WHY FIRMS ADOPT ANTITAKEOVER ARRANGEMENTS

LUCIAN ARYE BEBCHUK[†]

INTRODUCTION 714
I. THE OPTIMALITY INFERENCE AND ITS SHORTCOMINGS 719
A. *The Debate over Board Veto in Corporate Takeovers* 719
B. *IPO Behavior and Optimality* 721
C. *Conflicting Midstream Behavior* 723
D. *Attempting to Reconcile IPO and Midstream Behavior* 724
II. EXPLAINING IPO AND MIDSTREAM BEHAVIOR 728
A. *A Simple Model* 728
B. *Efficiency-Based Explanations* 730
1. Inducement to Deconcentrate Ownership 730
2. Efficient Rent Protection 733
C. *Agency-Based Explanations* 734
1. Agency Problems Among Pre-IPO Shareholders 735
2. Agency Problems Between Pre-IPO Shareholders and Lawyers 736
D. *Information-Based Explanations* 739
1. Asymmetric Information 739
2. Bounded Attention and Imperfect IPO Pricing 740
a. *Bounded attention at the IPO stage* 740
b. *Midstream* 742
c. *Investment bankers* 743
E. *Private vs. Social Optimality* 745
F. *IPO Firms with Private Equity Funding* 746
III. POLICY IMPLICATIONS 748
A. *No Board Veto Is Best Default* 748
B. *Limited Menu* 750
C. *Sunset Arrangements* 751
D. *Lessons for Corporate Governance in General* 752

[†] William J. Friedman and Alicia Townsend Friedman Professor of Law, Economics, and Finance, Harvard Law School; Research Associate, National Bureau of Economic Research and Center for Economic Policy Research. E-mail: bebchuk@law.harvard.edu; Web site: http://www.law.harvard.edu/faculty/bebchuk. I am indebted to BJ Trach for his extremely valuable assistance in preparing this Article. For helpful conversations and suggestions, I am grateful to Bill Bratton, Marcel Kahan, Alexandra McCormack, Andrew Metrick, Lynn Stout, and participants in the corporate law lunch group at Harvard Law School and the *University of Pennsylvania Law Review* conference on corporate control transactions. I also wish to thank the John M. Olin Center for Law, Economics, and Business at Harvard Law School for its financial support.

INTRODUCTION

Strong antitakeover defenses are common among publicly traded firms. Why do firms adopt such arrangements? Does the adoption of such arrangements indicate that a board veto over takeovers enhances share value? What explains the fact that, at the initial public offering (IPO) stage, firms adopt strong takeover provisions, such as effective staggered boards, which shareholders systematically reject midstream? To what extent should corporate law place limits on a firm's choice of antitakeover arrangements? This Article seeks to address each of these questions.

Firms opt for antitakeover protection in two main ways, both of which have attracted some attention. First, firms adopt antitakeover charter provisions. Recent work has documented that, in the last decade, firms choosing to go public have increasingly been incorporating such provisions into their charters.[1] Second, firms incorporate in states that have statutes or case law making takeovers difficult. Recent evidence indicates that states with more antitakeover statutes are more successful in attracting incorporations.[2]

Supporters of board veto have argued that the adoption of antitakeover arrangements at the IPO stage provides "market proof" that board veto is desirable for shareholders.[3] Their inference is

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[1] For studies documenting the widespread use of antitakeover provisions in the charters of firms going public during the 1990s, see John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 95-97 (2001); Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857, 1858 (2002).

[2] *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 404-20 (2003) (presenting evidence that states with more antitakeover statutes are more successful both in retaining in-state firms and in attracting out-of-state incorporations); Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law*, 90 CAL. L. REV. 1775, 1815-18 (2002) (surveying and discussing the evidence on how states' takeover laws affect incorporation decisions); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1838 (2002) (finding that firms are less likely to incorporate out-of-state when their state has more antitakeover statutes).

[3] For arguments that firms' adoption of antitakeover provisions in their IPO charters implies that such provisions are likely to enhance shareholder value, see Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 982-86 (2001); Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473 (2003); Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1057-58 (2002); Jonathan R. Macey, *Displacing Delaware: Can the Feds Do Better than the States in Regulating*

unwarranted, however, because the evidence about shareholder preferences for antitakeover protections are, to say the least, rather mixed. While the adoption of antitakeover protections at the IPO stage has increased over the last decade, shareholder opposition to antitakeover protections through voting decisions has increased as well.[4] This seemingly contradictory evidence makes it necessary to have a theory sufficiently rich to account for the behavior of firms and investors both at the IPO stage and in midstream.[5]

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

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Takeovers?, 57 BUS. LAW. 1025, 1039 (2002); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 847-56 (2002); John Elofson, What if They Gave a Shareholder Revolution and Nobody Came? Poison Pills, Binding Shareholder Resolutions and the Coase Theorem 4 (unpublished manuscript, on file with author).

[4] *See* Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1187 (1999) (discussing the implications of this midstream behavior for an assessment of shareholders' preferences); *see also* Lucian Arye Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 VA. L. REV. 993, 999-1001 (2001) (refuting claims that if a shareholder opt-in rule were beneficial, it would have been adopted already).

[5] Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003), also stresses the conflicting patterns of IPO and midstream behavior and the need to reconcile them. His analysis focuses on the firms with private equity funding, where some of the institutional investors regularly voting against antitakeover provisions are also investors in the private equity funds taking public firms with such provisions.

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

antitakeover protections disappear. This change can explain the midstream opposition of such investors to antitakeover arrangements.

Under the *efficient rent protection* explanation, antitakeover arrangements are always undesirable for public investors and reduce the value of their shares. However, the benefits of rent protection obtained by the founders through the antitakeover provisions are, at least at the IPO stage, greater than the resulting reduction in share price that the provisions cause. Therefore, antitakeover arrangements are efficient overall, and assuming no informational problems, founders find it in their interest to adopt them at the IPO stage even though this reduces the price they can get for their shares. At the midstream stage, however, shareholders have every reason to vote against a proposed antitakeover arrangement unless they receive appropriate compensation for the resulting reduction in the value of their shares. Similarly, if they could undo the antitakeover arrangement, shareholders would likely vote to do so midstream.

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

One type of agency problem could arise *among IPO shareholders*. Here, when only some of the pre-IPO shareholders will continue to run the firm after the IPO, these founder-managers might have an incentive to include antitakeover arrangements in the charter. After all, they will fully capture the benefits of rent protection and will bear only part of the cost of reduced IPO share price.

Another type of agency problem could arise *between lawyers and pre-IPO shareholders*. To the extent that lawyers' expertise gives them influence over decision making, they might have an incentive to tilt their recommendations in favor of antitakeover arrangements. The downside of not having antitakeover protection—that incumbents might find themselves unprotected from a hostile bid down the road—might be attributed to the lawyers and might negatively affect their reputation. Furthermore, the potential upside of not including antitakeover provisions—a slightly higher IPO share price—would

hardly be credited to the lawyers' work. Thus, since the adoption of antitakeover provisions provides a benefit but little cost to lawyers, they have an incentive to use their influence over the drafting of the charter to encourage antitakeover arrangements, even though these arrangements are inefficient for both founders and shareholders.

Under the *asymmetric information* theory, public investors are assumed to have perfect information about the effect of the provision given any value of the company's assets, but to have imperfect information about the value of these assets. In such a case, assuming that higher asset value is associated with higher expected benefits from rent protection, some or all founders will have an incentive to signal a high asset value by adopting antitakeover arrangements. Although shareholders know that antitakeover arrangements are inefficient and will reduce the share price at the IPO stage accordingly, the increase in share price as a result of the information conveyed concerning asset value outweighs this negative antitakeover consequence. Thus, the signaling effect may provide founders with an incentive to adopt inefficient antitakeover provisions at the IPO stage. Shareholders, however, will oppose such inefficient protections in midstream.

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

In contrast, down the road at the midstream stage, questions concerning antitakeover arrangements will come to a vote in circumstances that make investors focus on the issue in isolation from others and that make the issue practically important. At this latter point, the inefficiency of antitakeover arrangements will lead shareholders to vote against them.

In addition to identifying several potentially plausible explanations for observed IPO and midstream patterns, I also discuss why some other potential explanations, including ones put forward by Marcel

Kahan and Ed Rock, Lynn Stout, and Michael Klausner, cannot account for these patterns. I thus attempt to provide a comprehensive review of the factors that contribute to producing the observed patterns of behavior.

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

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

Third, the analysis highlights the difference between what might be optimal at the IPO stage and what might be optimal down the road. Even if certain measures that benefit managers and controllers are to be permitted at the IPO stage, it is not necessarily the case that companies should be permitted to adopt such measures for an indefinite term. State corporate law has thus far opted to either prohibit a given arrangement or permit its adoption for an indefinite period. An additional and potentially valuable strategy is to permit firms to adopt provisions that opt out of the law's default but (unless the charter is amended to re-adopt them) remain in place no longer than a specified period. The potential value of this strategy is suggested by the analysis of the differences between the IPO and midstream stages.

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

The analysis of this Article is organized as follows. Part I describes the conflicting evidence of shareholder preference for antitakeover provisions. Part II then develops and analyzes alternative explanations for the difference in firm and investor behavior between the IPO and midstream stages. Finally, Part III discusses the policy implications of the analysis.

I. THE OPTIMALITY INFERENCE AND ITS SHORTCOMINGS

A. *The Debate over Board Veto in Corporate Takeovers*

As I review in detail elsewhere,[7] there are reasons to believe that strong antitakeover protections decrease share value. To begin, ex post—that is, once a bid is on the table—incumbents can use their veto power to block an acquisition that would be beneficial to shareholders. The evidence indicates that incumbents armed with a staggered board are much more likely to retain independence in the face of a hostile bid and that the decision to remain independent commonly places shareholders in a worse position.[8]

Furthermore, ex ante, having a board veto reduces the disciplinary force that the takeover threat can exert on incumbents. The evidence indicates that, when managers are protected from takeovers by strong antitakeover statutes or by antitakeover provisions, managerial

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[7] *See generally* Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002) (analyzing each of the arguments in favor of board veto made by its proponents and concluding that none of them provides a good basis for board veto).

[8] *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 930-39, 950 (2002) (reporting that effective staggered boards nearly doubled the odds of remaining independent for an average target in the study period and that effective staggered boards substantially reduced the returns of shareholders of hostile bid targets).

slack increases.[9] When managers have less to fear from takeovers, they fail to reduce costs and have poorer operating performance, including lower profit margins, return on equity, and sales growth.

Are there any potential benefits of board veto that outweigh the above costs of it? Supporters of board veto argue that, even if incumbents might abuse their veto power in hostile bid cases, they are likely to use it to benefit shareholders by raising premia in negotiated transactions.[10] As I explain in detail elsewhere, however, there are good theoretical reasons to doubt the presence, or at least the significance, of the bargaining advantage that a board veto is claimed to have.[11] In a preliminary empirical study of this question, John Coates, Guhan Subramanian, and I indeed found no statistically significant effect of staggered boards on premia in negotiated acquisitions.[12] Furthermore, two recent studies found evidence that managers are willing to trade off premia for personal gains in the wake of a takeover,[13] which further reinforces doubts that giving managers more bargaining power will result in more value to shareholders.

Proponents of board veto have also argued that it might have beneficial effects ex ante. They suggest that board veto can encourage

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[9] *See* Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535, 536-37 (1999) (finding that the adoption of antitakeover statutes weakened managers' incentives to minimize labor costs); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519, 520-21 (1999) (finding that firms protected by antitakeover statutes are characterized by increased corporate slack); Paul A. Gompers et al., *Corporate Governance and Equity Prices*, 118 Q. J. ECON. 107, 129 (2003) (finding that antitakeover arrangements are associated with lower profits, lower sale growth, and higher capital expenditures).

[10] *See, e.g.*, Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 824-25 (2002) (arguing that takeover defenses are likely to raise acquisition premia).

[11] Bebchuk, *supra* note 7, at 1007-13.

[12] Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 STAN. L. REV. 885, 887, 904-05 (2002).

[13] *See* JAY HARTZELL ET AL., WHAT'S IN IT FOR ME? CEOS WHOSE FIRMS ARE ACQUIRED 3 (Stern Sch. of Bus., N.Y.U., Working Paper No. FIN-00-013, 2002) (presenting evidence that acquisition premia accepted by target CEOs are lower in transactions involving more generous personal treatment of the CEO), *available at* http://pages.stern.nyu.edu/~eofek/Parachutes.pdf; JULIE WULF, DO CEOS IN MERGERS TRADE POWER FOR PREMIUM? EVIDENCE FROM "MERGERS OF EQUALS" 21, 30 tbl.6b (The Wharton Sch., Univ. of Pa., Working Paper No. 2002-03, 2002) (presenting evidence that CEOs accept lower premia in mergers in which they get a position in the combined company), *available at* http://jonescenter.wharton.upenn.edu/papers/2002/wp02-03.pdf.

long-range investment and prevent managerial myopia.[14] They also claim that board veto can encourage firm-specific investments by managers (and other employees).[15] As I explain elsewhere, however, there is currently no empirical support for the view that these conjectured effects are sufficiently significant to outweigh the adverse ex ante effects of board veto.[16]

A current study by Alma Cohen and myself investigates empirically the overall effect that board veto has on shareholder value.[17] We find that staggered boards established by company charters are associated with a lower market value, with a median reduction of about five percent of market value. We also find evidence consistent with charter-based staggered boards causing, and not merely reflecting, a lower firm value. This evidence provides support for the view that board veto has an overall adverse effect on shareholders.

Thus, in terms of direct evidence about the effects of board veto, supporters of board veto have no favorable empirical evidence to rely on and confront a significant body of unfavorable empirical evidence. It is thus unsurprising that proponents of board veto now welcome and attempt to rely so heavily on certain indirect evidence—the evidence that companies adopt antitakeover provisions at the IPO stage.

B. *IPO Behavior and Optimality*

Although state corporate law has, for the most part, sanctioned the various elements of board veto, it has by no means mandated these elements. Corporate charters could seek to tie management's hands from blocking offers by restricting board power to use poison pills. Alternatively, corporate charters could provide arrangements that reinforce the pill by making it more difficult for a hostile bidder to replace the board with a team that would redeem the pill. Recent empirical evidence, which has attracted much attention, indicates that

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[14] For articles taking this position, see Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 115-16 (1979); Martin Lipton & Steven Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205-14 (1991).

[15] Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 305 (1999).

[16] Bebchuk, *supra* note 7, at 1011-13.

[17] Lucian A. Bebchuk & Alma Cohen, The Cost of Entrenched Boards (Oct. 2003) (unpublished manuscript), *available at* http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/03.bebchuk-cohen.entrenched-boards.pdf.

firms going public during the past decade have designed their charters to support, rather than eliminate, board veto.[18]

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

Although the ability to force a shareholder vote through the poison pill is not by itself value-decreasing, there are other antitakeover protections—those that substantially impede the ability of shareholders to replace the board quickly—that can provide management with substantial veto power. In particular, the combination of the poison pill and an effective staggered board provides management with considerable veto power. Unlike the poison pill, which can be adopted at any time by the board and does not require shareholder approval, staggered boards usually require a charter provision.

As noted, empirical evidence suggests that IPO firms opted for staggered boards and other antitakeover provisions at an increasing rate throughout the 1990s. In his study of IPO charter provisions, Coates found that only thirty-four percent of firms adopted staggered boards at the IPO stage in 1991–1992.[19] By 1998, that number had risen to sixty-six percent, and by 1999, the number rose again to eighty-two percent of firms.[20]

According to a widely held view, firms at the IPO stage have powerful incentives to adopt arrangements that benefit shareholders,[21] and the adoption of arrangements at this stage thus provides evidence of their optimality. Applying this general view to the takeover context, supporters of board veto argue that this pattern was due to—and thus

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[18] *See* sources cited *supra* note 1 (providing evidence about the prevalence of antitakeover provisions in corporate charters).

[19] Coates, *supra* note 1, at 1376.

[20] *Id.*

[21] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976) (discussing the incentives that those taking a firm public have to choose efficient corporate governance arrangements).

was evidence of—the positive effects of a board veto on share value.[22] According to this view, the IPO evidence indicates that shareholders—who are in the best position to know their interests—wish to have board veto. The existing direct evidence concerning the adverse effects of board veto, it is argued, should take a back seat to the clear expression of shareholder preferences that IPO charters provide.

C. *Conflicting Midstream Behavior*

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

Throughout the past decade, shareholders of existing companies have been generally unwilling to vote in favor of amending the charter to include antitakeover provisions that would make replacement of the board more difficult. In the wake of this dwindling shareholder support, boards have all but stopped proposing such amendments. From 1986–2002, the annual number of such proposals dropped by ninety percent.[23]

Furthermore, shareholders' opposition to antitakeover charter provisions has been reflected in the large and growing support given to precatory resolutions to dismantle existing staggered boards.[24] For instance, Patrick McGurn, Special Counsel for Institutional Shareholder Services (ISS), has stated:

> In the wake of the corporate scandals of the past several months, ISS often receives inquiries as to our views on the two or three key governance changes that—if adopted by all issuers—would help investors to avoid similar market meltdowns in the future. Unquestionably, the item on our

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[22] *See* sources cited *supra* note 3 (listing authors who infer from firms' adoption of antitakeover provisions in IPO charters that such provisions benefit shareholders).

[23] Klausner, *supra* note 5, at 758-59, 759 tbl.2.

[24] *See* GEORGESON SHAREHOLDER, ANNUAL CORPORATE GOVERNANCE REVIEW: SHAREHOLDER PROPOSALS AND PROXY CONTESTS 6 fig.8 (2002) (reporting that, in 2002, precatory resolutions to repeal classified boards obtained on average sixty percent of votes cast), *available at* http://www.georgeson.com/pdf/02wrapup.pdf.

> wish list that draws the blankest stares from corporate America is the call for annual elections of all members of corporate boards.[25]

McGurn goes on to note that, over the last three years, precatory resolutions to repeal staggered boards have, on average, received support from a majority of the shareholders participating in the vote.[26] The evidence shows that this support is strong and has been increasing over the last decade.

That these proposals have been able to gain a majority vote is particularly striking in light of shareholders' general reluctance to oppose the board in votes on precatory resolutions. Many other such resolutions, even those that are potentially beneficial for shareholders, receive little institutional support.[27] But on the issue of staggered boards, the institutional shareholders speak loudly, persistently, and with a clear voice. This pattern provides very strong evidence that shareholders do not favor charter provisions that facilitate a board veto.

D. *Attempting to Reconcile IPO and Midstream Behavior*

Can supporters of board veto reconcile the shareholder voting evidence with their claim that shareholders often prefer a board veto? Marcel Kahan and Ed Rock raise the possibility that it may take time for shareholders to learn about the precise effects of board veto on share value.[28] According to this view, shareholder voting against takeover defenses is a transient phenomenon that will gradually go away as all shareholders learn to recognize the beneficial effects of such defenses.

This explanation, however, is undermined by an examination of the trends over time. During the 1990s, the incidence of antitakeover provisions in IPO charters increased, as did the percentage of shareholders voting in opposition to staggered boards. Under the learning conjecture, learning should gradually lead to convergence of IPO and midstream behavior, but in fact, we have seen the opposite. As players' experience with antitakeover provisions has increased, both the

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[25] Patrick S. McGurn, *Classification Cancels Corporate Accountability*, 55 STAN. L. REV. 839, 839 (2002) (footnote omitted).

[26] *Id.* at 840-41.

[27] *See* GEORGESON SHAREHOLDER, *supra* note 24, at 6 fig.8 (reporting that proposals concerning executive compensation commonly fail to obtain majority support).

[28] Kahan & Rock, *supra* note 3, at 484-89.

IPO adoption and the midstream opposition have become more pronounced.

Figure 1 below presents a summary of the evidence in various studies about the incidence of staggered boards in the charters of IPO companies.[29] The Figure indicates that this incidence has been growing steadily, rising from an average of 35% during the years 1988–1992 to more than 80% in 2002. Figure 2 presents Georgeson Shareholder's data about the average percentage of shareholder votes cast in favor of precatory resolutions to repeal staggered boards during this period.[30] As Figure 2 indicates, shareholder opposition has been growing, rising from an average vote of 45% for such resolutions in 1996 to 62% in 2002. Investor Responsibility Research Center (IRRC) data presented by Michael Klausner indicates that the trend of growing shareholder opposition was consistent during the first half of the 1990s as well.[31]

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[29] Figure 1 is based on the figure in Coates, *supra* note 1, at 1377, with the addition of the evidence about 2002 appearing in Joanne Allegra, SharkRepellent.net, *IPO Year in Review 2002*, *at* www.sharkrepellent.net/pub/rs_20030106.shtml (Jan. 6, 2003).

[30] For the 2003 figure, see GEORGESON SHAREHOLDER, ANNUAL CORPORATE GOVERNANCE REVIEW: SHAREHOLDER PROPOSALS AND PROXY CONTESTS 7 fig.8 (2003), *available at* http://www.georgesonshareholder.com/pdf/2003WrapUp.pdf. For the 2002 figure, see *supra* note 24, at 6 fig.8. For the 2001 figure, see GEORGESON SHAREHOLDER, ANNUAL MEETING SEASON WRAP-UP: CORPORATE GOVERNANCE 6 fig.8 (2001), *available at* http://www.georgesonshareholder.com/pdf/01Wrapup.pdf. For the 2000 figure, see GEORGESON SHAREHOLDER, ANNUAL MEETING SEASON WRAP-UP: CORPORATE GOVERNANCE 6 fig.8 (2000), *available at* http://www.georgesonshareholder.com/pdf/00Wrapup.pdf. For the 1999 figure, see GEORGESON SHAREHOLDER, ANNUAL MEETING SEASON WRAP-UP: CORPORATE GOVERNANCE 6 fig.8 (1999), *available at* http://www.georgesonshareholder.com/pdf/99Wrapup.pdf. For the 1998 figure, see GEORGESON SHAREHOLDER, ANNUAL MEETING SEASON WRAP-UP: CORPORATE GOVERNANCE 6 fig.8 (1998), *available at* http://www.georgesonshareholder.com/pdf/98_Wrapup.pdf. For the 1997 figure, see GEORGESON SHAREHOLDER, ANNUAL MEETING SEASON WRAP-UP: CORPORATE GOVERNANCE 6 fig.8 (1997), *available at* http://www.georgesonshareholder.com/pdf/97Wrapup.pdf. For the 1996 figure, see GEORGESON SHAREHOLDER, ANNUAL MEETING SEASON WRAP-UP: CORPORATE GOVERNANCE 7 fig.8 (1996), *available at* http://www.georgesonshareholder.com/pdf/96Wrapup.pdf.

[31] Klausner, *supra* note 5, at 757, 758 tbl.1.

Figure 1: Incidence of Staggered Boards in IPOs

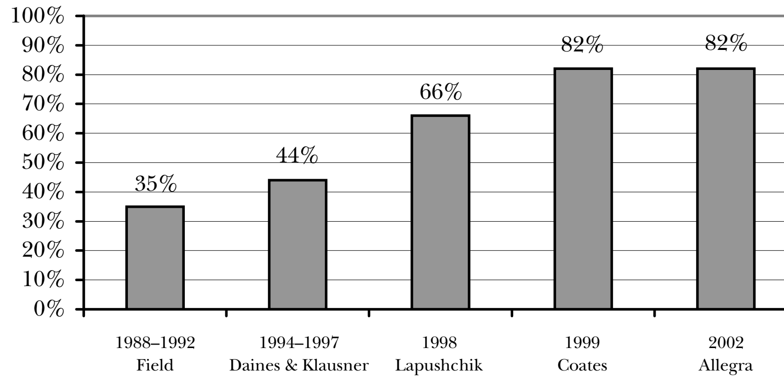
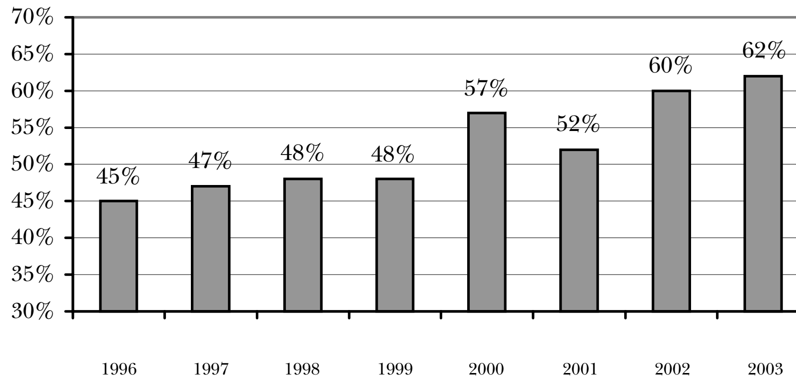


Figure 2: Shareholder Support for Precatory Resolutions to Repeal Staggered Boards



Thus, the passage of time has not done anything to reduce the considered differences between IPO and midstream behavior. To the contrary, IPO firms and shareholder voting have been moving in opposite directions with respect to staggered boards. As firms and shareholders have gained more information over time, IPO firms have

increased their use of staggered boards at the same time that shareholder voting against staggered boards has become more pervasive. Thus, the considered differences between IPO and midstream behavior are unlikely to be the transient product of a learning process on the part of shareholders.

Kahan and Rock also suggest that strong antitakeover protections are beneficial for some companies but not for others.[32] According to this view, IPO adoption of antitakeover arrangements is limited to companies of the former type that go public, while midstream opposition to such arrangements occurs in firms of the latter type that do not. This heterogeneity-based explanation, however, is also inconsistent with the evidence.

For one thing, IPO adoption of antitakeover arrangements has become practically universal rather than limited to certain types of companies. The incidence of staggered board adoption at the IPO stage now exceeds eighty percent.[33] At the same time, shareholders' midstream opposition to staggered boards is also practically universal, rather than limited to some types of companies. To be sure, precatory resolutions to dismantle staggered boards—which are non-binding anyway—occur in only a limited fraction of companies. In many companies that do not have a staggered board, however, management would have been happy to have obtained a charter provision establishing a staggered board if it could have, but it could not do so because of shareholders' unwillingness to approve such charter amendments.

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

[32] Kahan & Rock, *supra* note 3, at 500.

[33] Allegra, *supra* note 29.

midstream adoption of such an amendment is universal, rather than specific to certain types of companies.

Finally, let us consider Lynn Stout's argument against inferring from shareholders' voting decisions that shareholders do not benefit from antitakeover arrangements.[34] According to her view, such arrangements benefit shareholders by encouraging managers (and other employees) to make firm-specific investments in human capital, and IPO firms adopt them for this reason. Once shareholders derive some benefits from managers' making such sunk-cost investments, she argues, they may be tempted sometimes to try to remove takeover defenses. But this argument cannot explain why the large fraction of existing firms that did not have a staggered board in 1990 have generally been unable since 1990 to persuade shareholders to add such a defense. If the shareholders of IPO firms generally benefit from takeover defenses that will encourage firm-specific investments in the years following the IPO, we should also expect that the shareholders of many existing companies would benefit from adopting defenses that encourage firm-specific investments in the years following the adoption. But shareholders of existing firms have generally been unwilling to vote in favor of adding such defenses.

I conclude that it is not possible to accept the simple Panglossian theory that the common adoption of antitakeover provisions in IPO charters indicates that shareholders prefer to have such arrangements. The view that IPO charters simply seek to satisfy shareholders' wishes to have companies governed by antitakeover provisions is inconsistent with the persistent opposition that existing firms' shareholders have to such provisions. What is needed, then, is a richer account that can explain both IPO and midstream behavior. The next Part seeks to develop such an account, identifying several explanations for the complex empirical reality that we observe.

II. EXPLAINING IPO AND MIDSTREAM BEHAVIOR

A. *A Simple Model*

In order to explore the incentive effects facing firms and shareholders, both at the IPO stage and midstream, it is helpful to consider a paradigmatic, stylized model. This model will be useful in analyzing

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[34] Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 702 (2003).

the various possible theoretical explanations for the empirical data described above.

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

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

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

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

If the company adopted a *BV* arrangement at the IPO, the manager will be able to continue to enjoy a private benefit of B even though the company is now in dispersed ownership. In contrast, under *No-BV*

and dispersed ownership, the manager will be able to enjoy only a lower level of private benefits, $B - \Delta B$. Thus, ΔB represents the positive effect that antitakeover protection has on the expected value of private benefits: antitakeover protection makes the manager's obtaining the private benefits more likely, and freeing the manager from fear of a takeover might increase the level of private benefits that the manager would extract.

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

B. *Efficiency-Based Explanations*

1. Inducement to Deconcentrate Ownership

Under this explanation, although *BV* has a negative effect on shareholders when there is dispersed ownership, shareholders are even worse off when the company does not move to dispersed ownership. Thus, shareholders prefer *BV* in the IPO charter at T_0 because, in the event that a profitable investment opportunity emerges, it will encourage the firm to raise capital and move to dispersed ownership at T_1.[35]

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[35] The analysis in this Section builds on LUCIAN ARYE BEBCHUK, A RENT-PROTECTION THEORY OF CORPORATE OWNERSHIP AND CONTROL (Nat'l Bureau of Econ. Research, Working Paper No. 7203, 1999), *available at* http://papers.nber.org/papers/w7203.pdf, which establishes that controlling shareholders might be discouraged from making an efficient move to dispersed ownership when such a move would reduce their private benefits of control.

A move to dispersed ownership can increase the value of public investors' shares. In our model, the increase in value comes from the fact that the investment opportunity is a profitable one and the public investors share in the value of it. Furthermore, although we have assumed for simplicity that the manager enjoys the same high level of private benefits under either dispersed or concentrated ownership when operating under a *BV* arrangement, private benefits might well be higher under concentrated ownership. The lock on control when the founders maintain a controlling block of shares is stronger than their lock on control under *BV* with dispersed ownership.

Let us suppose that ΔV is positive. In this case, if public investors could count on the company moving to dispersed ownership in the event that a profitable opportunity arises, they would prefer to have a *No-BV* arrangement and would be willing to pay a higher price at the IPO for their shares under *No-BV* than under *BV*. Getting to dispersed ownership is not a certainty, however, and the likelihood of getting to dispersed ownership might depend on whether the company has chosen a *BV* arrangement.

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

In contrast, under a *No-BV* arrangement, the manager might elect not to pursue an efficient expansion opportunity if one emerges. Under *No-BV*, the expansion will reduce private benefits by ΔB, a cost that the manager will fully bear. The expansion will also increase the cash flows captured by the initial shareholders by $\Delta K + \Delta V$, but the founders will capture only a fraction $(1\text{-}\alpha)$ of this increase. Thus, because the manager will bear the full cost of the expansion in terms of forgone private benefits but will not fully capture the benefits in terms of increased cash flows, the manager's private interests might best be

served by rejecting the efficient investment opportunity. This will occur if

$$(1\text{-}\alpha)(\Delta K + \Delta V) - \Delta B < 0$$

or, alternatively stated, if

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

Thus, if this condition is satisfied, public investors purchasing shares at the IPO will prefer a *BV* arrangement to a *No-BV* arrangement even though ΔV is positive and a *No-BV* arrangement would increase the value of shares under dispersed ownership. When this condition is satisfied, the company will not reach dispersed ownership if *No-BV* is chosen, so the positive effect of *No-BV* under dispersed ownership is irrelevant in such a case.

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

Thus, the effect of *BV* arrangements on the likelihood of a subsequent move to dispersed ownership might make such an arrangement preferable for buyers of shares at the IPO stage. This could explain the adoption of *BV* in the IPO charter. Such an adoption would increase the value that buyers would be willing to pay for the fraction α of the shares sold and, at the same time, would maintain the value of the founders' block in the event that the company later moves to dispersed ownership.

This explanation is also consistent with the midstream opposition to *BV* arrangements. Once a company moves to dispersed ownership, and public investors' votes become important, the effect of *BV* on the likelihood of a move to dispersed ownership is no longer relevant. At this stage, as long as ΔV is negative, shareholders will have an incentive to vote against amendments to adopt *BV* arrangements, as well as to vote in favor of removing existing *BV* arrangements.

Assuming that this explanation accounts for the IPO adoption of *BV* arrangements, what are its implications for takeover policy? It

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

2. Efficient Rent Protection

Let us now put aside the first explanation considered above and assume that the company will move to dispersed ownership whenever an efficient opportunity to expand arises. Under an efficient rent protection theory, ΔV is assumed to be positive, so that the value of shares under dispersed ownership is lower with a *BV* arrangement. However, the reduction in cash flow ΔV is smaller than ΔB, the increase in private benefits enjoyed by the manager under a *BV* arrangement. Thus, even with a move to dispersed ownership, the use of a *BV* arrangement is efficient overall.

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

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

If *BV* arrangements produce an overall efficient increase in private benefits, one might wonder why managers of existing companies without such arrangements do not "bribe" shareholders to approve an

antitakeover charter amendment—i.e., offer to pay a certain amount to the company if the shareholders approve such an amendment. One possible explanation is that managers might be concerned that offering to make such a side payment could be regarded as a violation of fiduciary duties. Second, at later stages in the life of mature companies, managers might have cash constraints that prevent such a payment. When founders reduce their ownership over time not by selling their own shares and keeping the proceeds, but rather by raising more capital for the firm through issuing more shares, the founder-manager might not have enough cash to purchase shareholders' consent to move to a *BV* arrangement.

The two efficiency-based explanations thus far explored have different empirical implications that can provide the basis for empirical testing. Under the explanation based on incentives to deconcentrate ownership, a *BV* arrangement has a positive effect on the value of public investors' shares immediately following the IPO. Share value (controlling for industry, size, and other relevant company characteristics) should thus be higher for firms with *BV* provisions than for firms without such provisions. In contrast, under the efficient rent protection theory, a *BV* arrangement has a negative effect on the value of public investors' shares immediately following the IPO. Thus, share value should be lower for firms with *BV* provisions than for firms without such provisions.

As for policy implications, the efficient rent protection theory and the explanation based on incentives to deconcentrate ownership have similar implications. Under the efficient rent protection explanation, because *BV* provisions at the IPO can increase the overall pie, adopting them in the IPO should be permitted. In the absence of explicit charter authorization of a *BV* arrangement, however, the default arrangement should be one of *No-BV*. Under the considered explanation, as long as public investors are not compensated for such a change, a move to a *BV* regime makes them worse off. Thus, the legal rules that imposed *BV* arrangements on shareholders of existing firms could not have been justified as an attempt to protect and benefit these shareholders.

C. *Agency-Based Explanations*

Under the two explanations set forth above, the founders—the pre-IPO shareholders—benefited overall from the adoption of a *BV* arrangement in the IPO charter. In contrast, under the set of explanations to which I now turn, such an adoption makes the pre-IPO

shareholders worse off *as a group*. Nonetheless, agency problems lead these shareholders to make an adoption decision that leaves them with a smaller pie overall. The first such explanation focuses on agency problems among the firm's founders. The second such explanation focuses on agency problems between the founders and their lawyers.

1. Agency Problems Among Pre-IPO Shareholders

Consider a situation in which the founders of a company consist of five shareholders with equal holdings, all of whom are members of the same extended family. One of the members manages the firm and is expected to continue in that role after the IPO, while the other members conduct a life of leisure and philanthropic activities. In this case, the interests of the shareholder-manager, who might have a dominant influence on the design of the IPO, are different from—and in particular, are more favorable to a *BV* arrangement than—the interests of the other pre-IPO shareholders.[36]

The reason for these divergent interests is the ability of the shareholder-manager to capture one hundred percent of the higher private benefits that a *BV* arrangement would produce. In contrast, the shareholder-manager would not fully bear the costs of such an arrangement to the pre-IPO shareholders. (These costs, which stem from lower future cash flow and, correspondingly, lower prices for shares sold at the IPO stage and at the second public offering, will be shared by all the pre-IPO shareholders.) The shareholder-manager would bear only twenty percent of these costs.

Thus, because the shareholder-manager would capture one hundred percent of the benefits of a *BV* arrangement to the group of pre-IPO shareholders but would bear only twenty percent of the arrangement's costs to this group, the shareholder-manager might prefer to include this arrangement even if it would reduce the overall wealth of the group. Essentially, the distortion arises from the fact that the shareholder-manager might ignore the external cost that the adoption of a *BV* arrangement may impose on the other pre-IPO shareholders.

The question raised by this explanation, of course, is why the other founders do not prevent such an agency problem from occurring. If a

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[36] *See* Field & Karpoff, *supra* note 1, at 1885 (discussing the possibility of agency conflicts between managers and nonmanagerial shareholders at the IPO stage).

BV arrangement would make them worse off, why would they not prevent the shareholder-manager from adopting it or, alternatively, "bribe" this shareholder-manager not to do so? The answer may sometimes lie in the other shareholders' characteristics or circumstances. At times, the other shareholders might be passive and uninformed and thus have little ability to control or monitor the decisions of the shareholder-manager with respect to many of the fine points of the IPO design.

The considered agency explanation, like the other explanations, is one under which the optimal default in the absence of a charter provision to the contrary is that of a *No-BV* arrangement. However, unlike the two efficiency-based explanations discussed above, this explanation does not imply that it is desirable to permit IPO charters to adopt *BV* arrangements. To the extent that such arrangements are adopted due to an agency problem, such adoption cannot be expected to produce efficiency benefits.

A recent study by Laura Casares Field and Jonathan Karpoff provides evidence that is consistent with the considered agency problems playing a role in the IPO adoption of antitakeover protections.[37] The study finds that, during the 1988–1992 period, the likelihood that a firm going public adopted antitakeover provisions was inversely related to the fraction of the pre-IPO shares held by the manager. The smaller this fraction, of course, the greater the incentive of the manager to include antitakeover provisions even if they are value-decreasing. The study also finds that the likelihood of antitakeover provisions was positively related to various parameters that are correlated with greater managerial power at the time of the IPO.[38]

2. Agency Problems Between Pre-IPO Shareholders and Lawyers

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

Founders taking their company public may elect to defer to counsel with respect to the choice between *BV* and *No-BV* because of their

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[37] *Id.* at 1867-73.

[38] *Id.* at 1884.

recognition that counsel might have superior information and expertise. In particular, the lawyers—with their paramount expertise in advising public companies—might have better information about the future ramifications of *BV* or *No-BV* arrangements. Furthermore, lawyers might be perceived to have a better understanding of the effect of *BV* or *No-BV* arrangements on the price that public investors would be willing to pay for shares. Indeed, recent empirical evidence indicates that counsel is likely to have significant influence on the design of charters at the IPO stage.[39]

The fact that founders may defer to lawyers' superior information creates a potential for agency costs. The very reason why founders might wish to rely on the lawyers' recommendation implies that founders will not be able to fully monitor whether lawyers are giving them the right recommendation (one that reflects the lawyers' undistorted judgment).[40] Because lawyers have some discretion, the lawyers' own incentives might influence the recommendation they ultimately provide.[41]

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

In contrast, the benefits of a *No-BV* arrangement, which stem from a slightly higher IPO price, may not be visible and, more important, are unlikely to be attributed to the lawyer if visible. The founders are

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[39] *See* Coates, *supra* note 1, at 1371-72 tbl.6, 1377-83 (presenting evidence that the identity of counsel influences the inclusion of antitakeover provisions in the IPO charter); *see also* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1580-82 (2002) (presenting evidence that the identity of counsel influences the choices that IPO firms make about where to incorporate).

[40] *See* Coates, *supra* note 1, at 1310 ("[M]ost clients will be ill-equipped to monitor implementation and will defer to the advice of the lawyers for the same reasons the client has retained the lawyer to begin with (lack of expertise, division of labor).").

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

not going to observe the extra value obtained by the use of a *No-BV* arrangement. And, in any event, the professional assessment of the lawyers' work is unlikely to be much affected by the IPO price.

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

The evidence is consistent with this analysis. In the early 1990s, there were a substantial number of IPO firms that included antitakeover provisions in their charter, but also a substantial number of firms that did not.[42] According to a study by Coates, firms elected to adopt *BV* arrangements in their charter provisions at increasing rates throughout the 1990s; by the end of the decade, a great majority of IPO charters had adopted staggered boards.[43]

Coates views this trend as evidence of an agency problem that differs from the one on which I focus. In his view, the adoption of a *BV* arrangement at the IPO stage was good for pre-IPO shareholders, and the reason why some firms did not adopt *BV* arrangements was that their lawyers were not doing an adequate job.[44] Over time, even bad lawyers caught up and learned to serve their clients well by adopting *BV* arrangements. Coates's evidence, however, is also consistent with a different account. Under the account considered in this subsection, pre-IPO shareholders were best served by not including a *BV* arrangement, and lawyers deviated from their clients' interests when they recommended *BV*, rather than when they recommended *No-BV*. Over time, lawyers increasingly switched to recommending a *BV* arrangement since this was the safest route for them—it produced the smallest likelihood that their clients would complain about the legal advice received.

Finally, I should note that the policy implications of this account are similar to those of the first agency-based explanation. Like the first, this explanation implies not only that *No-BV* is the best default

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[42] *See* Coates, *supra* note 1, at 1357-58 (providing evidence about the incidence of antitakeover provisions among a sample of firms in the early 1990s).

[43] *See id.* at 1375-76 (providing evidence about the increase in the use of classified boards during the 1990s).

[44] *Id.* at 1377-83.

arrangement, but also that permitting the adoption of *BV* charter provisions could lead to inefficient outcomes.

D. *Information-Based Explanations*

1. Asymmetric Information

Under this explanation, it is common knowledge among founders and public investors at the IPO stage that, in the event the company converts to dispersed ownership, a *BV* arrangement would be inefficient compared with a *No-BV* arrangement. However, while both founders and public investors have the same information about the identity of the efficient arrangement, founders have some private information about the magnitude of the private benefits to them, as well as the costs to public investors, of the *BV* arrangement. Through a model developed in a companion piece, I show that such asymmetry of information might lead founders to adopt inefficient provisions at the IPO stage.[45]

To appreciate this intuition, consider the following numerical example. Suppose that firms going public sell thirty percent of their shares and that such firms are equally likely to be either of high-value type, *H*, or low-value type, *L*. Founders know their firm's type, but public investors do not. *H* and *L* firms differ in the likelihood of having an investment opportunity that will lead them to move to dispersed ownership. For simplicity, suppose that *H* firms have a one hundred percent likelihood and *L* firms have a ten percent likelihood of facing such an opportunity. Suppose also that, when an opportunity emerges, it will be sufficiently profitable for the founder-manager to pursue it under either a *BV* or a *No-BV* arrangement. Finally, suppose that a *No-BV* arrangement will be less efficient (i.e., $\Delta V > \Delta B$).[46]

Even though investors know that a *No-BV* arrangement is efficient for both *H* and *L* firms, it can be shown that an efficient pooling equilibrium—one in which both types of firms go public with a *No-BV* arrangement—might not exist. In such an equilibrium,

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[45] LUCIAN ARYE BEBCHUK, ASYMMETRIC INFORMATION AND THE CHOICE OF CORPORATE GOVERNANCE ARRANGEMENTS 4 (John M. Olin Ctr. for Law, Econ., & Bus., Harv. Law Sch., Discussion Paper No. 398, 2002), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/398.pdf.

[46] In the model I develop in a companion piece, *id.* at 7, *H* and *L* differ in the value of their assets, rather than in the value of their investment opportunities. The latter difference might be more relevant to the choice between *BV* and *No-BV* arrangements, and I adjust the discussion below accordingly.

public investors, unable to distinguish between *H* and *L* types, will pay the average value to them of a *No-BV* arrangement. As a result, founders with *H* firms are not fully capturing the value of the cash flows they confer on public investors by adopting a *No-BV* arrangement and forgoing their private benefits under *BV*. Consequently, founders with an *H* firm would have an incentive to deviate from the efficient equilibrium. They would have an incentive to reduce somewhat the price at which IPO shares are offered but include a *BV* arrangement. This incentive to deviate would prevent an efficient pooling equilibrium.

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

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

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

2. Bounded Attention and Imperfect IPO Pricing

a. *Bounded attention at the IPO stage*

Bounded attention arises at the IPO stage when rational buyers do not have unlimited informational and computational capacities.[47] As a

[47] For a detailed explanation of "bounded rationality," see David M. Kreps, *Bounded Rationality*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 168 (Peter Newman ed., 1998).

result, potential buyers only take into account aspects of the company that are sufficiently salient or important; other aspects that may have some effect on value are simply not factored into the estimates of value formed by the buyers.[48]

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

One reason for ignoring such nuances is the inherently large degree of uncertainty regarding firms that go public. Such firms have not been subject to the scrutiny and valuation of the market prior to the IPO. Thus, potential IPO buyers might concentrate their efforts on assessing the business prospects of the firm going public.

Furthermore, takeover arrangements might be less important at the IPO stage because their effects on shareholders are not immediately relevant. The adoption of a *BV* arrangement will impact shareholders only when (and if) the company will move to dispersed ownership down the road. As a result, the existence of a *BV* arrangement has a lower relative impact on a firm's value at the IPO stage than in a midstream point at which the existence of a *BV* arrangement is immediately relevant.

To see this, suppose that whether a *BV* arrangement exists will not be relevant during the first five years after a firm's IPO and that there is some probability it will become relevant in five years. An assessment of the value of the IPO company should depend on (i) an assessment of what will happen to the company in the next five years (e.g., whether and how much managerial slack there will be, whether the company will be acquired, etc.); (ii) an assessment of what will happen to the company in subsequent years (after the fifth year) in the event that the *BV* arrangement does not become relevant (and the company

[48] This subsection's argument is a particular type of the general argument that capital markets do not usually price each and every corporate provision. For earlier works expressing skepticism about the existence of such pricing, see Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1410-14 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1411-27 (1985); Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 55-70 (John W. Pratt & Richard J. Zeckhauser eds., 1991).

still exists, of course); and (iii) an assessment of what will happen to the company in those later years in the event that the existence of a *BV* arrangement becomes relevant. Whether a *BV* arrangement is present at the IPO stage affects only element (iii) which is only part of the overall assessment of the value of the IPO firm. In contrast, consider a company that is in a midstream point at which whether a *BV* arrangement exists is immediately relevant. At this point, whether or not a *BV* arrangement exists affects one's assessment of what will happen to the firm not only down the road, but also in the immediate future.

Indeed, at road shows, buyers tend not to inquire about the fine details of firms' corporate charters, so long as those details fall within the established set of arrangements. Buyers do not inquire—and might not even bother to check—whether, say, shareholders can act by written consent or how quickly shareholders can call a special meeting.

Assuming that IPO buyers do not pay attention to differences among takeover arrangements within a certain set of conventional arrangements, founders have an incentive to gravitate toward the arrangements in this set that protect them most from takeovers. Because founders benefit from such arrangements in terms of expected private benefits of control, it would be rational for them to adopt whatever takeover protections will not cost them in terms of the IPO price. The gravitation toward the adoption of staggered boards during the 1990s is consistent with this explanation.

b. *Midstream*

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

Furthermore, at the IPO stage, potential buyers might act on the presumption that, even though conventional antitakeover provisions have a negative expected effect, the effect is not sufficiently significant for them to try assessing its magnitude and factoring it into their decision whether to buy shares at the IPO. In contrast, when shareholders

face a voting decision, the recognition that conventional antitakeover provisions may negatively affect their interests, even if only slightly, is sufficient to instigate a "nay" vote.

It is also worth noting that midstream votes on such questions often come at a stage in which the issue of takeover bids already has more practical significance. Unlike a *BV* arrangement in a charter at the IPO stage, the effects of a *BV* arrangement on share price are likely to be more salient to shareholders by the time a vote on the issue occurs, since the company has already moved to dispersed ownership and the negative effects of *BV* in terms of entrenchment are thus relevant. As explained, the existence of a *BV* arrangement has more importance for assessing the value of a company in midstream than it had for assessing the company's value at the IPO stage.

Thus, the bounded attention explanation is consistent with the persistent midstream voting against *BV* arrangements. This pattern can be explained by the fact that, in midstream, the issue of antitakeover provisions comes to a vote in isolation from other issues. Voting against a provision therefore requires no more than a qualitative judgment that its impact is negative.

c. *Investment bankers*

A common argument is that the presence of underwriters protects buyers of stock at IPOs and provides them with a reliable signal concerning the quality of the initial charter's provisions.[49] According to this argument, the underwriter will have an incentive both to study the charter's proposed provisions and to bargain for the optimal provision. The underwriter, as it were, will represent the interests of the buyers of stock. As explained below, however, the existence of underwriters cannot be expected to prevent the inclusion of conventional but inefficient provisions to which buyers do not pay attention.[50]

To examine this argument in our context, suppose that founders take a company public and that they must decide whether to include a charter provision *BV* that, in the event that the company moves to

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[49] *See, e.g.*, Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554 (1984) (discussing how investment bankers "facilitate efficiency in the capital market").

[50] The discussion below draws on LUCIAN ARYE BEBCHUK, FREEDOM OF CONTRACT AND THE CORPORATION: AN ESSAY ON THE MANDATORY ROLE OF CORPORATE LAW 57-58 (John M. Olin Ctr. for Law, Econ., & Bus., Harv. Law Sch., Discussion Paper No. 46, 1988).

dispersed ownership down the road, would have an adverse effect of one percent on the firm's cash flows. Furthermore, suppose that buyers cannot be expected to pay attention to this issue in their IPO purchase decisions. Would the presence of an underwriter, which we can assume knows the effect of *BV*, lead the founders to exclude *BV* from the company's charter?

The answer is "no" because the underwriter would have no incentive to prevent the inclusion of *BV*. In examining the underwriter's incentives, researchers have suggested two reasons why the underwriter might care about the shareholders' interests. First, the underwriter commits itself to purchasing the shares if the public does not, and this commitment gives the underwriter an incentive to make the stock more appealing to the public.[51] But if, by hypothesis, public investors do not pay attention at the IPO stage to the effects of *BV*, the inclusion of *BV* would not affect the salability of the stock, and therefore, the underwriter would have no reason to object to it. That is, the interest of the underwriter—as far as the underwriting commitment is concerned—is solely to cater to the market's demand which is based on the potential buyers' information. The underwriter's interest does not lie in acting on the basis of its superior information concerning the long-term effects of a *BV* arrangement.

Second, it is often said that the underwriter has a valuable reputation and that the underwriter would defend the interests of stock purchasers to prevent damage to its reputation.[52] Whether this reputational element would provide the underwriter with an incentive to oppose *BV*, however, is far from clear. The presence of a reputable underwriter only guarantees to buyers that charter provisions are not misleading or value-reducing in some unconventional, hidden way. The reputable underwriter's presence does not guarantee that the charter excludes non-optimal but conventional provisions.

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[51] *See* John H. Langmore & Robert A. Prentice, *Contribution Under Section 12 of the Securities Act of 1933: The Existence and Merits of Such a Right*, 40 EMORY L.J. 1015, 1088 n.386 (1991) (discussing underwriters' incentives to avoid being stuck with unsold shares).

[52] *See, e.g.*, James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 506 (1997) (viewing an underwriter's reputation as "an important signal of the offering's quality").

E. *Private vs. Social Optimality*

Before concluding my exploration of possible explanations for the observed patterns, I should note one factor that might well be at work but that cannot explain the observed combination of IPO and midstream behavior. There is literature showing that socially inefficient restrictions on control contests might be adopted at the IPO because such restrictions might impose a negative externality on outside bidders.[53] Because such bidders are not "at the table" during the IPO, designers of the IPO charter have no reason to take their interests into account. Although extracting a higher premium from outside bidders would be a mere transfer from a social point of view, it would be desirable from the private perspective of the target's shareholders. Thus, shareholders might prefer a socially undesirable arrangement that inefficiently reduces the likelihood of a takeover but raises premia. It follows that, on the margin, shareholders prefer to restrict takeovers more than is socially optimal.

The above analysis implies that, even if standard antitakeover provisions were desired by shareholders, possible grounds exist for not permitting some such provisions. The evidence, however, indicates that shareholders do not in fact prefer to have these provisions. If the effect of these provisions on expected future premia were sufficient to make them desirable for shareholders, shareholders of existing companies would not systematically oppose the midstream adoption of such provisions. Opposition from such shareholders indicates that they do not judge the effect of these provisions on surplus extraction from bidders sufficient to make them beneficial overall for shareholders.

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

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[53] For an analysis of such negative externality, see Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1073, 1073-77 (1990); Lucian Arye Bebchuk & Luigi Zingales, *Ownership Structures and the Decision to Go Public: Private Versus Social Optimality*, *in* CONCENTRATED CORPORATE OWNERSHIP 55, 56 (Randall K. Morck ed., 2000); Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, 43-44 (1980).

F. *IPO Firms with Private Equity Funding*

In an article focusing on the adoption of antitakeover charter provisions by IPO firms backed with private equity funding, Michael Klausner questions whether the explanations I put forward in this Article are applicable to such firms.[54] He also proposes an explanation that in his view can account for the behavior of such firms. As I discuss below, however, the explanation that Klausner sets forth in fact has to rely on one of the explanations that I put forward.

Klausner questions whether my explanations are applicable to *VC*-backed IPO firms (i.e., firms that received earlier funding from one or more venture capital firms) on grounds that, when such firms go public, their founder-manager commonly holds a minority of the shares and the venture capitalist(s) hold a majority of the shares. In such circumstances, the explanation based on inducement to deconcentrate ownership is indeed inapplicable because the company is expected not to have a controlling block once the *VC*(s) unload their shares in the market, which they commonly do before too long.

Klausner argues, however, that the explanations based on efficient rent protection and asymmetric information are also inapplicable to *VC*-backed IPO firms. These explanations assume that those making the decision whether to adopt a *BV* arrangement take into account the arrangement's effect on the manager's private benefits of control. But, Klausner argues, when *VC*s hold a majority of shares in the IPO firm, the manager who is going to obtain private benefits of control does not have a decisive say over IPO design.

In Klausner's view, the reason why *VC* firms permit the inclusion of antitakeover arrangements even though they will not directly share any part of management's private benefits of control is that they wish to maintain their reputation of being friendly to management. This reputation for treating management well—especially successful management—in turn helps *VC*s attract firms in which they could invest. To incorporate this element in the simple model, we need to add a venture capital financing stage, T_{VT}, that comes before T_0, the time in which the firm goes public. According to the explanation proposed by Klausner, when the founder-manager and the *VC* contract at T_{VT}, the *VC* makes an implicit commitment, backed by the *VC*'s reputation, to permit the founder-manager to adopt a *BV* arrangement in the fortunate event that the firm ends up going public.

[54] Klausner, *supra* note 5, at 775-81.

Having a reputation for acting in this way is supposed to help the *VC* attract a deal flow and compete with other *VC*s.

The reputation argument can explain why the *VC* can, at T_{VT}, make its commitment implicit, rather than in a legally binding form. Bernard Black and Ronald Gilson argue that, being repeat players, *VC*s are able to make various understandings they have with managers implicit, enforced only by a reputational sanction.[55] But this argument does not speak to the question of what implicit commitments will be optimal for a *VC* to make at T_{VT}.

Standard and familiar reasoning suggests that, at T_{VT}, a *VC* will have an incentive to make implicit commitments only to actions down the road that can be expected to increase, rather than decrease, the expected joint surplus of the parties. Suppose that, in the event of an IPO, adopting a *BV* arrangement will produce an overall benefit of $100 million to the manager and an overall loss of $50 million to the *VC*. In such a case, the *VC* will have an incentive to commit at T_{VT} to permit a *BV* arrangement should the company go public later on even though at that stage a *BV* arrangement would produce a loss of $50 million to the *VC*.

Having such an implicit commitment, however, would not be in the parties' and the *VC*'s interest if it is expected that, in the event of an IPO, adopting a *BV* arrangement will produce an overall benefit of $100 million to the manager and an overall loss of $200 million to the *VC*. In such a case, a commitment to permit a *BV* arrangement in the event of an IPO would in fact reduce the parties' expected joint surplus from the transaction.

Thus, the introduction of *VC* reputation and commitment is not by itself sufficient to explain the adoption of *BV* arrangements by *VC*-backed IPO firms. One needs to explain additionally why, when viewed by the group at T_0, adopting a *BV* arrangement in the event of an IPO can be expected to maximize the total value to the parties. It is only in this case that the *VC* would have an incentive to maintain a reputation of allowing *BV* arrangements at the IPO stage.

What can explain why *VC*s and the manager—the pre-IPO shareholders—will be made better off as a group by adopting a *BV* arrangement at the IPO stage? The possible explanations are those that my analysis has identified. A *BV* arrangement could be in the interest of the pre-IPO shareholders as a group under the efficient rent

55 Bernard S. Black & Ronald J. Gilson, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. FIN. ECON. 243, 245 (1998).

protection explanation, the asymmetric information explanation, or the bounded attention explanation. In short, rather than being inapplicable to the *VC*-backed firm context, the explanations I put forward are an essential complement to the reputational story that Klausner offers to account for why *VC*s are willing to go along with *BV* arrangements when they have considerable say over IPO design.

III. POLICY IMPLICATIONS

A. *No Board Veto Is Best Default*

It is natural to begin by discussing the implications of the analysis for choosing the optimal default arrangement. Even assuming that opting out is permitted, state law must choose default arrangements. The analysis of this Article indicates that the optimal default arrangement is one that does not include a board veto over takeover bids.

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

State courts have acted similarly in adopting defaults that favor management and disfavor takeovers.[56] With the invention of the poison pill, courts had to decide whether and when this device could be used by management. As in the case of legislatures, courts had two options. First, they could have allowed boards to adopt poison pills only if the use of poison pills was authorized by shareholders in a charter provision or otherwise. Alternatively, courts could have set the permissibility of poison pills as a default, permitting boards to use this device as long as it was not prohibited by the charter. Courts chose the latter route.

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[56] For example, the following cases find that defensive actions taken by a board of directors in response to a perceived threat are presumptively valid, subject only to a showing of reasonableness and proportionality: *Katz v. Chevron Corp.*, 27 Cal. Rptr. 2d 681, 689, 693-94 (Cal. Ct. App. 1994); *Hedberg v. Pantepec Int'l, Inc.*, 645 A.2d 543, 546 (Conn. App. Ct. 1994); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953-58 (Del. 1985); *Burcham v. Unison Bancorp, Inc.*, 77 P.3d 130, 147-49 (Kan. 2003).

In a recent article, Assaf Hamdani and I put forward a "reversible defaults" approach to the adoption of defaults for existing companies.[57] Under this approach, when courts and legislatures face a choice between two possible defaults, they should err on the side of choosing the arrangement that is more restrictive with respect to management, even if the other arrangements appear somewhat more likely to be value-maximizing for shareholders.

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

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

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

It follows from this analysis that legislatures and courts erred in the late 1980s and early 1990s when they imposed *BV* arrangements on the shareholders of existing companies. A more sensible approach would have provided for the possibility of a *BV* arrangement,

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[57] Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 492-93 (2002).

but would have required firms to opt into such an arrangement through a charter amendment. In any event, the setting of default rules is a process that never ends. For instance, as Vice Chancellor Leo Strine recently observed, Delaware cases have not clearly resolved whether boards may generally maintain a poison pill to block an acquisition offer after losing an election conducted over the offer.[58] This Article indicates that, when courts resolve this question, shareholders' interests would be best served by a negative answer.

B. *Limited Menu*

The analysis above also indicates that there are reasons to be skeptical about allowing unlimited contractual freedom with respect to corporate charters. This Article thus provides some support for the existing strategy of state law, which offers a menu of options rather than unlimited contractual freedom. State law currently provides firms with some board veto options, but not others. For instance, although staggered boards are allowed, state law generally requires that some directors be elected at each annual meeting.[59] Thus, state law does not permit arrangements under which elections for directors are held only every two or three years, even though it does permit dual class structures that can provide even stronger entrenchment.

An influential view in corporate law scholarship strongly supports contractual freedom in IPO charters.[60] This position is based on a view of the IPO process as close to perfect, with all those involved in the design of the IPO charters having powerful incentives to select value-maximizing provisions. In contrast, the picture of IPO decisions emerging from the analysis of this Article is more mixed, and it does not support the view that all IPO charter provisions should be strongly presumed to maximize value.

To be sure, under the two efficiency-based explanations discussed above, even though *BV* arrangements do not increase the value of shares under dispersed ownership, it is desirable to allow and respect the adoption of *BV* arrangements at the IPO stage. However,

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[58] Leo E. Strine, Jr., *The Professorial Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 55 STAN. L. REV. 863, 878 (2002).

[59] For an example of such state law, see DEL. CODE ANN. tit. 8, § 141(d) (2001).

[60] *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1422-24 (1989) (arguing that firms should be given broad freedom to choose the corporate governance rules to which they will be subject).

each of the two agency-based explanations—and each of the two information-based explanations—indicates that some limitations on the freedom to adopt antitakeover provisions might be desirable.

More empirical evidence on the extent to which each of the six explanations plays a role in the real world is needed before definite conclusions can be reached about the optimal limits on *BV* arrangements. The available state of knowledge, however, does justify a reasonable measure of skepticism toward claims of unlimited contractual freedom to adopt antitakeover charter provisions. For now, when public officials attach substantial likelihood to the undesirability of some arrangements, it would be sensible not to include them in the menu of permissible choices for charter provisions.

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

C. *Sunset Arrangements*

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

The reason for using such a sunset strategy is the existence of significant differences for both shareholders and management in the IPO and midstream stages. The identity of the desirable arrangement might well change over time. As this analysis has highlighted, the optimal arrangements for a publicly traded company that just went

public and still has a rather concentrated ownership structure might well be different from those optimal for a large, mature publicly traded company with dispersed ownership. Therefore, we should not expect that IPO-stage arrangements will generally remain optimal for a firm decades after it first goes public.

Because of the board's control over charter amendments, there is concern that entrenching arrangements which were chosen at the IPO stage for an efficiency reason will remain in place long after they outlive their value. A sunset strategy would ensure that, in such a case, there will be a resetting after a certain period of time following the IPO. This resetting would in turn ensure that an entrenching mechanism remains in place only if it serves shareholder value.

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

D. *Lessons for Corporate Governance in General*

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

The analysis of this Article is thus relevant for general questions that arise with respect to all corporate governance issues and arrangements. The six reasons that I have identified for why IPO firms

might adopt provisions that reduce the value of public investors' shares can apply not only to antitakeover provisions, but also to provisions governing other corporate governance issues. Indeed, if anything, the problem of bounded attention might be even more severe with respect to other corporate issues than it is with respect to takeover arrangements. Similarly, given the smaller importance of nontakeover governance issues, agency problems with respect to such issues might well be more severe than with respect to takeover issues.

Thus, one general lesson suggested by the analysis is that we should not infer from the adoption of certain provisions in IPO charters that they provide the arrangement which best serves shareholders. There is a substantial amount of corporate work that relies on such inferences to make claims about optimal arrangements. For example, scholars have argued that, since no firms are known to have prohibited insider trading in their charters prior to the laws finding the practice illegal, insider trading must be beneficial for shareholders.[61] The analysis of this Article indicates that such inferences are often unwarranted.

Another general lesson of the analysis concerns the long-standing debate concerning contractual freedom in corporate law.[62] The single but important example of antitakeover provisions provides an opportunity to enrich the debate by using the large amount of empirical evidence and information that we have about IPO provisions and shareholder preferences in the takeover area. The takeover area thus provides us with a good lens through which to investigate the optimality of charter provisions and of charter design in IPOs. As we have seen, this investigation provides reasons to be skeptical about claims for complete contractual freedom in IPO charters.

[61] *See* Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 859 (1983) (criticizing those opposed to insider trading for not having offered an explanation "for why firms have made so little attempt to prohibit insider trading").

[62] For articles presenting a wide range of views on the subject, see Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989).