders will require that the executive's rewards approximate the executive's marginal product, including the marginal product of his firm-specific human capital. In that way the executive himself will bear the full cost of a withdrawal of his services.

But that implies there is no payoff at all to the firm for prior investment in firm-specific capital uniquely embodied in executives. If the initial investment is to be made, it must be made entirely by the executive; but, symmetrically, that leaves the executive at risk of expropriation of the returns to the

investment, should the firm begin to bargain strategically. The text now address this problem.

25. This resembles vertical integration, which is one mechanism identified by Klein, Crawford and Alchian, supra note __, for controlling opportunism. Of course, ownership of shares is not the only device available to managers for mitigating the risk of expropriation. Pension rights, golden parachutes, severance pay and the like all raise the cost to the firm of carrying through an opportunistic threat. But to say there are alternatives does not mean that they are perfect substitutes for all firms in all situations. That, in turn, means that depriving managers of the ability to make and protect investments in blocks of shares must increase the cost of managerial services.

26. Demsetz and Lehn, supra note __. In The Structure of Ownership and the Theory of the Firm, supra note __, Demsetz finds that management and directors do indeed own substantial blocks of the employing firm's shares (usually 20 percent or more), except in the very largest corporations.

Controlling managerial malfeasance, upon which the takeover literature concentrates, and controlling passive shareholder opportunism, upon which we are focusing here, are linked. For both reasons, shares of firms that are relatively difficult to control are worth more to controlling shareholder-managers than to passive investors, and so one expects a high degree of integration of management and shareholding in those firms.

27. In some cases, minor divergences of interests among shareholders may be usefully neglected through resort to a

"single owner" analogy. See, e.g., Bebchuk, Towards Undistorted Choice and Equal Treatment in Corporate Takeovers, supra note __, at __. ("It is widely thought that enabling sole owners to reject acquisition offers serves efficiency."). This is particularly true when shareholders have equivalent interests ex ante, but free-rider and hold-out problems create disputes ex post. Grossman & Hart, Takeover Bids, the Free-Rider Problem and the Theory of the Corporation, 11 Bell J. Econ 42 (1980). When there are substantial and fundamental differences among shareholder interests ex ante, however, as there are in the instance we consider here, there is no logically consistent way to amalgamate divergent interests into a conceptual "sole owner." K. Arrow, Social Choice and Individual Values (1951).

28. Acquiring control of one of the few largest corporations in the economy requires a non-diversified investment of impressive size, with daunting cost to the risk-averse. Although there are exceptions, Demsetz has shown that the stock interest of management in very large corporations tends to be low, averaging 2 to 3 percent, compared with smaller companies, where managers and directors typically hold 20 to 30 percent of their corporation's voting shares. See Demsetz, The Structure of Ownership and the Theory of the Firm, supra note __.

If, in the face of their more tenuous, minority voting control, management of a giant corporation is to make the value-increasing investments in firm-specific human capital, assurance against expropriation of quasi-rents must be embodied in greater

allowances to resist hostile takeovers than is true for managers who hold controlling interests in smaller corporations. When the relative cost of alternative tools differs between situations, the optimal mix of tools will differ also.

29. R. Epstein, Takings....

30. This notion of expropriation of managerial quasi-rents is similar to that analyzed by Knoeber, Golden Parachutes, Shark Repellents and Hostile Tender Offers, 76 Am. Econ. Rev. 155 (1986) (hereinafter Golden Parachutes). However, Knoeber focuses on potential expropriation of managerial compensation that has been deferred until better information of performance becomes available. Deferral of compensation for past services creates a risk that payment will not be made in the event of a hostile takeover. We focus instead on firm-specific investments whose returns are to be realized in subsequent periods, and which are thus subject to similar opportunism in the event of a takeover.

31. This hypothetical setting parallels an actual episode. Prior to the recent threat by Sir James Goldsmith to acquire control of Goodyear Tire & Rubber Company, Goodyear had hired two investment banking firms to study possible restructuring of Goodyear. Restructuring was recommended, but the information was to be kept private. Before the firm could act on the restructuring recommendations, however, Goldsmith acquired a substantial minority stake interpreted as preliminary to a takeover bid, after which Goldsmith himself would restructure the company. See Winter & Stricharchuk, "Goodyear, Responding

to Takeover Bid, Seeks Buyer for Its Oil and Gas Unit," Wall St. J., Nov. 4, 1986, p. 3. col. 1. Partly because the prospects of Goldsmith's restructuring were becoming dimmer, he eventually agreed to resell his shares at a premium to the firm, which then proceeded with its prior restructuring plans. Stricharchuk & Stewart, "Goodyear Tire To Buy Interest From From Sir James," Wall St. J., Nov. 21, 1986, p. 3, col. 1. Goldsmith himself said that the company's restructuring plans were largely the same as his. Stewart & Revzin, "Sir James Goldsmith, As Enigmatic as Ever, Bails Out of Goodyear," Wall St. J., Nov. 21, 1986, p. 1, col. 6.

32. Barzel, Optimal Timing of Innovations, 50 Rev. Econ. & Stat. 348 (1968). Dasgupta & Stiglitz, Uncertainty, Industrial Structure, and the Speed of R and D, 11 Bell J. Econ. 1 (1980). Mortensen, supra note __. In Mortensen's terminology, hostile takeovers have some of the aspects of an "innovation game" and some aspects of a "mating game." Only if takeovers were purely a mating game, and only if bidders were the only parties searching, would a no-resistance rule be desirable. One crucial assumption of Mortensen's mating game is that the success of a party of one type (such as targets) does not affect the distribution of complementary types available to be found. This assumption does not accurately represent matters in the market for corporate control. See also Haddock, First Possession Versus Optimal Timing: Limiting the Dissipation of Economic Value, 64 Wash. U. L. Q. 775 (1986), for a generalized

application of the Barzel-Dasgupta/Stiglitz-Mortensen analysis to examples that extend beyond property rights in research and development. For an analysis of one historical instance in which first-come-first-served property rights proved inefficient, see McChesney, Government Prohibitions on Volunteer Fire Fighting in Nineteenth-Century America: A Property Rights Perspective, 15 J. Legal Stud. 69 (1986).

33. Alchian, Costs and Outputs, in The Allocation of Economic Resources (M. Abramovitz et al. eds. 1959); and Alchian, Reliability of Progress Curves in Airframe Production, 31 Econometrica 679 (1963).

34. Posner, Economic Analysis of Law 33-39 (3d ed. 1986); Kitch, The Nature and Function of the Patent System, 20 J. Law & Econ. 265 (1977).

35. Gordon, The Economic Theory of a Common Property Resource: The Fishery, supra note __; Hardin, The Tragedy of the Commons, 162 Science 1243 (1968). See also Cheung, A Theory of Price Control, 17 J. L. & Econ. 53 (1974).

36. Easterbrook & Fischel, Proper Role, supra note 1; Auctions, supra note 1.

37. Proper Role, supra note 1, at 1194 (business judgment rule "should never serve to justify a decision to oppose a tender offer").

38. The empirical evidence indicates that target-firm shareholders receive upwards of a 30 percent premium from successful tender offers. See Jensen & Ruback, supra note __, at 9-16. The returns to successful bidders are much smaller,

averaging only about 4 percent. Id. at 16-17.

39. Proper Role, supra note __, at 1175.

40. Id. at 1176-7.

41. Auctions, supra note __, at 6.

42. Not all defensive tactics fit the Easterbrook-Fischel paradigm. Greenmail paid to prospective bidders, for example, has only trivial resource costs and can increase, not decrease, the amount of monitoring bidders do. Macey & McChesney, A Theoretical Analysis of Corporate Greenmail, 95 Yale L. J. 13 (1985).

43. E.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985). Citing Easterbrook and Fischel, the Delaware Supreme Court noted that "[it] has been suggested that a board's response to a takeover threat should be a passive one...[But] as the proponents of this rule of passivity readily concede, it has not been adopted either by courts or state legislatures." 493 A.2d at 955 n.10. See also Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986); Moran v. Household Int'l, Inc. 500 A.2d 1346, 1356 (Del. 1985).

With a lengthy discussion of Easterbrook and Fischel's analysis, Judge Posner has stated that "[p]ersonally we are rather skeptical about the arguments for defensive measures." Dynamics Corp. v. CTS Corp., [Current Binder] Fed. Sec. L. Rep. (CCH) para. 92,768, 93,756 (7th Cir. June 9, 1986). But the Seventh Circuit refused to rule the target company's poison pill plan invalid per se, despite "grave doubts" about defensive measures,

because the court was construing Delaware law. The court recognized that "Delaware courts have been quite emphatic that defensive measures in general...are within the power of the board of directors of a target corporation."

44. E.g., Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 Stan. L. Rev. 51 (1982); Bebchuk, The Case for Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028 (1982); see also Oesterle, Target Managers As Negotiating AGents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis, 71 Corn. L. Rev. 53 (1985).

45. In other words, the real resource costs of resistance may be offset by savings in the transaction costs of subsequent serial transfers. Bebchuk, supra note __, at 1048-49. Easterbrook and Fischel suggest the reverse, that auction costs exceed the costs of successive transfers. Auctions, supra note __, at 14. The issue is solely empirical, but neither side has presented any data to support its position.

46. The elasticity debate has centered on the size of bidders' sunk costs, that is, on the extent to which costs can be recouped in the event bidders are thwarted by managerial resistance, and therefore on the overall effect of resistance in reducing bidder's search. E.g., Bebchuk, The Case for Facilitating Competing Tender Offers: A Reply and Extension, 35 Stan. L. Rev. 23, 30 (1982) (admitting that allowing managerial resistance reduces bidders' search, but claiming that the reduction "is unlikely to be substantial"). Again, no data are offered in support of the claim that elasticities are low, so

the empirical claim cannot be evaluated. But the Easterbrook and Fischel model does not depend on the size of the supposed externality; as long as there is any, they claim, too little monitoring and bidding will result. See Auctions, supra note __, at 7.

47. E.g., Jarrell, The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?, 28 J. L. & Econ. 151 (1985). Jarrell found that when target firms resist initial tender offers by litigating against the bidder, the expected gains from higher subsequent bids outweigh the costs of both the litigation and the risk that no subsequent offer will materalize. Defensive tactics, Jarrell initially suggests, may seem to be "sensible gambles, rather than shameful self-dealing by managers." Id. at 175. But Jarrell ultimately concludes that resistance is nevertheless welfare-reducing:

> [T]his conclusion--that litigious defenses can be beneficial to target shareholders--does not imply that such actions enhance social welfare. Indeed, the opposite is more likely to be true, because litigious defenses redistribute some of the gains from corporate combinations from acquirers to the targets. This redistribution is analogous to a tax on acquirers.

Id. But the redistribution is not analogous to a tax, because it does not simply disappear into an uninvolved treasury. It is received by the other party to the transaction, someone capable of reacting appropriately to the implied opportunity cost. See Coase, The Problem of Social Cost, 3 J. Law & Econ. 1 (1960), especially Section IX.

48. E. J. Mishan, Cost-Benefit Analysis 107 n.5 (1971).

49. Id. at 103-5; John F. Due and Ann F. Friedlaender, Government Finance: Economics of the Public Sector 80-81 (5th ed. 1973) (changes in prices "will lead to changes in the equilibrium output of goods and services, but each equilibrium will be equally efficient, or Pareto optimal").

50. See passage from Proper Role quoted supra at note __.

51. If the actors in the legal system are self-interested, these five conditions, while still necessary, will not be sufficient to assure the desirability of legal intervention.

52. Buchanan & Stubblebine, supra note __. More technically, the externality must be marginal rather than infra-marginal if this second condition is to be met.

53. Id. Because the desire of one party to alter the other's behavior is only one of several conditions that must be met if legal intervention is to be justified, Buchanan and Stubblebine refer to externalities satisfying this particular criterion as only "potentially relevant."

54. An example underlines the point. A person is not required to accept the first marriage proposal received. One may spurn the first (or nth) suitor, even though that creates a risk of never getting a better offer. But the amount of search for spouses does not necessarily fall when such discretion is tolerated. True, the possibility of being refused is a disincentive to suitors' search, all other things equal. But the ability to refuse unattractive suitors makes marriage itself more desirable, and so gives a potential partner greater incentive to acquire (i.e., invest in) attributes or skills that make him or

her more likely to be acceptable to a suitor. Because potential partners are then more desirable, there will be more search (by more suitors), all else equal.

55. As Buchanan and Stubblebine note,

> the observation of external effects, taken alone, cannot provide a basis for judgment concerning the desirability of some modification in an existing state of affairs. There is not a prima facie case for intervention in all cases where an externality is observed to exist. The internal benefits from carrying out the activity, net of costs, may be greater than the external damage that is imposed on other parties.

Buchanan and Stubblebine, supra note __, at 381. Buchanan and Stubblebine refer to externalities satisfying this condition as "Pareto relevant."

56. According to Easterbrook and Fischel, shareholders as a group benefit from non-resistance, as do bidders. Auctions, supra note 1, at __. So all parties are allegedly better off with mandatory inability to resist.

57. See text accompanying note __, supra.

58. Demsetz makes the same point.

> [P]roperty rights convey the right to benefit or harm oneself or others....What converts a harmful or beneficial effect into an externality is that the cost of bringing the effect to bear on the decisions of one or more of the interacting persons is too high to make it worthwhile.

Demsetz, Toward a Theory of Property Rights, 57 Am. Econ. Rev. (Papers & Proceedings) 347, __ (1967).

59. R. H. Coase, The Problem of Social Cost, 3 J. Law & Econ. 1 (1960).

60. Proper Role, supra note __, at __.

61. Knoeber, Golden Parachutes, supra note __; Lambert and Larcker, Golden Parachutes, Executive Decision-Making and Shareholder Wealth, 7 J. Account. & Econ. 179 (1985).

62. Easterbrook & Fischel, Close Corporations and Agency Costs, 38 Stan. L. Rev. 271, 277-78 (1982).

63. Grossman & Hart, supra note __.

64. Actually, few firms would keep their promises if bidders could not tell the difference. See George A. Akerlof, The Market For "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q. J. Econ. 488 (1970).

65. Perhaps the Williams Act has forced bidders to reveal their intentions so far in advance that preexisting corporate charters now offer insufficient restraints on resistance. But if that is so, the solution is not more law, but less--repeal or modification of the Williams Act.

66. See Revised Model Business Corporations Act, Sections 10.01-03; see also Del. Corp. Law, Section 242 (b)(1).

67. 15 U.S.C.A. Section 78a-14; 17 C.F.R. Section 240.14a (1983). Rule 14a-6 of the U.S. Securities and Exchange Commission requires that five copies of all proxy statements and accompanying forms must be filed with the SEC ten days prior to the date such material is given to stockholders, 17 C.F.R. Section 240.14a-6(a), although the SEC may authorize a reduction in the ten day period "upon a showing of good cause therefore." Id.

68. E.g., Knoeber, An Alternative Mechanism to Assure Contractual Reliability, 12 J. Legal Stud. 333 (1983) (describing the merits

of third party bonding arrangements, particularly in the farming industry); See generally Klein & Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 J. Pol. Econ. 615 (1981).

69. Winter, Government and the Corporation 7-11 (1978); Winter, State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977); Fischel, The 'Race to the Bottom' Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Northwestern Law Rev. 913 (1982); But see Fischel, Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers, 57 Texas L. Rev. 1, 29 (1978).

70. C.f. Romano, Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225, 268 (1985). At first blush it may seem that individual states will be unable to enforce a local statute that forbids resistance. It is easy for a firm initially to locate in a state with strict limitations on defensive tactics, but then to reincorporate in a lenient state when the takeover seems imminent. But a state mandating no resistance could require all firms incorporating there to post a monetary bond, which would be forfeited if the firm exited the state when a takeover was threatened.

Another problem with relying on states to provide bonding services for firms wishing to make credible promises of no resistance is that individual states may, for their own reasons, prefer to encourage rather than help discourage resistance.

States with strict statutes forbidding resistance would suffer from the loss of tax revenues from firms that are taken over by corporations outside of the state, and these losses might not be offset by the increased revenues from chartering that come from providing a no-resistance rule. If that is true, of course, the value of no-resistance bonding is modest. Otherwise, at least one state would make a market in no-resistance charters, because the revenue-maximizing level of fees is endogenous, increasing as the number of closely competing states declines.

71. Easterbrook, Managers' Discretion and Investor Welfare: Theories and Evidence, 9 Del. J. Corp. Law. 540, 556 (1984) ("The willingness of people to trade depends... on their belief that they will get a fair deal. Thus it is in the interest of stock exchanges to establish rules for the protection of investors, and managers who seek to attract money will submit to these rules").

72. Benston, Security For Investors, in Instead of Regulation, 169 (R. Poole, ed. 1981); Watts and Zimmerman, Agency Problems, Auditing and the Theory of the Firm: Some Evidence, 26 J. Law & Econ. 613 (1983).

73. Easterbrook, Managers' Discretion supra note at 556.

74. Vol. 1, No. 5, BNA Corporate Practice Weekly, NYSE Will Permit Dual Stock Classes, Unequal Voting Rights, Study Predicts, February 5, 1986, at 1.

75. Neither the National Association of Securities Dealers, the industry self-regulatory organization that governs trading in the over-the-counter market, nor the American Stock Exchange

forbid their listed firms' ability from adopting dual stock classes with unequal voting rights. Recently, several NYSE-listed firms considered to be likely takeover targets violated exchange rules by adopting dual classes of stock with different voting rights (so-called "super shares") to avoid a hostile takeover. Rather than enforce its rule and lose listings to these competing markets, the NYSE public policy committee is considering changing its rules regarding voting rights for common stock. See BNA Corporate Practice Weekly, supra note __, at 1. Thus, a firm could claim to be bonding itself not to engage in certain defensive tactics by listing on the NYSE, but then jump to another exchange or to the over-the-counter market when a bidder committed itself.

76. See Knoeber, An Alternative Mechanism to Ensure Contractual Reliability, supra note __.

77. Easterbrook, Managers' Discretion and Investors' Welfare, supra note __, at 543-53; See also Jensen, supra note __. Shareholders have other mechanisms besides the market for corporate control to monitor their managers. Frequent trips to the capital markets can be an effective monitoring device. Frank H. Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650, 652-56 (1984). So are outside auditors, independent directors, and management consultants. The market for managerial labor also rewards and punishes managerial performance as appropriate. Shareholders who utilize more of these other monitoring devices will demand less monitoring by

takeover bidders, ceteris paribus, and will want their firms to engage in more defensive tactics. In that way they realize the full value of their own monitoring activities.

78. "Politics is the art of compromise because political outcomes are very indivisible. The greater divisibility of market outcomes makes business the art of serving new wants without compromising old ones." H. Demsetz, Economic, Legal and Political Dimensions of Competition 76 (1982). One should not overstate a firm's ability to "fine tune" the allowable resistance prospectively. But a court is not perfectly foresighted either. Any flexibility provided by court enforcement of a uniform and compulsory no-resistance rule would seem to be less than that provided by a court intrepreting a voluntary no-resistance contract.

79. Baysinger & Butler, Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation, 71 Va. L. Rev. 1257 (1985). Baysinger and Butler note that "many large corporations have adopted charter and bylaw amendments that discourage unsolicited tender offers," but that the adoption of such devices has been only "partial." Id. at 1257, 1259 (citing sources).

80. Alchian & Demsetz, Production, Information Costs and Economic Organization, 62 Am. Econ Rev. 777 (1972); R. Posner, Economic Analysis of Law 369-72 (3d ed. 1986) ("The Corporation as a Standard Contract"); Baysinger & Butler, supra note __.

81. Proper Role, supra note 1, at 1182 (corporate law should "provide standard form 'contracts' of the sort shareholders

would be likely to choose").

82. Id. at 1202.

83. According to Easterbrook and Fischel, target-firm managers create no wealth in the corporate control market. They reduce wealth by resisting takeover attempts, in order to save their jobs. In their model, only bidders create wealth, by locating and acquiring undervalued assets and so transferring them to higher-valued uses. But as discussed in Section II, the takeover process involves inputs from targets, bidders and broker-intermediaries such as investment bankers.

84. See Proper Role, supra note __, at 1169 (benefits of takeovers "could be achieved by friendly merger as well as by hostile tender offer," but a "tender offer is by far the more costly device"). As support for this empirical claim, Easterbrook and Fischel cite a study of tender offer costs, but offer no data concerning the cost of mergers. Id. at n.22.

85. For a summary of the data, see Knoeber, supra note __, at 155 n.1. In 1982, the most recent year reported, tender offers constituted only 4 percent of all acquisition announcements.

86. Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540 (1984).

87. Similar skepticism about the importance, relevance, or even meaning of agency costs is expressed in Demsetz, Structure of Ownership, supra note __; Alchian, Corporate Management and Property Rights, in Economic Policy and the Regulation of Securities (H. Manne ed. 1969).

88. E.g., Hawkins, "Tull Execs Guaranteed Pay for 3 Years in Buy-Out Plan," Atl. Const., March 27, 1985, p. 3-B, col. 5.

89. Jensen & Ruback, supra note __, at 9-16.

90. Easterbrook and Fischel also neglect that management's ability to enhance gains in merger negotiations depends on an ability to resist tender offers. A bidder encountering hard bargaining for a merger can go directly to shareholders by launching a tender offer. A target's tough line in merger negotiations is not credible if management can do nothing against a tender offer to force the bidder back to the merger bargaining table.

By the same token, a bidder's ability to resort to a hostile tender offer tempers the demands that a target can make at the merger table. The recent acquisition of Sperry by Burroughs illustrates how a bidder can try to outmaneuver a target by mixing a hostile tender offer with friendly merger offers. See Crudele, "Persistence Pays Off in Burroughs Deal," New York Times, May 28, 1986, p. 21, col. 4; Buss & Hertzberg, "Sperry Is Said to Meet Today on Higher Bid," Wall St. J., May 27, 1986, p. 3, col. 4.

91. Partly because there are so many reasons explaining corporate takeovers (see notes __ - __, supra), the empirical studies often cannot discriminate between competing hypotheses as to whether particular takeover activities are desirable or not. Roll, The Hubris Hypothesis of Corporate Takeovers, 59 J. Bus. 197 (1986). Further, the empirical evidence itself on the effects of management resistance to takeover bids is complex and

often contradictory. Empirical studies on greenmail, for example, are equivocal, but seem to indicate that firms are better off when a raider buys into a firm and then is paid greenmail for his shares. Macey & McChesney, supra note __, at __ - __. Likewise, shareholders apparently benefit when management resists takeovers ex post by filing antitrust actions. Jarrell, supra note __. Studies of antitakeover amendments, which are ex ante resistance, have generated more inconclusive results. DeAngelo & Rice, Antitakeover Charter Amendments and Stockholder Wealth, 11 J. Fin. Econ. 329 (1983), find that such amendments produce insignificant results on adopting firms' share prices. Linn & McConnell, An Empirical Investigation of the Impact of "Antitakeover Amendments" on Common Stock Prices, 11 J. Fin. Econ. 361 (1983), find that such amendments have significantly positive effects on adopters' share prices. A study by the SEC's Office of the Chief Economist finds that antitakeover amendments have significant, negative effects on firms' share prices, although one sort of amendment, fair-price provisions, has no effect at all. Office of the Chief Economist, Securities and Exchange Commission, "Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980," July 24, 1985 (hereinafter "Shark Repellents"). This evidence is of course inconsistent with the prior two studies, and is especially curious because the amendments studied were "[a]lmost always subject to approval by majority vote of shareholders." Office of the Chief Economist,

Shark Repellents, at 1.

In addition, a defensive tactic may hurt some but not all of the firms that adopt it. This was shown in another study by the Office of the Chief Economist, which looked at share price changes in firms adopting poison pills. The study concluded overall that such devices had significant, negative effects. But it found that of firms adopting poison pills during hostile control battles, the number of firms that lost value when the pill defeated the takeover equaled the number of firms that gained when the pill led to later takeover at a higher price. Such equivocal evidence hardly justifies a rule that supposedly would benefit firms that may not want a poison pill, but would prevent an equal number of firms from using a pill to benefit themselves.

Thus, the empirical case for banning resistance to takeovers is as unsettled as the theoretical argument. But of more importance, most of it is simply irrelevant to our argument here. The typical event study examines the effect of a defensive tactic at the time it is imposed, normally as a response to a takeover bid. E.g., Dann & DeAngelo, Corporate Financial Policy and Corporate Control: A Study of Defensive Adjustments in Asset and Ownership Structure (manuscript 1986) (finding that management response to attempted hostile takeovers by changes in asset or ownership structure has significant, negative effects on firm share prices). Even if agency costs are significant at the time of an attempted takeover, the benefits discussed in Section II of having a bargaining rule in

effect will long since have been incorporated into share prices. An event study at the time of the takeover will miss these benefits entirely.

92. If the interest groups benefitted by the Williams Act are too powerful to permit repeal or modification of their handiwork, they probably can avoid its being gutted indirectly. If so, indirect attacks on the Williams Act are doomed, and ought not occupy our time and energy further.