The Case Against Board Veto in Corporate Takeovers

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

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INTRODUCTION

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

A central issue in the debate has been whether boards should have power to block unsolicited acquisition offers. To some scholars, such power is a serious impediment to efficient corporate governance.[1]

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1 For an early work taking this view, see Frank H. Easterbrook and Daniel R. Fischel, *The*

To others, a board veto is, on the contrary, necessary for effective corporate governance.[2] Whereas opinions on the role of boards in corporate takeovers differ greatly, there is wide agreement about the importance of this subject for corporate governance and for the allocation of corporate assets.[3]

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

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

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

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

3 See William T. Allen, Jack B. Jacobs, and Leo E. Strine, *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U Chi L Rev 1069 (2002) (suggesting that the "great takeover debate" reflects a fundamental struggle between competing models of the corporation and corporate governance). But see Marcel Kahan and Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U Chi L Rev 871 (2002) (arguing that the takeover debate has lost much of its practical significance due to developments in executive compensation schemes).

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

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

There are different ways, some better than others, to introduce winning a shareholder vote as a formal or practical condition for a takeover. Many existing arrangements, both in the United States and Europe, have introduced voting as such a condition. In the United States, most states have control share acquisition statutes that make it practically necessary for a bidder to win a vote in order to gain control.[7] Furthermore, in most states, boards may install and maintain poison pills that prevent an acquisition. The power to maintain pills implies that a hostile bidder would be able to gain control over incumbents' objections only if the bidder first won a ballot box victory to replace the incumbents with directors that would redeem the pill.

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

However, boards in most companies around the United States have some significant veto power that enables them to block for a substantial period of time an offer that could (or even did) win a vote of

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

6 For a formal model that demonstrates the advantages of shareholder voting over tender decisions, see Lucian Arye Bebchuk and Oliver Hart, *Takeover Bids versus Proxy Fights in Contests for Corporate Control*, Harvard Olin Discussion Paper No 336 (2001), available online at <http://papers.ssrn.com/id=290584> (visited Apr 20, 2002). I also argued for requiring bidders to win a vote or some other vote-like test as a condition for an acquisition in Bebchuk, 98 Harv L Rev at 1695 (cited in note 4); Bebchuk, 12 Del J Corp L at 911 (cited in note 4); and Bebchuk, 17 J Legal Stud at 197 (cited in note 4).

7 See Grant Gartman, *State Takeover Laws* §§ A-2 to A-3 (Investor Responsibility Research Center 2000).

shareholder support. Some of this veto power comes from the interaction of the power to maintain pills with some antitakeover charter provisions (the large majority of which had been adopted *before* their antitakeover significance could have been recognized by shareholders). The combination of a poison pill and a staggered board, which exists in a majority of publicly traded firms, is especially powerful in providing boards with a veto power.[8] Incumbents' advisors keep coming up with new ideas for strengthening incumbents' veto power.[9] The push to expand and protect board veto over corporate acquisitions has been much helped by state legislators and courts.

Supporters of board veto have put forward a wide array of arguments in support of their position. They have used these arguments to suggest that boards should have the power to block acquisition offers at least for a substantial period of time. Indeed, in the view of the most well-known and powerful defender of the board veto position, the best regime would have directors elected for five-year terms and granted largely absolute power over acquisition offers made in the five years between elections.[10]

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

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8 See Lucian Bebchuk, John Coates IV, and Guhan Subramanian, *The Anti-Takeover Power of Classified Boards: Theory, Evidence and Policy*, 54 Stan L Rev (forthcoming 2002). This work provides a theoretical account and an empirical confirmation of the powerful antitakeover force of staggered boards. It also reports that 58 percent of the firms in a sample of about 2,400 publicly traded firms had staggered boards. The discussion of staggered boards in this Article, and the proposal discussed below for not allowing directors with a staggered board to maintain a pill after losing one election over a bid, are largely based on this work.

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

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

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

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

Another argument made in favor of board veto is that, because capital markets are not informationally efficient, board veto is necessary to protect shareholders during periods in which shares trade at "depressed" levels significantly below their fundamental value. The presence of such pricing inefficiencies, however, only implies that companies should have complete freedom at any given point in time to choose whether to reject a premium offer and remain independent. This position does not imply by itself that boards rather than shareholders should make such decisions.

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

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

Yet another argument made in favor of board veto concerns its effects on premia in the event of an acquisition. Boards, it is argued, can use their veto power to extract higher premia for shareholders. Having a regime of shareholder voting and no board veto, however, does not imply that management cannot engage in substantial bargaining. Lawyers can and do bargain for their client, for example, even though they generally have no veto power and the client is free to accept settlement offers. Similarly, a regime with shareholder voting and no board veto is consistent with significant bargaining by management on shareholders' behalf for a long period of time, provided only that shareholders are content to have management continue bargaining and do not elect to intervene to take management's bargaining mandate away. Furthermore, whatever extra bargaining lever management might obtain from board veto might be used not to extract a higher premium but rather to obtain a better treatment for management. The empirical evidence has not identified any significant positive effects of board veto on takeover premia and, furthermore, indicates that managers are willing to accept lower premia for shareholders in acquisitions providing more favorable treatment of managers.

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

Concluding that board veto is undesirable from the perspective of target shareholders, I turn to examine the question from other perspectives. In particular, I discuss whether the case for board veto becomes stronger if it is evaluated from (i) the perspective of targets' long-term shareholders, (ii) the perspective of aggregate shareholder wealth (incorporating the effects of board veto on bidders' shareholders), and (iii) the perspective of all corporate constituencies (incorporating effects on targets' stakeholders). I conclude that board veto is unwarranted when examined from any of these perspectives.

Because of the importance in the debate of arguments based on stakeholder interests, I pay significant attention to such arguments.

Even assuming that stakeholders should get some protection beyond the one accorded by their contracts, I argue, support for board veto would not follow; such a veto would not be a good way to address this concern. The overlap between managements' and stakeholders' interests is hardly such that management could be relied on to use its powers to protect stakeholders.

Therefore, those concerned about providing extra protection to stakeholders in corporate acquisitions should focus on acquisitions in general, rather than on hostile acquisitions, and should seek arrangements tailored to address this concern. Concerns about stakeholders do not provide a good basis for expanding the discretionary power of boards in the hope that this would somehow work to the benefit of stakeholders. The debate over board veto, I suggest, does not involve a choice between shareholders and stakeholders but rather a choice between more and less power to management.

Part II ends by discussing the implications of the analysis for the judicial review of defensive tactics. In other work I do some exploring of the best design, starting from a clean slate, of a regime of undistorted choice and no board veto. Here, however, I limit myself to discussing how a move toward such a regime could be accomplished by courts taking as given the basic structure of existing doctrine. In particular, existing doctrine subjects the use of defensive tactics in general and poison pills in particular to a requirement of proportionality to the threat posed, and the analysis below can inform how this requirement is interpreted. In particular, a substantial reduction in board veto power would be achieved by a doctrine that, at least in the absence of explicit shareholder authorization to the contrary, incumbents protected by a staggered board should not be allowed to continue maintaining a poison pill after losing one election fought over an acquisition offer.

Finally, the Appendix to this Article provides a detailed analysis of the recent takeover case of Willamette on which Martin Lipton relies in his response to this Article. I show that, in contrast to Lipton's suggestions, the story of the Willamette takeover does not weaken the case against board veto. Indeed, I argue, it would be valuable for target shareholders if the type of stalling done by Willamette's incumbents were not permitted in the future.

Before proceeding, I wish to note two related issues that my analysis will put aside. I will focus on analyzing the nature of the optimal default arrangement concerning board veto. Although I will discuss what inferences can be made with respect to this question from IPO charters, I will not examine in this work the extent to which opting out of the default arrangement should be permitted and, if permitted, what should be required for such opting out to be valid.[11] Second, I will put aside the question, relevant for both the United States and Europe, of whether the provision of the default arrangement should be done at the federal or state level.[12] Although these two questions are important, my subject can be adequately analyzed without getting into them, and thus I will focus on whether, at least in the absence of appropriate shareholder authorization to the contrary, it would be desirable for boards to have veto power in corporate takeovers.

I. PREREQUISITE: ENSURING UNDISTORTED SHAREHOLDER CHOICE

A. Ensuring Undistorted Choice via Voting

One reason that could be given for granting boards a veto power is a concern that shareholders facing a takeover bid might be unable to exercise an undistorted choice. In the absence of any restrictions on bidders, shareholders might be pressured to tender. The pressure-to-tender problem is by now familiar to students of takeovers, and it can thus be described with brevity.[13] In deciding whether to tender, each shareholder will recognize that its decision will not determine the fate of the offer. The shareholder therefore will take into account the scenario in which the bid is going to succeed regardless of how the shareholder acts. Whenever the expected post-takeover value of minority shares is lower than the bid price, this scenario will exert pressure on the shareholder to tender. As a result, shareholders might tender, and a takeover might occur, even if most shareholders do not view a takeover as being in their collective interest.

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11 Other work in which I discuss these questions include Lucian Arye Bebchuk and Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 Nw U L Rev 489 (2002); Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments,* 102 Harv L Rev 1820 (1989); Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 Colum L Rev 1395 (1989).

12 I discuss this question in other work, including Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv L Rev 1435 (1992); Lucian Arye Bebchuk and Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 Va L Rev 111 (2001); Lucian Arye Bebchuk and Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 Va L Rev 993 (2001); Oren Bar-Gill, Michal Barzuza, and Lucian Arye Bebchuk, *A Model of State Competition in Corporate Law*, working paper (2001), available online at <http://papers.ssrn.com/id=275452> (visited Apr 27, 2002); Lucian Arye Bebchuk and Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition in Corporate Law*, 112 Yale L J (forthcoming 2002); Lucian Arye Bebchuk and Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 Bus Law (forthcoming 2002).

13 For a full account of this problem, see Bebchuk, 98 Harv L Rev at 1717–33 (cited in note 4); Bebchuk, 12 Del J Corp L at 917–31 (cited in note 4). For a formal model of the problem, see Bebchuk and Hart, *Takeover Bids versus Proxy Fights in Contests for Corporate Control* (cited in note 6); Lucian A. Bebchuk, *A Model of the Outcome of Takeover Bids*, Harvard Law School Program in Law and Economics Discussion Paper No 11 (1985) (on file with author).

The pressure to tender is most visible and conspicuous in the case of partial, two-tier bids. In *Unocal*, the landmark takeover case, the potential coercive effect of such a bid was held to pose a substantial threat that justified strong defensive measures.[14] Although the pressure to tender is most visible in such cases, it is in no way limited to them. It can be shown to exist also when bids are for all shares, and when no second-step, low-value freezeout is expected, as long as the expected post-takeover value of minority shares is lower than the bid price.[15]

The approach for addressing the distorted choice problem that I favor is one based on using a voting or vote-like mechanism. Under this approach, the problem is addressed by enabling each shareholder to express separately its preferences with respect to the following two questions: (i) whether it prefers a takeover to take place; and (ii) whether it prefers that its shares be acquired in the event that a takeover takes place. The pressure-to-tender problem essentially results from the fact that even shareholders who wish to answer question (i) in the negative (that is, who prefer that a takeover not take place) might tender and thereby support the bid because of their interest in giving a positive answer to question (ii) to ensure that their shares are acquired in the event of a takeover.

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

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

15 See Bebchuk, 98 Harv L Rev at 1735–42 (cited in note 4); Bebchuk, 12 Del J Corp L at 925–27 (cited in note 4).

B. Can Preventing "Structurally Coercive" Bids Ensure Undistorted Choice?

As I have said, having a vote-like mechanism in place would be the best way of ensuring undistorted choice. Before turning to discuss alternative versions of a voting requirement, however, I wish to consider briefly an alternative approach based on restricting the form that bids may take. In particular, some influential cases and commentators identified distorted choice with the presence of a bid that is "structurally coercive."[16] On this view, in the face of a bid that is "structurally noncoercive"—in particular, a cash bid for all shares with a back-end (that is, a planned freezeout for remaining shares) in cash and at the bid price—shareholders can be expected to exercise undistorted choice.

Although I do not favor this approach to addressing the pressure-to-tender problem, I wish to stress at the outset that Part II's analysis of the case against board veto should still be wholly relevant to readers who do favor this approach. The analysis in that Part suggests that, once a mechanism ensuring undistorted choice is in place, having a board veto is undesirable. If a person favors ensuring undistorted choice by preventing structurally coercive bids and is also persuaded by Part II's analysis, then this person should support a regime combining a prohibition on structurally coercive bids with no board veto.

Having made this point, let me turn to explaining why prohibiting structurally coercive bids does not ensure undistorted choice as effectively as would shareholder voting.[17] Consider a shareholder that must decide at the present time whether to tender to a \$100-per-share bid that, in the event of success, is supposed to be followed in four months by a freezeout at \$100 per share. Supposing that the relevant discount rate of return for this shareholder is 6 percent a year—that is, 2 percent for four months—the freezeout consideration has a present value of \$98. Although the \$2 difference between the present value of the bid price and the freezeout consideration is small, and thus might appear at first sight of little practical significance, it will likely weigh heavily in the shareholder's considerations. The reason is that (i) the scenario in which the shareholder is going to be pivotal has a smaller likelihood than (ii) the scenario in which the offer is going to succeed regardless of how the shareholder acts. And in considering the latter scenario (ii), a 2 percent difference is sufficient to make tendering

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

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

clearly preferable; many financial decisions are influenced by a 2-percent or even smaller difference.

In theory, distortions could be eliminated by ensuring perfect equality—rather than merely rough equality—between the values of the bid price and the freezeout consideration. If such perfect equality were ensured, and if the transaction costs of tendering were zero,[18] then deciding shareholders would be able to ignore the scenario in which the bid is going to succeed regardless of their decision, since the outcome for them in this scenario would be exactly the same regardless of how they act. However, such "knife's edge" conditions of perfect equality are practically unattainable.

It might be thought initially that the necessary conditions can be attained by requiring that the freezeout price be equal to the bid price plus interest. The discount rates of target shareholders, however, are likely to vary considerably and each shareholder's rate might be unobservable. Thus, no interest rate could be set to ensure for *all* shareholders equality between the values of the bid and the freezeout consideration. The decisions of all shareholders for whom such equality is not assured, would be distorted—either in favor of tendering (in case the present value of the freezeout consideration is lower than the bid price) or in favor of holding out (otherwise). Thus, the practical inability of attaining the knife's edge conditions of perfect equality renders the considered approach incapable of removing from shareholders' decisionmaking the scenario in which the bid is going to succeed regardless of the shareholder's decision. Because this scenario is commonly more likely than the scenario in which the shareholder is going to be pivotal, even small deviations from perfect equality might distort outcomes in a big way.

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

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

always would be removed completely from the shareholder's decisionmaking.

C. Alternative Ways of Introducing Voting

Thus far I have spoken abstractly about the benefits of having a voting or vote-like mechanism. Choosing a particular version requires making a number of procedural choices. I explore elsewhere the considerations relevant for the optimal design of the voting procedure. In early work, for example, I discussed an arrangement under which tendering shareholders may tender approvingly or disapprovingly and the bidder may proceed only if a majority of shareholders tendered approvingly.[19] For the purpose of this Article, however, choosing the particular parameters of an optimal voting procedure is not necessary. It still might be useful to give some concreteness to the idea of a voting mechanism by briefly noting some voting arrangements that are in place.

As noted in the Introduction, many states have control share acquisition statutes that practically make it necessary for a hostile bidder to win a vote in order to gain control.[20] Under such statutes, a buyer of a large block of shares may not vote these shares unless such voting is approved by a vote of the other shareholders. This arrangement greatly discourages bidders from purchasing a large block without obtaining in advance a shareholder vote of approval for their being able to vote the purchased shares. Under the statutes, bidders may ask for a shareholder meeting to vote on this matter, and the meeting must take place within a certain period (which in most states is fifty-five days) following such a request. Although the vote formally would be on whether the bidder would be able to use the voting power of shares acquired through its bid, the vote essentially would be a referendum on the offer.

Also, and perhaps most importantly for an analysis of the takeover landscape in the United States, the development of poison pills practically made the winning of a vote a necessary condition for a hostile takeover. In the presence of a poison pill, buying shares beyond a certain limit (which is commonly in the range of 10–20 percent) would

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19 See Bebchuk, 98 Harv L Rev at 1747–52 (cited in note 4). An arrangement of this kind was incorporated into Israel's new corporate code following a proposal by Professor Uriel Proccacia (the code's chief designer) and myself. See Lucian Bebchuk and Uriel Proccacia, *Corporate Acquisitions*, 13 U Tel Aviv L Rev 71 (1988). Another "clean" version of a voting mechanism would allow merger proposals to be initiated and brought for a shareholder vote not only by the board but also by (a sufficient number of) shareholders. See Bebchuk and Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* at 24 (cited in note 6); Lucian Arye Bebchuk, *The Allocation of Power between Managers and Shareholders*, working paper (Nov 2001) (on file with author).

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

be so costly as to make the buyer regret its purchases. Because directors usually can maintain a pill as long as they are in office, a hostile takeover would require that the bidder first replace the directors through a ballot box victory with directors that would redeem the pill. The voting, again, would not be formally on the offer but rather on the election of directors. But the vote would be practically a referendum on the offer; the voting on directors would decide the fate of the offer, would be understood as such, and would be determined by shareholders' judgments concerning the offer.

D. Arrangements with Voting and No Board Veto

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

There are, again, procedural choices that must be made in designing such a regime. For example, how long should the preparatory period be? Should this period be uniform or be determined on a case-by-case basis? How should a vote be triggered? I examine these questions in other work, which explores the possible alternatives and the best design, starting from a clean slate, of such a regime.[21] Below I will put aside such questions because my focus is on the general policy comparison between a regime with and without board veto.

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

To illustrate, let us consider Wachtell, Lipton's second-generation pill. The first generation of pills, one of which was approved in *Moran*,[22] did not impede a buyer's gaining control but only a second-

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21 Bebchuk and Hart, *Takeover Bids versus Proxy Fights in Contests for Corporate Control* (cited in note 6); Bebchuk, *The Allocation of Power* (cited in note 19).

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

step freezeout. In 1987, Wachtell, Lipton recommended to its clients adopting a "second generation" type of pill with a "flip-in" provision making it prohibitively costly for hostile bidders to cross a 20-percent-ownership threshold.[23] Because the *Moran* decision was partly based on the threat of abusive freezeouts, the designers of the new pill sought to "decrease concerns regarding judicial acceptance" of the flip-in[24] and to address "shareholder democracy and fiduciary duty arguments."[25] To this end, the designers of the new pill added to its terms a procedure under which "qualified" bidders would be able to obtain a special shareholder meeting within ninety to one hundred and twenty days from their request, and a majority vote in this meeting against the pill (that is, in favor of the offer) would lead to the pill's redemption.

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

While existing pills do not generally include provisions that enable shareholders to vote to redeem the pill, board veto could be limited or eliminated by courts placing limits on how long a board may maintain a pill. As noted, a majority of publicly traded firms have staggered boards, with a majority of such staggered boards adopted before the developments in takeover jurisprudence that made them so potent. If a board with a staggered structure could maintain the pill indefinitely, a hostile bidder would have to win two elections, one year apart, to gain control. As a result, staggered boards currently provide incumbents with a great deal of power to block bids. This veto power could be much reduced by requiring boards that lose one election over a bid to redeem the pill. Such a requirement would prevent

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

24 Lipton, 136 U Pa L Rev at 70 (cited in note 23) ("[T]o decrease concerns regarding judicial acceptance, the new pill provides that, under certain circumstances, a special shareholders meeting will be held to determine whether the pill should be redeemed.").

25 See Wachtell, Lipton memo (cited in note 23).

boards from using a staggered board-poison pill combination to block an offer that enjoys shareholder support beyond the next annual election.[26] How courts could move toward a regime of shareholder voting and no board veto, taking as given the existing structure of takeover doctrine, is a topic to which I shall return in Part III.G.

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

II. THE CASE AGAINST BOARD VETO

On the view that I label the "board veto" view, boards should have the power to block acquisition offers, at least for a significant period of time beyond what would be necessary for preparing alternative plans and communicating them to the shareholders. I already noted some of the arrangements that currently provide managers with substantial veto power. The ubiquitous staggered board does so whenever directors can maintain a poison pill as long as they remain in office. Similarly, when boards adopt dead-hand pills or slow-hand (delayed-redemption) pills,[27] as they may for sure in some states and possibly in others, boards can completely block, or at least greatly impede, a bid that otherwise would likely win. My interest in this main part of the Article, however, is not in the particulars of veto-providing arrangements but rather in the general question of whether a board veto regime is desirable.

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26 This approach is put forward in Bebchuk, Coates, and Subramanian, 54 Stan L Rev (forthcoming) (cited in note 8).

27 For example, Virginia allows dead-hand pills, the most lethal, see *Chesapeake Corp v Shore*, 771 A2d 293, 322 (Del Ch 2000), and Maryland permits slow-hand pills, see James Hanks, *Something Old, Something New: Maryland's Unsolicited Takeovers Act*, 3 M&A L 12, 12–18 (1999).

Although the board veto view has other supporters,[28] it is most closely associated with Martin Lipton. As inventor of the "poison pill," Lipton made a great practical contribution to incumbents' ability to defend the corporate citadel. In his various writings on the subject, which span more than twenty years, Lipton has put forward a wide array of reasons for why incumbents should have substantial veto power over acquisitions.[29] Below I attempt to consider all of the arguments put forward by Lipton and by other supporters of board veto.

A. Alternative Normative Perspectives

An important premise for any policy analysis is the normative objective in light of which outcomes are evaluated. What counts and what does not count as a benefit depends on the normative perspective used. An examination of the arguments by supporters of board veto reveals that more than one normative perspective has been used.[30] Because I wish to consider the full range of possible arguments for board veto, I will examine the board veto question from each of the four different normative perspectives that have been invoked in the literature.[31] It would be worthwhile to describe briefly at the outset each of these perspectives.

(1) *The perspective of target shareholders:* The rules governing defensive tactics are often analyzed from the perspective of target share-

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

29 These writings start with Martin Lipton's 1979 article, *Takeover Bids in the Target's Boardroom*, 35 Bus Law at 101 (cited in note 2), and the most recent work preceding this Article is Martin Lipton and Paul Rowe, *Pills, Polls, and Professors: A Reply to Professor Gilson*, New York University Working Paper CLB-01-006 (2001), available online at <http://www.stern.nyu.edu/clb/> (visited May 12, 2002). Some of the other important pieces in this series are Martin Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 NYU L Rev 1231 (1980); Lipton, 136 U Pa L Rev at 69 (cited in note 23); and Lipton and Rosenblum, 58 U Chi L Rev at 224–52 (cited in note 10). Lipton responds to this Article's analysis in a new piece published in this Volume. See Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U Chi L Rev 1039 (2002). I discuss some arguments made in Lipton's response in the Appendix to this Article.

30 See Allen, Jacobs, and Strine, 69 U Chi L Rev at 1074 (cited in note 3) (observing that there are different strands in the board-veto camp (referred to by the authors as "the entity model")).

31 By examining the subject from these four normative perspectives, I attempt to respond to the challenge posed by Allen, Jacobs, and Strine, 69 U Chi L Rev at 1072 (cited in note 3), who suggest that the participants in the takeover debate "seem to be talking past each other" because their arguments are based on fundamentally different objectives and normative perspectives.

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

holders. From this perspective, the rules that should govern target boards are those that would best serve the shareholders of these companies. These rules are those that informed and rational shareholders of these companies would have wished to adopt ex ante. In defending board veto from this perspective, supporters have argued that such veto power benefits target shareholders.

(2) *The perspective of targets' long-term shareholders:* Supporters of board veto sometimes draw a distinction between short-term shareholders, which do not plan to hold shares for long and therefore focus on short-term returns, and long-term shareholders, which plan to keep holding their shares and focus on long-run returns. Target boards, supporters of board veto sometimes argue, should give greater weight to the interests of the targets' long-term shareholders.[32] These supporters also believe that there is some divergence of interest between these two categories of investors in the takeover context.

(3) *The perspective of total shareholder wealth:* Another normative perspective is that of aggregate shareholder wealth, which combines the wealth of targets' shareholders and acquirers' shareholders.[33] The use of this perspective might be justified on grounds that most target shareholders hold diversified portfolios and therefore prefer rules that would maximize aggregate shareholder gains rather than gains to targets.[34] Alternatively, the use of this perspective might be justified on grounds that, in setting takeover rules, society should not seek rules that benefit target shareholders but rather ones that increase the total value of the corporate sector.

(4) *The perspective of all corporate constituencies:* Supporters of board veto have also argued that it would serve the interests of nonshareholder constituencies, such as employees, suppliers, host communities,

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32 See, for example, Lipton, 136 U Pa L Rev at 36 (cited in note 23) ("[T]hose who choose to invest for the long-term are surely deserving of management consideration."). Compare Allen, Jacobs, and Strine, 69 U Chi L Rev at 1084 (cited in note 3) (discussing the concern that a regime of shareholder choice would let "short-term" stockholders cause a sale of the corporation for a "one-time profit").

33 Allen, Jacobs, and Strine, 69 U Chi L Rev at 1079 (cited in note 3), discuss this perspective and view it as potentially more favorable to board veto than the perspective of target shareholders. The perspective of total shareholder wealth was also used in the early work of Easterbrook and Fischel. See, for example, Easterbrook and Fischel, 94 Harv L Rev at 1175 (cited in note 1) ("Even resistance that ultimately elicits a higher bid is socially wasteful [because] [a]lthough the target's shareholders may receive a higher price, these gains are exactly offset by the bidder's payment and thus by a loss to the bidder's shareholders.").

34 See Allen, Jacobs, and Strine, 69 U Chi L Rev at 1077 (cited in note 3); Frank H. Easterbrook and Daniel R. Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 Stan L Rev 1, 7–9 (1982) (arguing that shareholders, who do not know whether their firm will be a target, a bidder, or a bystander, are best off under the legal or contractual rule that maximizes total shareholder wealth). For a critique of this basis for using the perspective of aggregate shareholder wealth, see Bebchuk, 35 Stan L Rev at 27–30 (cited in note 31).

and so forth.[35] Therefore, another perspective that I will use to evaluate board veto is that of the aggregate wealth of all corporate constituencies, including both shareholders and stakeholders.

Supporters of board veto have not generally taken a clear position on which perspective is the decisive one. Indeed, because they have not conceded that board veto is undesirable from any one of the above four perspectives, they have not had to make such a choice. Invoking several normative perspectives provides these supporters with fallback positions—even if board veto were identified as undesirable for target shareholders, they could retreat to the view that such veto would be justified from the perspective of long-term shareholders. And even if board veto were identified as undesirable for any significant group of target shareholders, they could still retreat to defending it on grounds of aggregate shareholder wealth or the aggregate wealth of all corporate constituencies.

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

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

1. Ex post agency costs.

Although the ex post agency problem is a serious one, it is conceptually simple and thus can be described with brevity. The takeover context is one in which managers' and shareholders' interests often diverge. Managers might lose their control and the private benefits associated with it. To use the language of *Unocal*, the takeover context con-

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[35] See, for example, Lipton, 35 Bus Law at 105–06 (cited in note 2); Lipton, 136 U Pa L Rev at 36–39 (cited in note 23); Blair and Stout, 85 Va L Rev at 287 (cited in note 28). See also Allen, Jacobs, and Strine, 69 U Chi L Rev at 1083 (cited in note 3) ("Judges presented with a takeover case, are unavoidably aware that interests of more than stockholders are usually at stake.").

fronts us with "the omnipresent specter that a board may be acting primarily in its own interests."[36]

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

Lipton and Rowe recently argued that the absence of legal cases condemning incumbents' standing behind pills is evidence that directors have in fact used their powers responsibly; the absence of such cases, they believe, indicates that the "pill has been used; it has not been abused."[37] But the absence of such court cases does not indicate whether shareholders have been hurt. Once judicial standards are established, incumbents can be expected not to deviate from them. Thus, absence of violations merely indicates that incumbents and their advisers can predict what actions would withstand judicial scrutiny.

Whereas the incidence of judicial condemnation does not provide a test for the presence of agency costs, there is other evidence that these costs are significant. To start with, the evidence indicates that, in the event that incumbents use their veto power to defeat bids, shareholders end up worse off compared with the scenario in which the bid would have been accepted. Studies indicate that, when target managers defeat offers, shareholders on average experience a significant stock market loss. For example, Cotter and Zenner found that when offers are defeated shareholders suffer a 21 percent decline in their stock price.[38]

It might be objected, however, that incumbents' resistance should be evaluated by its effects on shareholders' wealth in the long-term rather than short-term. In a recent empirical study on staggered boards, Coates, Subramanian, and I therefore studied how the defeat of bids affected shareholders when evaluated from a long-term perspective.[39] We examined hostile bid cases during the period 1996–2000

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36 *Unocal*, 493 A2d at 954.

37 Lipton and Rowe, *Pills, Polls, and Professors* at 19 (cited in note 29).

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

39 See Bebchuk, Coates, and Subramanian, 54 Stan L Rev (forthcoming) (cited in note 8) (section IV.C). Note that this evidence indicates that, even compared with a state of affairs in which all these companies would have been acquired, the instances of bid rejection and remaining independent produced on average significant losses to shareholders. The losses produced by

in which targets remained independent. We found that, evaluated thirty months after the bid's announcement, the shareholders of targets remaining independent were on average substantially worse off compared with the scenario in which the bid would have been accepted. To illustrate, in the period we studied, we estimated that the average return to target shareholders during the thirty months following the offer was 54 percent higher for targets that were acquired than for targets that remained independent.

Additional evidence of the agency problem is provided by studies examining the circumstances in which incumbents are likely to resist bids. An early study by Walkling and Long indicated that the probability of a hostile reaction by incumbents is negatively related to the effect of the acquisition on managers' financial interests.[40] Subsequently, Cotter and Zenner found that managers are more likely to resist offers when they have smaller holdings (and their interests thus overlap less with those of the shareholders).[41]

Finally, the presence of ex post agency costs is also suggested by evidence that managers might be willing to trade off premia to shareholders for personal benefits. A recent study by Hartzell, Ofek, and Yermack found that target CEOs are willing to accept lower acquisition premia in transactions that involve an extraordinary personal treatment (such as special payments to the CEO at the time of the acquisition or high-ranking managerial post in the buyer).[42] Another study by Wulf indicated that, in merger negotiations, CEOs are willing to trade off higher acquisition premia in exchange for better managerial positions in the merged firm.[43]

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defeating bids might have been even greater in comparison to a state of affairs in which shareholders would have made choices whether to reject the offer. To the extent that shareholders would have rejected some bids in this state of affairs, those bids that were relatively less attractive would have been more likely to be rejected.

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

41 See Cotter and Zenner, 35 J Fin Econ at 95 (cited in note 38).

42 See Jay Hartzell, Eli Ofek, and David Yermack, *What's in It for Me?: Personal Benefits Obtained by CEOs Whose Firms Are Acquired* at 21, working paper (2000), available online at <http://papers.ssrn.com/id=236094> (visited Feb 12, 2002).

43 See Julie Wulf, *Do CEOs in Mergers Trade Power for Premium?: Evidence from "Mergers of Equals"*, working paper (2001), available online at <http://knowledge.wharton.upenn.edu/show_paper.cfm?id=1009> (visited Feb 12, 2002). Some of the famous takeover cases nicely illustrate the weight that CEOs give in takeover negotiations to their managerial position in the merged firm. In *Paramount Communications, Inc v Time Inc*, 571 A2d 1140 (Del 1989), one of the sticking points in the negotiations was which managerial team would be more dominant following the combination of Time and Warner. See id at 1144 (recounting how, before the merger, the consensus among Time's board members was that "a merger of Time and Warner was feasible, but only if Time controlled the board of the resulting corporation"). In *QVC v Paramount*, 635 A2d 1245 (Del Ch 1993), Herb Wachtell argued for QVC that, in seeking to facilitate an acquisition by Viacom, Paramount's CEO was motivated by his desire to become CEO of Paramount/QVC. See

2. Ex ante agency costs.

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

Conversely, by eliminating or reducing the threat posed by a takeover, board veto provides managers with security that in turn could produce significant agency costs. With a veto power, managers might contemplate that, even if they perform poorly and a takeover bid follows, their power will enable them either to retain their control or at least to extract a good deal for themselves. Either way, the presence of a board veto eliminates or much reduces any adverse effect that a takeover might otherwise have on managers' interests. As a result, the takeover threat will lose much of its disciplinary power. Board veto might thus weaken incentives to avoid managerial slack, consumption of private benefits, empire-building, and other actions that are beneficial or convenient for managers but costly to shareholders.

The evidence indicates that insulation from the threat of a takeover does indeed have such adverse effects. Studies by Bertrand and Mullinathan and by Garvey and Hanka found that stronger protection from antitakeover statutes causes increases in managerial slack.[44] Gompers, Ishii, and Metrick found that companies whose managers enjoy more protection from takeovers (as measured by a governance index taking into account both corporate arrangements and state antitakeover provisions) are associated with poorer operating performance—including lower profit margins, return on equity, and sales growth.[45]

There is also evidence that insulation from takeover threats results in greater consumption of private benefits by managers. Borokhovich, Brunarski, and Parrino found that managers with stronger antitake-

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id at 1248 (noting "Mr. Davis's insistence that he become CEO").

44 See Marianne Bertrand and Sendhil Mullinathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 Rand J Econ 535 (1999) (finding that the adoption of antitakeover statutes weakened managers' incentives to minimize labor costs); Gerald T. Garvey and Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J Fin 519, 520 (1999) (concluding that antitakeover statutes "allow managers to pursue goals other than maximizing shareholder wealth").

45 See Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, NBER Working Paper No 8449 (2001), available online at <http://papers.nber.org/papers/w8449.pdf> (visited Apr 19, 2002).

over defenses enjoy higher compensation levels.[46] Bertrand and Mullinathan obtained similar findings for managers that are more protected due to antitakeover statutes.[47] Finally, Gompers, Ishii, and Metrick found that companies whose managers enjoy more protection from takeovers are more likely to engage in empire-building.[48]

C. The Target Shareholders' Perspective: Arguments for Board Veto

1. Analogies to other corporate decisions.

Before examining arguments that "start from first principles," I wish to consider first a common and influential claim that is based on an *analogy* to other corporate law decisions. Board control, it is argued, characterizes corporate decisionmaking in general. Indeed, for most corporate decisions, management has not merely veto power but rather the power to make the decision either way. When a corporation faces a choice, say, whether to undertake a major investment in a new plant or a new product, directors have the power to make the decision, either way, generally without any intervention from either courts or shareholders. Why should we rely on managers for other corporate choices, supporters of board veto ask, but not for decisions on takeovers?[49] If one accepts that delegation to boards works well in other contexts, so the challenge goes, are there any good reasons to view the takeover context as sufficiently different?

In fact, there are important differences, which call for a different treatment, between the takeover context and that of corporate decisions such as the investment decisions noted above. To begin, the concern that managers' and shareholders' interests might diverge is greater in the takeover context. Because managers' control is at stake in the takeover context, managers' preferences in this context are likely influenced by their private interests. In contrast, a divergence of interest is less likely to arise, and if it arises to be of great magnitude, in corporate contexts such as the considered investment decision. Therefore, given managers' common ownership of shares and options, as well as their general interest in making the shareholders content, man-

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

47 See Marianne Bertrand and Sendhil Mullinathan, *Executive Compensation and Incentives: The Impact of Takeover Legislation*, NBER Working Paper No 6830 (1999), available online at <http://papers.nber.org/papers/W6830> (visited May 12, 2002).

48 See Gompers, Ishii, and Metrick, *Corporate Governance and Equity Prices* at 31–32 (cited in note 45).

49 See Lipton, 35 Bus Law at 104 (cited in note 2) ("Takeover bids are not so different from other major decisions as to warrant a unique sterilization of the directors in favor of direct action by the shareholders.").

agers will likely focus on enhancing shareholder value in such other corporate contexts. They might err and therefore make incorrect decisions. But their decisions are unlikely to be distorted substantially by their private interests.[50]

Second, in other contexts, such as the investment context considered above, letting the shareholders of a publicly traded company make the decision is not a viable option. In contrast, in the takeover context, letting the shareholders decide is a viable and practical option. Experience indicates that proxy contests conducted over an acquisition offer draw heavy participation by shareholders. The question remains, of course, whether shareholders would make good decisions, and I will consider this question below. But the fact that letting the shareholders make the decision is a viable option in the takeover context clearly distinguishes it from other contexts.

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

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

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

discipline.[51] Thus, not having board veto over takeovers in fact contributes to the case for board control in other corporate contexts.[52]

2. Inefficient capital markets.

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

Let us start with the claim that board veto is called for by rejection of the efficient capital markets hypothesis.[53] On this view, board veto can address situations in which a company's stock is trading at a "depressed" level below its fundamental value.[54] "[M]ust we accept (and make boards accept) short-term trading value as the sole reference point in responding to takeover proposals?" supporters of board veto ask.[55] A negative answer to this question, they believe, calls for a board veto.

There are indeed good reasons to doubt the extent to which market prices generally reflect fundamental values. The efficient capital market hypothesis has been questioned by a large body of work in financial economics.[56] The recent burst of the Internet bubble has provided a vivid illustration that stock prices may deviate from fundamental values. As explained below, however, accepting that capital markets are not generally informationally efficient, as the Delaware courts have done,[57] does not imply that board veto is desirable.

To be sure, the stock market's informational inefficiency undermines the passivity approach of Easterbrook and Fischel, who believe that a takeover at a premium over the pre-bid market price is bound to

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

52 While the above analysis suggests that the takeover context should be an exception to the general principle of board control, I do not wish to imply that it must be the *only* exception. I discuss the desirable scope of exceptions to board control in Bebchuk, *The Allocation of Powers between Managers and Shareholders* (cited in note 19).

53 See, for example, Lipton and Rowe, *Pills, Polls, and Professors* at 8, 16 (cited in note 29) (equating opposition to defenses with support for the efficient market theory).

54 See, for example, Lipton, 35 Bus Law at 108 (cited in note 2).

55 Lipton and Rowe, *Pills, Polls, and Professors* at 30 (cited in note 29).

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

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

increase shareholder wealth and efficiency.[58] Such informational inefficiency also significantly weakens the case for the auctions approach; some of the likely causes of this inefficiency, such as limited arbitrage, might also indicate that auctions might not always fetch a price that equals or exceeds the target's independent value.

Acceptance of informational inefficiencies, however, is consistent with a regime of shareholder voting and no board veto. In such a regime, targets of hostile bids will not be necessarily acquired for the highest price that would be offered for them in a market that might be temporarily depressed. Shareholders would vote down any premium offer if they believed that, although significantly above the target's temporarily depressed price, it falls below the target's fundamental value, which would be eventually reflected in market prices if the target were to remain independent.[59]

That shareholders' decisions might discriminate in this way is nicely illustrated by comparing shareholders' reactions to the recent hostile bids for Shorewood and Willamette, two targets that had substantial antitakeover protections.[60] In both cases, the hostile bidders offered a substantial premium over the pre-bid market price of the target, though not over its historic price. In both cases, the board rejected the offer as inadequate on grounds that the stock market was greatly undervaluing the target's shares. In the case of Shorewood, shareholders apparently shared the view that the premium bid price was below the target's value, and only 1 percent of the targets' shares were tendered to the bidder.[61] In contrast, in the case of Willamette, shareholders took a different view, and the bidder attracted 45 percent of the shares initially and, after the bid price was raised somewhat, 64 percent of the shares.[62]

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

59 It might be objected that, if shareholders viewed the market price as depressed, they themselves would keep buying shares, and the price would keep going up. But this argument ignores risk aversion and liquidity constraints on the part of the shareholders. More importantly, the critical question is not what shareholders' views were prior to the bid but rather what their views will be when making voting decisions. At this point, shareholders will be able to draw on the information produced by the very making of the bid, the communications and recommendations of the board, and other information produced during the takeover contest.

60 See *Chesapeake Corp v Shore*, 771 A2d 293, 296 (Del Ch 2000); Jim Carlton and Robin Sidel, *Willamette Agrees to Be Bought by Weyerhaeuser*, Wall St J A3 (Jan 22, 2002).

61 See *Chesapeake*, 771 A2d at 314.

62 See Robin Sidel, *Weyerhaeuser Fails to Win Willamette Mandate*, Wall St J A4 (May 22, 2001) (reporting that 45 percent of Willamette's shareholders tendered into Weyerhaeuser's $50-per-share offer); *Weyerhaeuser Bid Wins 64% Support in Target Company*, Wall St J B8 (Jan 11, 2002) (reporting that the percentage of shares tendered increased to 64 percent following the raising of Weyerhaeuser's bid). A detailed examination of the Willamette case is provided by the Appendix.

Thus, shareholders might sometimes accept, and might sometimes reject, claims that a premium offer is inadequate because the prebid market price was highly depressed. Therefore, even if we do not accept short-term value "as the sole reference point in responding to takeover proposals," board veto does not necessarily follow. The question would still remain who—shareholders or directors—should decide whether a given takeover proposal is worth accepting. Accepting that capital markets might be informationally inefficient does not by itself compel or suggest an answer to this question. To be sure, supporters of board veto might take the additional position that boards would make such decisions better. This is the claim to which I shall now turn.

3. Directors' superior information.

a) The threat of an inadequate offer. Whether a takeover would benefit shareholders depends on how the offered acquisition price compares with the target's value in the event that it remains independent at least for the time being. This "independent value" of the target includes both the value of the possibility of remaining independent for the long haul and the value of the possibility of receiving higher offers later on.[63] Because managers might have superior information about the target, supporters of board veto suggest, managers would be in a better position to estimate the target's independent value. Accordingly, it is argued, shareholders' interests would be served by delegating the decision to the board.[64]

That managers might sometimes be better informed has been long accepted by takeover law.[65] The Delaware courts have viewed as plausible and legitimate directors' concern that shareholders might mistakenly view as adequate an offer that is, in fact, inadequate according to directors' superior information.[66] The danger that imperfectly informed shareholders will accept an inadequate offer has been referred

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

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

65 See *Paramount Communications, Inc v Time Inc*, 1989 Del Ch LEXIS 77, *56 (Allen) ("No one, after all, has access to more information concerning the corporation's present and future condition [than managers].").

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

to, using a term coined by Ronald Gilson and Reinier Kraakman, as "substantive coercion."[67]

b) Does informational advantage warrant a board veto? I agree that target managers often have private information, both hard and soft, that public investors do not possess. Managers also might have devoted more time and effort to assessing the body of information about the company that is publicly available. Managers' superior information might indicate to them that the target's independent value is lower or higher than the level estimated by the target's shareholders. The possibility that shareholders will overestimate the target's value cannot provide a basis for board veto. But can the possibility that shareholders will underestimate the target's value provide such a basis? As I explain below, the answer is no.[68]

Note first that, even accepting that directors sometimes have better informational basis for comparing the bid price and the target's independent value, they do not have the *best incentives* for making the right decision. Thus, a regime with board veto moves decisionmaking to a party that might be better informed but also has worse incentives. Directors might use their veto power not (or not only) for the intended purpose of blocking inadequate offers, but also to block offers that would be beneficial to shareholders. This concern is real and significant because the claim of offer inadequacy is one that incumbents can generally raise, and that would be hard to falsify, whenever they prefer their independence.[69] In contrast, if shareholders had decisionmaking power, they might sometimes be less informed, but they would never have a reason to reject an offer that they view as beneficial to shareholders.

The above discussion indicates that board veto might well be unwarranted even if we assumed that directors' superior information would go totally unused in a regime of shareholder voting and no

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

68 The analysis below responds to the concern expressed by Allen, Jacobs, and Strine, 69 U Chi L Rev at 1084 (cited in note 3), that those opposed to board veto "seem to give little credit to the fact that directors have much greater access to information flows respecting business prospects and values." Fully accepting this fact, the analysis below shows that it does not undermine the case against board veto.

69 As was observed by Vice Chancellor Strine: "It is important to recognize that substantive coercion can be invoked by a corporate board in almost every situation." *Chesapeake Corp v Shore*, 771 A2d 293, 327 (Del Ch 2000). Note that the raising of a false claim cannot be discouraged by fears that even if the claim is not demonstrably false when made, it will become so down the road. Suppose that managers block an offer of $100 per share on grounds that the target's independent value is $120 per share, and suppose that the market price three years down the road will be $90 per share. Managers still will be able to defend their earlier estimate: The $120 per share estimate was accurate at the time it was made, they will argue, but it was an expected-value estimate; the price after three years has fallen below this expected value because uncertainty has been resolved unfavorably.

board veto. Such a regime, however, would not imply that directors' superior information would generally be wasted. It only would preclude directors from blocking offers on grounds that they have such information. But such information could and would likely be used as a basis for directors' communications and recommendations to shareholders.

To begin, following the making of an offer, directors can and often do provide shareholders with new information, sometimes backed by investments bankers' opinions, about the target's independent value and how it compares with the offered price. Such communications might close or significantly reduce whatever information gap existed between management and public investors prior to the offer.

Of course, in some circumstances, incumbents might be unable to communicate the information underlying their high estimate of value because business considerations require secrecy[70] or because the information is difficult to disclose credibly.[71] In such cases, incumbents can still communicate to the shareholders their estimate for the target's value and their recommendation to reject the offer.

In the face of such a communication from directors, rational shareholders can be expected to balance two considerations. On the one hand, they will recognize that directors might be better informed; that shareholders are imperfectly informed about the target's value hardly implies that they are unaware that this is the case. This consideration would weigh in shareholders' decisionmaking in favor of deferring to the directors.

On the other hand, shareholders will also take into account considerations that weigh against deferring to the directors. First, directors might have self-serving reasons for preferring independence. Furthermore, like other humans, the directors might make mistakes and might suffer from a cognitive-dissonance tendency to view favorably both their own past performance and the course of action serving their interests. As Chancellor William Allen wisely remarked in *Interco*: "[H]uman nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial."[72]

In balancing these considerations, shareholders will consider various circumstances of the particular case facing them. Among other

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

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

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

things, shareholders might take into account the following factors: their own estimate of the target's value (if it is just below the bid price, for example, the risk of deferring to the board is small); how likely the managers are to have private information of substantial import for the target's value (which in turn might depend on the nature of the company's business); and the estimated magnitude of management's divergence of interest (the more shares the managers hold, for example, the smaller the likely divergence of managers' and shareholders' interests).

It is worth noting that in a regime with no board veto, managers that view the target's independent value as significantly higher than the bid price might elect to take steps that would credibly signal that their recommendation is indeed based on their genuine estimate of the target's value. For example, managers could so signal by committing themselves, in the event that the bid fails, to spend some of their own funds to purchase from the company *at the bid price* some specified number of shares and hold them for a specified period of time. Such an investment would be profitable if and only if the target's independent value exceeded the bid price. Accordingly, a commitment to make such an investment would provide a credible signal that managers genuinely view the target's independent value so favorably. Under a regime with no board veto, managers might elect to make such a commitment when they believe remaining independent would be indeed beneficial.[73]

In any event, after balancing the considerations for and against deferring to the directors, rational shareholders might sometimes conclude that deference would be best on an expected-value basis, and might sometimes reach the opposite conclusion. Of course, shareholders might not always get it right. But given that their money is on the line, shareholders naturally would have incentives to evaluate the tradeoff as well as possible.[74]

In contrast, a board veto regime mandates deference to the directors as a general rule. A board veto regime and a shareholder voting

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

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

regime would produce different outcomes only in those cases in which shareholders would elect not to defer if the decision were left with them. Thus, to prefer a board veto regime one would have to believe that—due to ignorance of their imperfect information, irrationality, or hubris—shareholders would be making the wrong choice in most of these cases. That is, one would have to believe that shareholders' decisionmaking on whether to defer would be so flawed that tying shareholders' hands and mandating general deference to boards would make shareholders better off.

Although target shareholders are often less informed than management about the target's value, there is little reason to view shareholders as unaware of this state of affairs or as likely to ignore it out of hubris, irrationality, or otherwise. Target shareholders do not seem to be a group for which paternalistic hands-tying is warranted. As the United States Supreme Court stated in *Basic Inc v Levinson*, management should not "attribute to investors a child-like simplicity."[75]

The substantial presence of institutional investors makes paternalistic mandating of deference especially unwarranted. Institutions are likely to be aware of the informational advantage that management might have, and they appear capable of making reasonable decisions on whether deferring to the board would be best overall. Some institutional investors conduct their own analysis, and some rely on proxy-advisory firms such as Institutional Investors Services, which researches questions put to a shareholder vote and recommends to institutions how to vote.[76] There is little reason to believe that the decisions of institutional investors on whether to defer would be so poor that mandating deference would be preferable to letting them make such decisions.[77]

Finally, voting shareholders can hardly be regarded as a group that is excessively reluctant to defer to managers. Indeed, the normal patterns of corporate voting indicate that shareholders, including institutions, commonly display a great deal of deference to management's views. Thus, if anything, there are grounds for concern that voting

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75 *Basic, Inc v Levinson*, 485 US 224, 234 (1988), quoting *Flamm v Eberstadt*, 814 F2d 1169, 1175 (7th Cir 1987).

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

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

shareholders might be excessively deferential. But that is, of course, not a reason to mandate deference. When circumstances would lead shareholders to overcome the tendency to defer to management, imposing deference on them would be unlikely to be beneficial.[78]

In assessing the arguments for and against board veto, Allen, Jacobs, and Strine wonder "whether shareholders have sufficient information and appropriate incentives to determine, equally or more competently than directors, whether the corporation should be sold."[79] On the view that I put forward above, however, the important question is not who can better judge whether the company should be sold, but rather who should decide whether deference will be given to the more informed but possibly conflicted directors. Shareholders have the best incentives to make this decision in a way that would serve their interests, and they should be permitted to make it.

c) Some evidence. It is worth noting that the case against mandated deference is supported by the existing evidence. When incumbents defeat offers, shareholders experience on average a significant decline in stock value,[80] a pattern that is consistent with the proposition that mandating deference makes shareholders worse off.

To be sure, supporters of board veto can rightly object that this evidence does not fully respond to their claim because it refers to short-term results. On their view, investors' possible underestimation of a target's long-term value is the very reason for board veto, and short-term declines in stock price thus do not rule out the possibility that the defeat of offers by incumbents ultimately pays off. As already noted, the staggered boards study done by Coates, Subramanian, and myself examined long-term returns and found no such long-term payoff. To the contrary, we found that thirty months after the bid announcement, the shareholders of targets that remained independent obtained on average a significantly lower value than they would have obtained had the board agreed to be acquired.[81]

d) Judicial screening of inadequate offer claims. In response to the above analysis, it might be suggested that board veto should not be allowed when directors simply assert that the offer is inadequate but

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78 See, for example, Lucian Arye Bebchuk and Allen Ferrell, 87 Va L Rev at 995–96 (cited in note 12). In this work, we defend a proposal to allow shareholders to vote to opt into a different takeover regime against a critique by Stephen J. Choi and Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 Va L Rev 961, 985–86 (2001). Responding to Choi and Guzman's claim that voting shareholders display deference to managers, we argue that such deference implies at most that shareholders might use their voting power less often than optimal but not that they should not have this power.

79 Allen, Jacobs, and Strine, 69 U Chi L Rev at 1085 (cited in note 3).

80 See Cotter and Zenner, 35 J Fin Econ at 86 (cited in note 38).

81 See Bebchuk, Coates, and Subramanian, 54 Stan L Rev (forthcoming) (cited in note 8).

should be permitted when they provide a particularized analysis in support of their view that the target's value is substantially higher than the bid price. This approach was put forward in an influential article by Gilson and Kraakman.[82] Recognizing the potential for abuse from allowing board veto based on mere assertions of offer inadequacy, Gilson and Kraakman suggested allowing such veto only when such assertions are judged (by a court) to be sufficiently substantiated and weighty. On their view, requiring such a particularized and substantial showing would screen out the instances in which board veto would be undesirable.

Chancellor Allen's famous opinion in *Interco* indeed subjected claims of offer inadequacy to judicial scrutiny. In that case, Allen did not permit a board to veto an offer of $74 per share in order to pursue a business plan that an investment banker estimated would produce a value of "at least" $76 per share. Confronting these numbers, Allen found the threat of offer inadequacy to be too mild to justify a board veto.[83] He left open, however, the possibility that the threat of substantive coercion could justify a veto in other circumstances, such as a case in which the company's investment banker would provide an estimated independent value greatly exceeding the offer price.

Consider a "screening" rule under which courts will permit a board veto if: (1) directors provide a particularized analysis—say, in the form of an investment banker opinion—of their estimated target value in the event of bid rejection; and (2) this estimated value or range of values is substantially higher than the offer price. Imposing such limits on claims of offer inadequacy clearly would eliminate some (and possibly the worst) cases of abuse. However, this rule would still provide an unnecessary "safe harbor" for offer inadequacy claims. It would be better to let shareholders rather than courts engage in the screening of such claims.[84]

Consider a target that was trading at $70 per share and received a hostile bid of $100 per share. Suppose that management subsequently put together an alternative business plan, and that the company's investment banker provided an opinion giving an estimated range of

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

83 *Interco*, 551 A2d at 799.

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

$120 to $130 per share (in present value terms) for the value that the target will have if it remains independent. Should blocking of the offer by the board be permitted (as the considered screening rule would do)?

Note that, in a regime of shareholder voting and no board veto, the $100-per-share bid would not necessarily win. The shareholders might be persuaded by the board's recommendation and the investment banker's opinion and might vote to reject the offer. In the absence of a board veto, however, voting shareholders might also decide not to accept the board's recommendation to remain independent. With due respect to investment bankers' opinions, their estimates are hardly money in the bank.[85] There is substantial room for discretion in financial estimates, and two analysts who use standard and accepted methodologies may reach very different estimates.[86] Furthermore, the investment banker hired by management might have an incentive to help it as long as the banker would not have to bear reputational costs; thus, the banker would have an incentive to come out with the highest estimate that can be justified using legitimate methodologies.[87]

Compared with a regime of shareholder voting and no board veto, the screening rule would produce different outcomes only in those cases in which shareholders otherwise would elect to accept the bid notwithstanding the board's recommendation and the investment banker's opinion. In such cases, however, why should deference to the directors and their investment banker be imposed on shareholders, as the screening rule would do? Essentially, a regime of shareholder voting and no board veto does not imply that there would be no screening of boards' inadequacy claims but rather that *shareholders* would be the ones doing the screening. The factors that courts would weigh under the screening rule might well be ones that would also guide the shareholders' screening decisions. The critical point, however, is that

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

86 See Bebchuk and Kahan, 1989 Duke L J at 29–37 (cited in note 85). See also *Interco,* 551 A2d at 799 (discussing the big difference between the estimates offered by the investment banker hired by the target's management and the one hired by the plaintiff in the case).

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

there is no reason to have the courts rather than shareholders screen boards' claims of offer inadequacy.

Thus, although at first sight the screening rule seems consistent with the tendency of courts to defer to business decisions made by market participants, it is not. If courts were to decide whether directors have a sufficiently substantiated case that remaining independent would be worthwhile, they would be substituting their judgment on this question for that of the shareholders. Given that courts do not have any clear advantage over shareholders in assessing offer inadequacy claims, courts should not take such decisions away from shareholders.[88]

4. Bargaining by management.

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

Management's bargaining is possibly beneficial, it is argued, because target shareholders are dispersed and therefore unable to bargain effectively. If management is given veto power, it could act as a single and effective bargaining agent on behalf of the shareholders. Therefore, so the argument goes, board veto enables managers to extract through bargaining a higher price—and thus a larger fraction of the surplus produced by the acquisition—than shareholders would obtain otherwise.[89] Note that an increased premium at the expense of the acquirer would not count in an evaluation from the broader perspective of aggregate shareholder wealth. This perspective will be considered, however, in Part II.E. For now, we are evaluating board veto from the perspective of target shareholders, and higher premia do count as a benefit for these shareholders.

There are reasons, however, to doubt the presence, or at least the significance, of the bargaining advantage that a board veto regime is

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

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

claimed to have. To begin, a regime of shareholder voting and no board veto is consistent with substantial bargaining by management on behalf of the shareholders. Such a regime would merely imply that shareholders would have the power, if they so chose, to take the bargaining mandate from management. Thus, the difference between a board veto regime and a regime with shareholder voting and no board veto is only that the former grants management an irreversible mandate to bargain whereas the latter gives management a mandate to bargain that is reversible.[90]

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

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

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

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[90] Note some similarity between the argument in Part II.C.4 that a regime with shareholder voting and no board veto is consistent with managers' contributing bargaining skills and the argument in Part II.C.3 that such a regime is consistent with manager's contributing their informed estimates. In both cases, my claim is that such a regime does not require forgoing all that management has to offer. Rather, such a regime mainly gives shareholders a choice whether to accept management's claims that it has better information or that it can obtain more value through bargaining.

Furthermore, in examining the question whether an irreversible bargaining mandate is the optimal strategy in the context of corporate takeovers, we should take into account that this context is one afflicted by significant agency problems. Given the agency problems, such a mandate might have two adverse effects. First, management might use an irreversible mandate not to extract a higher premium but rather to prevent a takeover altogether. Under a regime with a reversible mandate, shareholders would be able to limit such an abuse either by taking the bargaining mandate from management at some point or by refraining from doing so only if management constrains itself by committing to a price it would accept if offered.[91]

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

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

Supporters of board veto argue that the evidence shows that such veto has a substantial positive effect on premia.[92] They rely on early studies by Georgeson & Company that found an association between poison pills and higher premia in acquisitions.[93] Comment and Schwert, in a more systematic study, also found an association between pills and premia.[94]

As recent work by Coates shows, however, the findings of the above studies provide no basis for inferring that the presence of pills produces higher premia due to the bargaining power provided by pills.[95] Because every company can install a pill overnight, having the

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91 Consider our example, and suppose that the acquirer's current offer is $120 per share. If managers are concerned that shareholders might take away the bargaining mandate from them because of shareholders' concerns that the managers might be seeking an indefinite delay, managers might state that they would agree to a price of $140 per share if offered.

92 See, most recently, Lipton and Rowe, *Pills, Polls, and Professors* at 24–25 (cited in note 29).

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

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

95 See John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific*

pill already in place does not affect the power that management would have to block a hostile bid should it occur. Both companies with and without pills in place have pills available to them if needed to block a bid. Thus, the difference in premia found in the above studies between these two types of companies could not have resulted from the bargaining advantage of pills. The difference in premia presumably reflected whatever differences in characteristics and circumstances led firms to make different choices whether to install a pill or keep it on the shelf.

Because companies with a pill already installed do not stand out in terms of managers' power to block bids, they do not enable testing the impact of board veto on premia. In contrast, as noted, effective staggered boards do provide managers with especially strong defenses, and they thus present an opportunity for such testing. In our study of staggered boards, Coates, Subramanian, and I found that, controlling for other company and bid characteristics, managers armed with effective staggered boards obtained increases in premia that were small and statistically insignificant.[96] Our findings suggest that, even if further work does find that staggered boards produce some statistically significant benefits in terms of higher premia, these benefits would be unlikely to be sufficiently large to provide a basis for board veto.

There is also evidence that, in using their bargaining power, managers sometimes advance their interests at the expense of shareholders' premia. As noted earlier, recent studies found that target CEOs are willing to accept lower acquisition premia in transactions that involve an extraordinary personal treatment, such as special payments to the CEO at the time of the acquisition or high-ranking managerial posts in the buyer.[97]

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

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

96 See Bebchuk, Coates, and Subramanian, 54 Stan L Rev (forthcoming) (cited in note 8).

97 See Hartzell, Ofek, and Yermack, *What's in It for Me?* at 21–22 (cited in note 42); Wulf, *Do CEOs in Mergers Trade Power for Premium?* at 28 (cited in note 43).

1996–2000 period of our study, effective staggered boards reduced the expected returns of target shareholders on the order of 8–10 percent.[98]

5. Dangers of short-term focus.

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

Supporters of board veto have suggested that the threat of hostile takeovers forces managers to focus on short-term results and thereby discourages investments, such as investments in research and development, that would bear fruit only in the longer run.[99] Indeed, during the corporate governance debates of the 1980s, supporters of board veto argued that the short-term bias produced by takeovers was one of the reasons why the United States economy was performing less well than Germany and Japan, where corporate managers were largely insulated from unsolicited offers.[100] This particular concern about the consequences of takeovers is presumably no longer with us, but the basic claim underlying it should be taken seriously.

At the level of theory, there is no question that, when managers' inside information is not fully observable to public investors, managers' concern about short-term results might distort their decisions. It is worth noting, however, that the direction of the distortion is ambiguous and depends on the type of information that is unobservable to investors. Jeremy Stein developed models in which the level of investment in long-term projects is unobservable, an assumption that seems especially fitting for investments of time and effort by management.[101] In these models, should a takeover bid occur, shareholders deciding on it would not be able to observe the level of investment in long-term projects. As a result, the threat of an unsolicited bid discourages investment in such projects.

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98 See Bebchuk, Coates, and Subramanian, 54 Stan L Rev (forthcoming) (cited in note 8). In his response to this Article, Lipton, 69 U Chi L Rev at 1057–59 (cited in note 29), argues that the recent takeover of Willamette demonstrates that staggered boards produce substantial increases in premia for target shareholders. The Appendix to this Article, however, provides a detailed analysis of this case and shows that such an inference cannot be drawn from it.

99 See Lipton and Rosenblum, 58 U Chi L Rev at 205–14 (cited in note 10); Lipton, 35 Bus Law at 115–16 (cited in note 2).

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

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

Another model, developed by Lars Stole and myself, analyzes the case in which the level of investment in long-term projects is observable but its quality or expected profitability is not.[102] This assumption might well fit most cases of capital investments in long-term projects made by firms. Under this assumption, the threat of unsolicited offers leads to *excessive* investments in long-term projects. Should a control contest arise, shareholders will be able to observe such investments. Furthermore, a higher level of investment will signal managers' confidence in the profitability of this investment, and this signaling effect provides incentives to invest excessively.

In any event, whichever direction distortions are expected to take in any given set of circumstances, the prospect of a takeover bid undoubtedly can, in theory, distort the level of long-term investments. For designing legal policy, however, the important question is whether these distortions are of sufficient magnitude to justify providing boards with veto power. Neither the theory nor the available empirical evidence supply a basis for believing this to be the case. The evidence on the existence of such distortions is mixed, with ambiguous results with respect to the sign of the effect of board veto on R&D expenditures.[103]

Furthermore, even assuming that board veto does have beneficial ex ante effects on investments in long-term projects, it must be taken into account that, as discussed in Part II.B, board veto also has significant ex ante costs. By removing or weakening the potential disciplinary force of the takeover threat, board veto might increase managerial slack, empire-building, consumption of private benefits, and so forth. Furthermore, as discussed earlier, there is evidence that these ex ante costs are pervasive and potentially significant.

Supporters of board veto have provided no reasons for believing that whatever ex ante effects board veto has on long-term investments will be sufficiently positive to outweigh the significant negative ex ante effects of board veto that have been discussed earlier. Indeed, as I now turn to note, the evidence that is available supports a conclusion that the overall effect of board veto is negative. To begin, Gompers, Ishii, and Metrick found a significant association between stronger antitakeover protections and lower stock market valuation (as measured by

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

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

Tobin's Q).[104] According to their study, throughout the 1990s, companies with stronger antitakeover protection had a lower Tobin's Q, with the effect becoming more pronounced as the decade proceeded.[105]

Furthermore, there is evidence that the passage of the strongest antitakeover statutes—the ones most capable of significantly enhancing boards' veto power over unsolicited offers—was accompanied by a significant decline in the stock price of the companies incorporated in these states. Massachusetts companies significantly declined in value when Massachusetts adopted a statute making staggered boards the default arrangement under state law.[106] Companies incorporated in Pennsylvania or Ohio significantly declined in value when these states passed statutes enabling a "disgorgement" of bidders' "short-term" profits.[107] In general, the overwhelming majority of event studies on the adoption of state antitakeover statutes found either no price reactions or negative price reactions. [108]

6. Executive compensation to the rescue.

The preceding discussion in this Part has paid much attention to the potential divergence of interest between managers and shareholders in the face of a takeover. It can be argued, however, that the potential agency problems of a board veto regime could be addressed by an appropriate design of executive compensation schemes. When such schemes are designed to reward managers sufficiently in the event of an acquisition, so the argument goes, they can neutralize managers'

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104 See Gompers, Ishii, and Metrick, *Corporate Governance and Equity Prices* at 34 (cited in note 45).

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

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

107 For studies documenting the negative impact of the passage of the Pennsylvania statute, see L. Mick Swartz, *The 1990 Pennsylvania Anti-Takeover Laws: Should Firms Opt Out of Antitakeover Legislation?*, 11 J Acct, Audit, & Fin 223 (1996); Jonathan M. Karpoff and Paul H. Malatesta, *State Takeover Legislation and Share Values: The Wealth Effects of Pennsylvania's Act 36*, 1 J Corp Fin 367, 368 (1995); Samuel H. Szewczyk and George P. Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310*, 31 J Fin Econ 3 (1992). For a study documenting the negative impact of the passage of the Ohio statute, see Michael Ryngaert and Jeffrey Netter, *Shareholder Wealth Effects of the 1986 Ohio Antitakeover Law Revisited: Its Real Effects*, 4 J L, Econ, & Org 373, 383 (1988).

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

private interests in preventing a takeover. Indeed, Kahan and Rock suggest that executive compensation schemes have already sufficiently developed in this way to produce a healthy and well-functioning acquisitions market.[109] On their view, even though board veto (which they do not endorse) might be undesirable by itself, the compensation schemes that market participants have adopted provide a countervailing force, neutralizing any adverse effects that the presence of veto power otherwise would have, and produce a good equilibrium.

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

Let us start with the ex post problem of ensuring that, in the event of a bid, managers use whatever veto power they have in the interest of shareholders. It is quite difficult, if not impossible, to design compensation schemes that eliminate divergence between managers' and shareholders' interests and thus ensure that managers exercise their veto power in shareholders' interests.

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

This conclusion, however, does not imply that optimal incentives could be secured by setting *G* at a very high level. If *G* is pushed to a level higher than *C*, managers' incentives would be distorted in favor of selling the company.[110] Could one take the view that managers' incentives to sell can never be excessive? Certainly not in an inquiry exploring whether a board veto could be justified. Such an inquiry must start from the premise that not all premium acquisitions would be beneficial to shareholders; otherwise, there would be at the outset no point to having a board veto.

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109 See Kahan and Rock, 69 U Chi L Rev at 845 (cited in note 3). For an early work on the potential benefits of golden parachutes and other acquisition-related benefits in providing incentives, see Charles R. Knoebler, *Golden Parachutes, Shark Repellents, and Hostile Tender Offers*, 76 Am Econ Rev 155 (1986).

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

Thus, for a compensation scheme to induce optimal decisions by managers facing an offer, the scheme must produce in each and every case that might emerge a monetary acquisition benefit *G* that would exactly equal *C*. That seems exceedingly difficult to do. To begin, even if *G* were to be determined on an ad hoc basis ex post, given the circumstances in place, difficulties would arise from the fact that *C* is hardly observable. Furthermore, ex ante, when compensation schemes are set, and when the particular circumstances that would arise in the future are uncertain, it seems impossible to set the scheme in a way that the produced *G* would always be equal to the value that *C* would take.[111]

Indeed, the evidence discussed earlier indicates that compensation schemes have not solved thus far the agency problems arising from managers' veto power. Consider, for example, the findings of the study by Coates, Subramanian, and myself that, during the period 1996–2000, managers facing hostile bids and armed with ESBs used them to reduce the likelihood of an acquisition without producing significant countervailing benefits in terms of higher premia. These findings are inconsistent with the view that executive compensation schemes have eliminated managers' preference for remaining independent. A similar observation can be made with respect to the findings in the studies by Wulf and by Hartzell, Ofek, and Yermack that managers bargaining in the past decade accepted lower premia in transactions that provided managers with favorable treatment.[112] Again, these findings are inconsistent with the view that executive compensation schemes have produced an alignment of interests between managers and shareholders in the context of takeovers.[113]

Turning from ex post to ex ante, compensation schemes cannot in any way eliminate the negative ex ante effects of board veto, as Kahan

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111 The analysis above indicates that, even if boards were setting compensation schemes at arm's length with sole concern for maximizing shareholder value, boards would be unable to design schemes that would fully align the interests of managers and shareholders in the face of a takeover bid. It is worth noting, however, that there are reasons to question whether compensation schemes are generally set to maximize shareholder value. See generally Lucian Arye Bebchuk, Jesse M. Fried, and David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U Chi L Rev 751 (2002).

112 See note 97 and accompanying text.

113 Kahan and Rock, 69 U Chi L Rev at 892–93 (cited in note 3), point to the large volume of acquisitions as evidence that compensation schemes have produced their hoped-for benefits. This aggregate data, however, does not establish that such schemes have eliminated the potential distortions arising from managers' veto power. Among other things, such aggregate data does not tell us whether all the targets that should have been acquired were acquired (and the other data discussed above suggests that they might not have been). It also does not tell us whether the targets that were acquired were bought by the right buyer, for the right price, and with the right arrangements for managerial succession.

and Rock themselves recognize.[114] To induce managers not to oppose a takeover ex post, compensation schemes would have to provide managers with monetary benefits in the event of a takeover that would eliminate or sharply reduce the adverse effect of a takeover on managers' private interests. Such compensation schemes would eliminate, however, the disciplinary force of the takeover threat. With managers not expecting to be hurt in the event of a takeover, the prospect of a takeover would no longer provide managers with ex ante incentives to avoid poor performance that could raise the likelihood of a takeover.

In sum, although compensation arrangements can improve matters, taking *as given* the presence of board veto, such arrangements cannot eliminate the adverse effects of such veto. Kahan and Rock might be correct in suggesting that such arrangements might present the best outcome that shareholders could have obtained in the past decade given the difficulty of changing takeover arrangements. Our interest here, however, is in identifying the best takeover law regime. The possibility of using compensation schemes to neutralize some of the adverse effects of a board veto regime can make such a regime less detrimental, but it does not provide a basis for favoring this regime.

7. Inferences from IPO charters.

Having concluded that a direct examination of the merits of board veto does not provide a good basis for supporting it, I turn to consider whether its desirability can be inferred from the choices made by firms going public. Recent empirical evidence that has attracted much attention indicates that firms going public during the past decade have not designed their charters to eliminate board veto.[115] To start with, no firm is known to have adopted a charter provision that eliminates or curtails the power of the board to maintain a poison pill. Secondly, the majority of firms going public adopted charters provisions, such as ones that establish staggered boards or prevent shareholders from calling a special meeting or acting by written consent, that make it difficult for shareholders to replace the board quickly. Researchers examining this pattern have raised the possibility that the adoption of such charter provisions resulted from imperfections in the IPO process.[116] Researchers have also raised the possibility, however, that this adop-

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114 See id at 887.

115 See Robert Daines and Michael Klausner, *Do IPO Charters Maximize Firm Value?: Antitakeover Protections in IPOs*, 17 J L, Econ, & Org 83 (2001); John Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 Cal L Rev 1301 (2001); Laura Casares Field and Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, J Fin (forthcoming Oct 2002).

116 See, for example, Daines and Klausner, 17 J L, Econ, & Org at 86 (cited in note 115); Choi and Guzman, 87 Va L Rev at 985–86 (cited in note 78).

tion was due to—and thus was evidence of—the positive effects of board veto on shareholder value.[117]

According to a widely held view, firms at the IPO stage have powerful incentives to adopt arrangements that serve shareholders, and the adoption of arrangements at this stage thus provides evidence of their optimality. Whether, when, and to what extent this proposition is valid is a large question that I discuss elsewhere[118] and that does not need to be resolved for our purposes. For these purposes, it is sufficient to observe that, even assuming this proposition to be valid in general, the evidence with respect to charter provisions contributing to board veto is sufficiently mixed and conflicted to make the inference under consideration unwarranted.

To start with, throughout the past decade, shareholders of existing companies have been generally unwilling to vote in favor of amending the charter to include provisions making replacement of the board more difficult. Once firms realized that shareholders are unwilling to vote for such charter amendments, boards all but stopped proposing such amendments. From 1986 to 2000, the annual number of such proposals dropped by 90 percent.[119] Furthermore, shareholders' opposition to such arrangements has been reflected also in the large and growing support given to precatory resolutions to dismantle existing staggered boards.[120] All this is clearly the opposite of what is predicted by the view that investors favor charter provisions that facilitate board veto.

Secondly, while no firm is known to have adopted in the 1990s a charter provision that takes from boards the power to maintain pills indefinitely—a power given to boards by developments in case law and state statutes in the late 1980s and early 1990s—firms also did not generally adopt charter provisions that provided boards with such

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117 See Daines and Klausner, 17 J L, Econ, & Org at 84–85 (cited in note 115); Choi and Guzman, 87 Va L Rev at 985–86 (cited in note 78); John Elofson, *What If They Gave a Shareholder Revolution and Nobody Came?: Poison Pills, Binding Shareholder Resolutions and the Coase Theorem* at 48, working paper (2002) (on file with author).

118 I discuss how inefficient IPO provisions might result from inaccurate pricing in Lucian Arye Bebchuk, *Freedom of Contract and the Corporation: An Essay on the Mandatory Role of Corporate Law*, Harvard Law School Program in Law and Economics Discussion Paper No 46, (1988) (on file with author); and Bebchuk, 89 Colum L Rev (cited in note 11). I discuss how problems of adverse selection and signaling might lead to inefficient IPO provisions, including ones providing excessive protection from takeovers, in Lucian Arye Bebchuk, *Asymmetric Information and Corporate Governance,* working paper (2002) (on file with author).

119 See Michael Klausner, *Institutional Shareholders' Split Personality on Corporate Governance: Active in Proxies, Passive in IPOs* at 3–4, Stanford Law and Economics Olin Working Paper No 225 (2001), available online at <http://papers.ssrn.com/id=292083> (visited Apr 17, 2002).

120 The average shareholder vote in favor of such proposals was 52.7 percent in 2000. See id at 3.

power prior to these developments.[121] During the 1980s, it often appeared uncertain, if not in some cases unlikely, that boards would ultimately be given broad permission to maintain pills. Nonetheless, although boards were actively seeking to enhance takeover protections, pill-authorizing (or functionally equivalent) charter provisions generally were not adopted.

Consider Delaware firms. Between the invention of the pill in 1982 and the *Moran* decision in 1985, there was uncertainty as to whether the Delaware courts would permit the use of pills at all. *Moran* permitted the use of pills, but left quite open the possibility that boards would be required to redeem pills in some circumstances, and *Interco* made the possibility of court-ordered redemption of pills a real one. It was only with the *Time* decision in 1990 that boards could have gained confidence that they would have a broad and open-ended power to maintain pills. Still, prior to 1990, Delaware firms had not been adopting, either when going public or through charter amendments, pill-authorizing (or functionally equivalent) charter provisions.

A similar point can be raised with respect to firms incorporated in states other than Delaware. In most states, the validity of pills was in doubt until the passage of pill endorsement statutes in the late 1980s.[122] Still, prior to the adoption of these statutes, firms incorporated in those states generally did not adopt, either when going public or through a charter amendment, pill-authorizing (or functionally equivalent) charter provisions.

The absence in the 1980s of proposals for amending charters of existing firms to include such provisions was presumably due to the expectation that shareholders would not vote for such proposals. For this reason, boards and their advisers placed their hopes on the validation by courts or legislators of pills that managers unilaterally adopted. Managers lobbied state legislatures to adopt pill endorsement statutes instead of lobbying shareholders to approve functionally equivalent charter amendments, presumably because managers did not expect shareholders would approve such measures.

Could supporters of board veto dismiss the above patterns by claiming that shareholders' unwillingness to vote for certain charter provisions reflects their preferences less well than their willingness to purchase shares at IPOs of firms with such charter provisions? Even if IPO choices were assumed to provide better evidence, there would still remain the question why firms going public between 1982 and 1990 did not include pill-authorizing (or functionally equivalent) provisions

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121 See, for example, Elofson, *What If They Gave a Shareholder Revolution and Nobody Came?* at 47 (cited in note 117).

122 See Gartman, *State Takeover Laws* § A8 (cited in note 7).

in their IPO charters. Thus, even if we were to put aside evidence based on voting decisions and to focus solely on IPO choices, the evidence on how board veto has been viewed by participants in IPOs would be rather mixed.

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

D. The Perspective of Long-Term Shareholders

Because supporters of board veto have stressed the interests of long-term investors—those that choose to invest in the target for the long haul—it is worth considering whether a case for such veto can be made from the perspective of such investors. To examine this question, we should first note that most of the factors discussed in this Part do not depend on whether target shareholders focus on the short-term.

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

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

E. The Perspective of Aggregate Shareholder Wealth

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

Examining the set of cases in which bidders make offers, board veto primarily affects two groups of cases: (i) cases in which the target is acquired but the presence of board veto affects the premium for which it is acquired; and (ii) cases in which the target is not acquired due to the presence of board veto but would have been acquired in the absence of such veto. Let us examine in turn how the evaluation of each of these two effects will be influenced by also taking into account bidders' interests.

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

Similarly, considering the second group of cases in which the effect of board veto is to prevent an acquisition, this effect of board veto hardly benefits bidders. Rather, this effect denies bidders an acquisition they were seeking. Again, incorporating the interests of bidders into the objective to be maximized does not help the case for board veto.[123]

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[123] Could it be argued that preventing acquisitions sought by bidders would be in fact in the interests of bidders' shareholders because of the evidence that bidders' shareholders do not benefit much, if at all, from acquisitions? Even if one takes such a negative view of acquisitions in general, it hardly follows that it would be desirable to give targets' boards veto power in order to save acquirers' shareholders from their empire-building managers. Such board veto, of course,

Indeed, the above analysis is consistent with earlier work that suggests that, in the context of corporate control contests, shareholders generally would prefer to restrict takeovers and proxy contest victories by outsiders more than what would be optimal once the outsiders' interests are taken into account.[124] Thus, once we conclude that a board veto regime is not desirable from the perspective of target shareholders, it is not surprising that taking bidders' interests into account cannot provide a basis for such a regime.

F. The Perspective of Stakeholders

Supporters of board veto also argue that it enables managers to prevent acquisitions that would harm stakeholders—nonshareholder constituencies such as employees, suppliers, or debtholders.[125] Indeed, a majority of the states enacted statutes allowing managers responding to a takeover bid to take into account the interests of stakeholders.[126] Supporters of board veto have used claims about stakeholder interests in the political arena, in the courts, and in the court of public opinion.

Acquisitions, whether hostile or friendly, might sometimes adversely affect the interests of stakeholders. Employees might be laid off, creditors' debt might become riskier, suppliers might be denied a valuable business partner, communities might lose a corporate headquarters or corporate operations, and so forth. It is desirable, so the argument goes, to have in place some mechanism that would ensure that stakeholders' interests would be taken into account in deciding whether to have a takeover and that these interests would be protected

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would not help acquirers' shareholders in the more numerous cases in which targets' boards agree to be acquired. One concerned about possible empire-building by acquirers' managers should focus on other ways for addressing this problem.

124 See Lucian Arye Bebchuk and Luigi Zingales, *Ownership Structures and the Decision to Go Public: Private versus Social Optimality*, in Randall K. Morck, ed, *Concentrated Corporate Ownership* 55 (Chicago 2000); Lucian Arye Bebchuk and Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests,* 78 Cal L Rev 1071, 1129–34 (1990); Sanford Grossman and Oliver Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 Bell J Econ 42, 54–57 (1980). For this reason, the perspective of aggregate shareholder wealth is one that can be expected to be used by those seeking to reduce restrictions on takeovers. Thus, it is not surprising to find it invoked by Easterbrook and Fischel, 94 Harv L Rev at 1161 (cited in note 1), who used it in arguing for their rule of passivity. Criticizing at the time Easterbrook and Fischel's view that higher premia should not count as a benefit, Lipton characterized this argument as one that "courts—and target shareholders—would find . . . both peculiar and unpersuasive." Lipton, 55 NYU L Rev at 1235 (cited in note 29).

125 See, for example, Blair and Stout, 85 Va L Rev at 253 (cited in note 28); Lipton, 35 Bus Law at 130–31 (cited in note 2).

126 See Gartman, *State Takeover Laws* §§ A-6 to A-7 (cited in note 7). The committee drafting the Revised Model Business Corporation Act, however, decided that directing directors to consider the interests of nonshareholder constituencies is undesirable. See Committee on Corporate Laws, *Other Constituencies Statutes: Potential for Confusion*, 45 Bus Law 2253, 2270–71 (1990)

if a takeover does take place. On this view, having such a mechanism would not only benefit stakeholders but also would ex ante be in the interest of shareholders; specifically, it would encourage ex ante beneficial investments and participation on the part of stakeholders.[127]

Critics of this view have argued that, although takeovers could in theory impose such harm on stakeholders, the evidence indicates that such losses are not very common and, furthermore, are small in magnitude relative to shareholders' gains when they do occur.[128] Critics have also argued that the law generally should not provide protection to stakeholders beyond what is called for by their contracts with the corporation. On this view of the critics, protection of stakeholder interests should be left to contracts between them and the corporation or to nonlegal sanctions.[129] Given this line of response, it is unsurprising that some observers view the board veto question as one of shareholders versus stakeholders.[130]

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

1. Expanding discretion to benefit stakeholders.

To begin, it is worth observing that there is no assurance that, if directors are given veto power, they will exercise it to protect stakeholders. In theory, one could consider permitting boards to block offers that shareholders would like to accept only if such blocking would protect stakeholders and thereby maximize the overall welfare of all

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127 See Blair and Stout, 85 Va L Rev at 304–05 (cited in note 28); Andrei Shleifer and Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in Alan J. Auerbach, ed, *Corporate Takeovers: Causes and Consequences* 33 (Chicago 1988); John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders, and Bust-Ups*, 1988 Wisc L Rev 435; John C. Coffee, Jr., *Shareholders versus Managers: The Strain in the Corporate Web*, 85 Mich L Rev 1 (1986).

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

129 An excellent discussion of this view can be found in Daniels, 43 U Toronto L J at 340–49 (cited in note 128).

130 See Allen, Jacobs, and Strine, 69 U Chi L Rev at 1071–72 (cited in note 3).

corporate constituencies. Courts, however, would be unable to enforce compliance with such a principle.

Indeed, courts are reluctant to review the merits of board decisions—even to determine whether they serve the narrower and well-defined interests of shareholders. For this reason, those opposed to board veto do not wish to limit it by having courts review board decisions but rather to replace it with shareholders making the key decisions. Clearly, if directors were instructed to maximize the joint welfare of all corporate constituencies, courts would be unable or at least unwilling to enforce compliance with such a principle. As Oliver Hart observed, a prescription to management to take the interests of all constituencies into account "is essentially vacuous, because it allows management to justify almost any action on the grounds that it benefits some group."[131]

Supporters of board veto indeed do not assume or imply that directors would *have* to use their power in ways that would protect stakeholders and that courts would review whether this is done. Indeed, lest there be any misunderstanding that courts are expected to ensure that directors take stakeholders' interests into account, drafters of state constituency statutes used (in all cases but one) language that authorizes (rather than requires) directors to take into account the interests of other constituencies.[132]

In sum, supporters of board veto wish to give boards *discretion* with the aspiration and hope that they would use their discretion to protect stakeholder interests. In considering how likely this is to happen, we should examine whether the interests of those granted the discretion are likely to overlap with the interests of the stakeholders that are supposed to benefit from this discretion.[133]

2. Are boards good agents of stakeholders?

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

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

132 See Committee on Corporate Laws, 45 Bus Law at 2261–63 (cited in note 126).

133 Some supporters of board veto list "managers" as a constituency whose interests should be taken into account. See Blair and Stout, 85 Va L Rev at 297 (cited in note 28). One can safely assume that the expanded discretion under consideration would ensure that the interests of this particular constituency be taken into account. But such an assumption cannot be made with respect to other constituencies.

terests, the takeover context is one in which managers' interests are likely to diverge from those of shareholders.

Do we have good reasons for expecting managers responding to a takeover bid to be better agents of stakeholders than they can be expected to be of shareholders? To begin, note that, in most other corporate contexts, managers' interests are actually more likely to be aligned with those of shareholders rather than stakeholders. Whereas managers usually have a significant fraction of their wealth in the form of shares and options, they do not usually have as much of their wealth tied to bondholder or employee wealth. And managers' private interests in the takeover context cannot be cannot be expected to be aligned with the interests of stakeholders.

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

There might well be acquisitions that would be beneficial to stakeholders—say, when an acquisition by a large and rich buyer would improve opportunities for employees—but that management might well disfavor for self-serving reasons. Conversely, there might well be acquisitions that would disadvantage stakeholders but that management, at least if it is offered a sufficiently good deal for itself, would favor. Finally, in cases in which an acquisition is likely to occur ultimately, management might use whatever veto power it has to bargain for better terms not for stakeholders but rather for itself or even for shareholders.[134] In sum, given the limited overlap between managers'

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

The third factor listed by Blair and Stout is corporate cultural norms of fairness and trust, reinforced by reputational sanctions and the selection to boards of trustworthy individuals. Id at 316. I doubt that this factor is sufficiently strong to ensure desirable use of discretion in the takeover context. Apparently, the norm that directors should not impose great financial losses on their shareholders was not sufficient to prevent Time's directors from defeating Paramount's bid, and stakeholders' interests, there is no basis for expecting board veto to translate into an effective protection of stakeholders.

3. The tenuous link between stakeholder protection and board veto.

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

First, a concern about the effects of acquisitions on stakeholders should clearly not limit itself to, or even focus on, hostile takeovers. Such takeovers, which constitute a rather limited fraction of relevant corporate transactions, are not especially or disproportionately ones that can be expected to harm stakeholders. Layoffs, for example, might result not only from hostile acquisitions but also from negotiated acquisitions of a company or of a division, from a change of course following a proxy contest victory by challengers, or from decisions by incumbents to shut down plants.[135] Whereas hostile takeovers are very important for an analysis focusing on how power is allocated between managers and shareholders, arrangements designed to protect stakeholders in corporate transactions have no reason to focus on hostile takeovers.

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

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thereby imposing a great loss on Time's shareholders. It is far from clear that cultural norms can induce management to ignore its self-interest in the takeover context, where managers' private interests are very much at stake and where acting in the managers' self-interest can always be defended as needed to protect shareholders or some other constituency. Indeed, cognitive dissonance might lead managers who would benefit from remaining independent to develop a genuine (even if mistaken) belief that their stakeholders would be well served by such independence.

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

employees various procedural and substantive rights in the event of such layoffs,[136] or provide employees and their representatives some say in corporate decisionmaking in general or in plant closings or layoffs in particular,[137] or supplement formal contracts between firms and stakeholders with implied and good faith terms.

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

In sum, the connection between board veto and the goal of protecting stakeholder interests is rather tenuous. And, indeed, the push for constituency statutes seems to have come from those seeking to enhance management power. Although acquisitions with their effects on stakeholders have been part of the corporate landscape for a long time, such statutes came into being only after the rise of hostile bids created a threat to management power. Furthermore, the majority of state constituency statutes were adopted as part of a larger wave of antitakeover statutes aimed at impeding hostile acquisitions.[138] In any event, whatever motivated the adoption of constituency statutes and board veto arrangements, they cannot be reasonably justified as a mechanism for protecting stakeholders.

4. Protecting stakeholders or protecting managers?

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

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136 See Ronald Daniels, *Mergers and Acquisitions and the Public Interest: Don't Shoot the Messenger*, in Leonard Waverman, ed, *Corporate Globalization through Mergers and Acquisitions* 195 (Calgary 1991) (discussing policies to address such issues, including plant closure legislation, mandatory successorship rights, and mandatory bargaining); Joseph W. Singer, *The Reliance Interest in Property*, 40 Stan L Rev 611, 740–43 (1988) (discussing rules governing severance payments, advanced notice, and rights of first refusal in connection with plant closings).

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

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

cies are introduced, the growing opposition of institutional investors to takeover defenses no longer has the weight that it would carry otherwise. Once stakeholders are brought in, such investors can be viewed as just one constituency out of several whose interests should be protected.

Thus, support for board veto can be presented as a rejection of the view that only shareholders count in favor of the view that stakeholders, especially employees, count too. Supporters of board veto would like us to accept that, if stakeholders are to count, then boards should have veto power to be able to act as the stakeholders' champion. By casting boards as the champion of stakeholders, supporters of board veto have been able to boost significantly the perceived legitimacy and appeal of their position. They also have sought to cast the debate over board veto as a debate between a narrow, shareholder-centered view of the corporation and a broad, inclusive view of the corporation.[139]

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

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

G. Implementation within Existing Case Law

I now turn to consider briefly implications of the analysis for takeover case law. As I said, there are different institutional arrangements that can produce a regime of shareholder voting and no board veto, and in other works I explore some of the possible alternatives and the best design, starting from a clean slate, of such a regime.[140]

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139 See Allen, Jacobs, and Strine, 69 U Chi L Rev at 1071–72 (cited in note 3). In reflecting on the debate over board veto, they view it as partly involving choice between a shareholder-centered view of the corporation and a broader, "entity" perspective that incorporates the interests of stakeholders. See id.

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

Here, however, I focus on examining how the analysis could inform the future development of takeover law, taking *as given* the existing structure of takeover doctrine.

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

> (1) *Maintaining Pills to Prevent a Takeover Unsupported by a Vote:* Subject to the conditions below concerning access to and consequences of shareholder voting, the board should be permitted to maintain a poison pill in the face of a takeover bid even if the bid is "structurally non-coercive."
>
> (2) *Access to a Vote:* After a bid is made and a period reasonably sufficient for the board's exploring and preparing alternatives for shareholder consideration passes, maintaining a pill would be consistent with fiduciary duties and thus permissible only if, within a period as short as reasonably practical, either: (a) shareholders would have or would be given an opportunity to vote (whether in a regularly scheduled meeting, a special meeting, or through written consents) to replace some or all of the directors; or (b) shareholders would have (by the terms of the rights plan) or would be given by the board an opportunity to vote to have the pill redeemed.
>
> (3) *Redemption of Pills Following Electoral Defeat:* When directors of a company with a staggered board lose one election fought over an acquisition offer, they should not be permitted (absent compelling corporate justification) to continue maintaining a pill.
>
> Furthermore, dead-hand pills, delayed-redemption pills, or any other pill terms that, in the aftermath of electoral defeat by incumbents, make it impossible, costly, or difficult to redeem the pills should be prohibited.
>
> (4) *Protecting the Shareholder Franchise:* In the face of an unsolicited takeover bid, the highest level of judicial scrutiny should be ap-

in note 19); Bebchuk and Ferrell, 87 Va L Rev 111 (cited in note 12).

plied to any board decisions that might frustrate or distort the outcome of shareholder votes that would have an effect on the fate of the offer. Specifically, boards should not be permitted (absent compelling corporate justification) to adopt defensive bylaws that either: (a) impose supermajority requirements on the adoption of shareholder bylaws; or (b) reverse shareholder bylaws.

Some of the above proposals are quite close to existing case law, whereas others might require some limited change of course. But they are all ones that would be consistent with, and indeed advance, the existing principles that defenses be proportionate to the threat posed and that the shareholder franchise be well protected. They all also would move arrangements toward a regime of shareholder voting and no board veto. They all would thus operate to enhance shareholder value and to improve the allocation of corporate assets.

CONCLUSION

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

APPENDIX: THE TAKEOVER OF WILLAMETTE

In a response to this Article, Martin Lipton vigorously defends his views in favor of board veto.[141] Lipton forcefully puts forward his concerns that shareholders not be in any way pressured to accept takeover bids, however high the premium they offer, and that tender decisions might not reflect well shareholders' preferences. As I explained, I share these concerns, which have led me to support a regime of shareholder voting.

Lipton continues to maintain, however, that shareholder voting is not sufficient and that board veto is desirable. He cautions against a regime of shareholder voting and no board veto by arguing that, whatever the merits of such a regime, it would constitute a "radical change."[142] As I explained in this Article, however, there are different ways of obtaining a regime of shareholder voting and no board veto. Some ways would indeed require a major legislative change to establish a referendum. However, such a regime could also be largely implemented by a limited adjustment of the existing jurisprudence.

Putting aside the question of whether moves to limit board veto would constitute a radical change, Lipton maintains that such moves would be detrimental to shareholders. Most of the reasons he gives for his position are ones that he has raised in his earlier work and that my analysis in this Article already addresses in detail. Below I therefore focus on some new claims that Lipton makes in his response in connection with the recent takeover of Willamette, where incumbents stalled the bid for fourteen months. He argues that (a) the stalling in Willamette illustrates well how board veto delivers substantial value for shareholders, and that (b) in any event, such stalling raises at most a theoretical concern. Below I argue (a) that the takeover of Willamette does not lend support to the case for board veto, and (b) that prohibiting a Willamette-type stalling would provide valuable and practically significant benefits.

A. Did Willamette's Incumbents Deliver Value for Shareholders?

My analysis has stressed the costs produced by staggered boards, which are present in about half of publicly traded companies and provide an important source of board veto. Lipton responds by offering a detailed discussion of the takeover of Willamette and inferring from it

141 Lipton, 69 U Chi L Rev at 1039 (cited in note 29).
142 Id at 1042.

that the veto power produced by staggered boards is actually beneficial for shareholders.[143]

The Willamette saga lasted fourteen months. In November 2000, Weyerhaeuser made an offer of $48 per share for Willamette. Weyerhaeuser raised its offer to $50 per share in May 2001 prior to conducting a proxy contest. Weyerhaeuser won this contest in June 2001, replacing a third of Willamette's board. Protected by the staggered board, however, incumbents continued to oppose the bid. In January 2002, Weyerhaeuser raised again the offered price to $55 per share and attracted 64 percent of the shares to its offer. Later that month, after encountering substantial shareholder resistance to an alternative deal with Georgia-Pacific, Willamette's incumbents agreed to be acquired by Weyerhaeuser for $55.50 per share, which was 16 percent higher than the initial $48 per share bid. Lipton suggests that this case offers a good illustration of how a staggered board delivers value for shareholders. He argues that the case is "no less than a shining example of how a staggered board and a poison pill operate to the benefit of shareholders" and that arguments against the staggered board-poison pill combination "evaporated" following the stellar success of the board in this case.[144]

It is far from clear, however, that the Willamette case is one in which the board's ability to stall has provided a substantial benefit for shareholders. To start with, even assuming hypothetically that $48 per share was the most that could have been obtained from Weyerhaeuser without massive delay, an extra 16 percent does not seem to be an especially impressive return on waiting for fourteen months and bearing in the meantime the risk that the deal will fall through.

More importantly, there is no reason to believe that a 16 percent increase from the $48 initial price required stalling for fourteen months. A bidder's initial offer is generally understood not to represent the final price that it would be willing to pay to acquire the target. Bidders generally keep something off the table for final negotiations, and they are generally willing to offer somewhat more than the initial bid to get the deal done. Such increases can be and often are obtained without the need for massive delay and a staggered board.[145] To take a recent example, consider the takeover of Detection Systems. In October 2000, Bosch Telecom made a $14-per-share bid for Detection Systems. The board expressed opposition to the bid, and a large shareholder started a proxy contest to replace the directors in an upcoming share-

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143 Id.

144 Id at 1050.

145 See *Detection Systems Inc. Proxy Fight Ends after Bid from Bosch Is Sweetened*, Wall St J A18 (Dec 12, 2000).

holder meeting. In December 2000, a few days before the scheduled meeting, the board and the bidder agreed on an acquisition for $18 per share, 29 percent more than the initial price. This increase in the offer price was obtained without charter provisions that preclude access to a quick vote and with a delay of only two months.

In fact, when Weyerhaeuser made its bid in November 2000, an analyst predicted that "the two companies will go to the bargaining table by the end of next week and reach a deal at $55 per share, possibly a tad higher."[146] But despite the strong signals that investors wanted to have discussions with the hostile bidder, Willamette's incumbents kept refusing to enter such discussions, saying that "Willamette is not for sale."[147] This refusal persisted after Weyerhaeuser stated explicitly in May 2001 that it would raise the offer if Willamette would negotiate a friendly deal; Willamette did not enter into discussions to explore what increase in premium Weyerhaeuser would be willing to offer.[148] It is thus not surprising that Institutional Shareholder Services, a proxy-advisory firm widely used by institutional investors, offered the following account when recommending that shareholders vote for Weyerhaeuser's slate in the June proxy contest:

> We believe management has made its position abundantly clear: it is simply not interested in selling. But in remaining unyielding towards negotiating with Weyerhaeuser, Willamette has shown a high degree of disregard for the wishes of its own shareholders.[149]

Only in October 2001, eleven months after the initial bid, and two months after being defeated in a proxy contest that enabled Weyerhaeuser to replace one-third of the board, did Willamette express willingness to sit down with Weyerhaeuser to explore how much it would be willing to raise its bid. However, Willamette subsequently terminated the brief discussion it held with Weyerhaeuser. Willamette tried to advance instead a controversial deal with Georgia-Pacific—even after Weyerhaeuser raised its offer to $55 per share—but encountered strong resistance from shareholders who tendered en masse into Weyerhaeuser's offer.[150] Willamette then agreed to sell for $55.50 per share.

It is far from clear that the above tale is a story of a board pursuing a bargaining strategy aimed at getting top dollar for shareholders.

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146 See Nikhil Deogun, *Weyerhaeuser Plans to Make Hostile Bid of $5.4 Billion for Willamette Industries*, Wall St J A4 (Nov 29, 2000) (quoting Deutsche Bank analyst).

147 See *Weyerhaeuser Bid for Rival Willamette Receives a Boost*, Wall St J C3 (Feb 2, 2001).

148 See Sidel, *Weyerhaeuser Fails to Win Willamette Mandate*, Wall St J at A4 (cited in note 62).

149 Robin Sidel, *Deals & Deal Makers: Proxy Adviser Gives Weyerhaeuser Boost on Willamette Bid*, Wall St J C18 (May 23, 2001).

150 See Robin Sidel and Chad Terhune, *Willamette Shareholders, Unhappy with Spurn of Weyerhaeuser, Fear Georgia-Pacific Deal*, Wall St J C2 (Jan 18, 2002).

If bargaining for a higher price was the goal of the board, why did the board for eleven months not even explore with Weyerhaeuser whether it would be willing to raise its price by at least 15 percent in order to get the deal done? The facts appear to be at least consistent with a story of management seeking to remain independent, and to avoid a sale to Weyerhaeuser altogether, and agreeing to be acquired by Weyerhaeuser only under massive pressure from shareholders. Indeed, some observers have noted that a factor in Willamette's resistance to a sale to Weyerhaeuser was animosity on the part of Willamette's incumbents toward Weyerhaeuser's CEO, who previously had been an executive of Willamette.[151]

In any event, even assuming counterfactually that Willamette's shareholders substantially benefited from incumbents' stalling for fourteen months, there are clearly examples in which shareholders indisputably suffered substantial losses from incumbents' use of a staggered board to block an offer for a long time. Consider the well-known case of Circon. U.S. Surgical made an offer of $18 per share for Circon in August 1996 and subsequently won a proxy contest and replaced one-third of Circon's board. But Circon's incumbents used the shield of an effective staggered board and a poison pill to keep blocking the offer. In June 1998, twenty-two months after Surgical first made an offer, Surgical withdrew its bid. Subsequently, in September 1998, under pressure from arbitrageurs, Circon sold itself in a friendly deal for 17 percent *less* than the original Surgical bid. The Circon case is certainly not an example of "how a staggered board and a poison pill operate to the benefit of shareholders."

Having discussed two particular cases, however, I wish to stress the limits to how much one can learn from an example, which might or might not represent the population from which it is drawn. Rather than look at any particular example, it would be better to focus on more systematic evidence whenever possible. The staggered boards study by Coates, Subramanian, and myself, discussed in the Article, provides such evidence for hostile bids during 1996–2000. And this study indicates that, overall, staggered boards *did not* operate in that period to the benefit of target shareholders.

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151 See Jim Carlton and Robin Sidel, *Willamette Accepts Weyerhaeuser's Offer—Deal for About $6.1 Billion Ends the Takeover Battle—Agrees to be Bought by Weyerhaeuser*, Wall St J A3 (Jan 22, 2002) (reporting, among other things, that "animosities were so high that Willamette Chairman Bill Swindells, who had groomed Mr. Rogel [Weyerhaeuser's CEO] to run the company his family co-founded, refused to take Mr. Rogel's calls"); Jim Carlton, *Weyerhaeuser Bulks Up to Avoid Consolidation Buzz Saw*, Wall St J B4 (Jan 24, 2002) (noting the particularly high tensions between Mr. Swindells and Mr. Rogel in connection with Willamette's following a "just say no" defense for fourteen months).

B. Should Willamette-type Stalling Be Permitted?

In June 2001, Weyerhauser's slate won in elections for one third of Willamette's board fought over the subject of an acquisition by Weyerhauser. Despite the electoral defeat suffered by Willamette's incumbents—a defeat that signaled clearly shareholders' desire that incumbents negotiate with Weyerhauser—incumbents continued to stall using a poison pill. Incumbents in a target with a staggered board like Willamette, I have argued, should not be permitted to keep blocking an offer after losing one election for a class of directors conducted over an acquisition offer. Lipton responds that, even if continued resistance after one electoral defeat were likely undesirable (which he does not accept), it would not present a concern of significance. This issue is "largely theoretical," Lipton suggests, because "[i]n very few instances has a target with a staggered board suffered a first-round loss —had a third of the board replaced with the raider's nominees—and continued to refuse to surrender its independence."[152] Therefore, on Lipton's view, this issue "does not in any way warrant a change in basic corporate law."[153]

However, even though there are only few instances in which incumbents lost an election for one third of the board and continued to resist the acquisition, the effects of the power to do so are not limited to these instances. The decisions of bidders and incumbents in all takeover contests are taken against the background of their expectations as to what powers incumbents will have down the road. When incumbents are protected by a staggered board and have the power to keep resisting after losing one election, this power would affect outcomes not only when it is actually exercised but also when it discourages bidders from continuing to pursue the target at earlier stages of the game. Without an effective staggered board, an electoral victory guarantees that the bidder will succeed in taking over the target. When a staggered board is in place, such a victory does not assure success (as U.S. Surgical painfully learned in its pursuit of Circon). Thus, when a bidder finds that incumbents are strongly opposed to a takeover, the presence of power to keep stalling after losing one election might lead the bidder to withdraw without attempting to run in any election.

Note that the ability to keep resisting after losing one election is what separates firms with effective staggered boards from firms that do not have such boards. The evidence indicates that this difference has a significant and not merely theoretical impact. As noted, targets with staggered boards have substantially higher odds of remaining

152 Lipton, 69 U Chi L Rev at 1059 (cited in note 29).
153 Id at 1058.

independent in the face of a hostile bid. During the period of 1996–2000, 60 percent of the targets with effective staggered boards remained independent, but only 34 percent of the targets without such boards remained independent. This difference was not due to instances in which a target with a staggered board remained independent after losing one election; there was only one case in which a spurned bidder went through a proxy contest and won one election. Rather, spurned bidders generally withdrew at earlier stages, presumably at least in part because of their expectation that victory in one election would not preclude the incumbents from continuing to say no.

The proposed approach—precluding incumbents who lose one election from maintaining pills—would take away from pills the special antitakeover power that they have in the presence of a staggered board. Given that about half of public companies now have staggered boards, a development with profound effects on the market for corporate control, this approach would not address an issue that is merely theoretical. Rather, it would substantially reduce boards' ability to block offers and would restore the safety valve of an effective shareholder vote in firms with staggered boards.

Lastly, the proposed approach should not be viewed, as Lipton argues, as a "change in basic corporate law." Lipton stresses that corporate statutes have long permitted the adoption of staggered boards.[154] The proposed approach, however, would not prevent firms from having staggered boards. Rather, it would speak to the question of when courts should allow boards to maintain a poison pill. Although the judicial trend in Delaware has been to abstain from court-ordered redemption of pills, the Delaware courts have left open the possibility that such redemption might be ordered when appropriate. Once it is recognized that permitting incumbents to maintain a pill after an electoral defeat would practically block bidders' route to a ballot box victory, limiting incumbents' power to do so would be an application of *Moran*'s principle that pills should not be used in a disproportionate fashion. In any event, the proposed approach can be hardly viewed as a radical departure from basic corporate law, and it therefore should not be ruled out regardless of its potential benefits for shareholders.

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[154] Id.