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Unregulable Defenses and the Perils of Shareholder Choice*

Jennifer Arlen[†] and Eric Talley[‡]

Abstract

A number of corporate law scholars have recently proposed granting shareholders an enhanced right to oversee the use of takeover defenses. While these ‘shareholder choice’ proposals vary somewhat in their content, they generally agree that shareholder oversight is justified only to the extent that shareholders hold a bona fide advantage over managers in evaluating and responding to hostile bids. This article challenges that basic premise, arguing that even if shareholders enjoy a comparative advantage over management in reacting to hostile bids, it does not follow that a shareholder choice regime is value enhancing. In particular, such a regime would give managers an incentive to search for ways to thwart prospective oversight, perhaps even through value-destroying managerial choices that render the firm an unattractive takeover target. We demonstrate (a) that a number of such thwarting defenses exist, (b) that managerial threats to use them are credible, and (c) that their utilization would be difficult or impossible for courts to regulate. Consequently, an immutable, one-size-fits-all shareholder choice rule is likely to be an imprudent policy choice for courts.

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1 Introduction

In the years since the infamous takeover wave of the 1980s, managers of public corporations have developed increasingly innovative strategies for fending off unwanted tender offers. Although defensive strategies (including poison pills, classified and staggered boards, dual class stock capitalization, and the like) initially induced great suspicion among judges, over time judges adopted a significantly more deferential tone. Managers of Delaware corporations¹ – while generally prohibited from playing favorites among bidders once a control change of the company has become inevitable² – face few obstacles in erecting defenses that deter unwanted acquisitions.³ Moreover, evidence suggests that corporate boards have used this power effectively to deter hostile acquirers while encouraging only friendly bids.⁴

The perceived widespread use of defensive tactics has motivated some corporate law scholars to advocate limiting managerial discretion over such measures. Their argument is relatively straightforward, consisting of two interlocking parts: First, when facing a hostile offer, managers are likely motivated less by a desire to serve the interests of the corporation than by a desire to preserve their own positions, since hostile acquisitions frequently portend managerial turnover. And second, the moment of a hostile offer is one where shareholders possess uncharacteristic incentives and abilities to become informed about the fair value of the company. Accordingly, some corporate scholars propose, the context of a takeover bid is one where shareholders' judgment is ultimately more reliable than that of professional managers.⁵

The universe of “shareholder choice” proposals is relatively varied, depending on the scope and contours of those defensive measures that would fall within shareholders' discretion. Under some variations, shareholders would have the authority to overturn defenses adopted after a

¹While Delaware is but a single state, it accounted for nearly three fifths of all publicly listed companies in 2002.

²See, e.g., *Revlon Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

³These categorical strategies are often dubbed “Just Say No” defenses. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990); cf. *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995); *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

⁴See 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 (2002) (analyzing the effect of poison pills used in combination with “effective staggered boards”).

⁵See *infra* Section 2 (discussing the current literature).

hostile bid becomes imminent (what we hereinafter call “post-bid defenses”), regardless of whether such a defense also served other legitimate purposes.⁶ Other variations focus on tailoring rather than timing, granting shareholders the authority to override either pre- or post-bid defenses whose only effect is to deter hostile bids (what we hereinafter call “pure defenses”).⁷

Nevertheless, despite this heterogeneity, shareholder choice proposals generally share a common prescriptive feature: that shareholders should be granted authority over defenses *if*, but only to the extent that, they enjoy bona fide advantage over managers in evaluating and responding to a hostile bid (given managers’ agency costs). The most aggressive shareholder choice proposals, therefore, generally limit shareholder authority to over-turn post-bid and pure defenses; they fall short of extending shareholder authority that extends even to ordinary business decisions. In ordinary business decisions made outside of the takeover context,⁸ shareholders have little incentive or ability to become adequately aware of the underlying issues at stake (indeed, that is why the shareholders hire a manager to begin with). Moreover, in such routine, workaday settings, self-preservation is less likely to motivate managers’ actions, and accordingly managerial authority is optimal.⁹

In this article, we argue that the case for shareholder choice is not as ineluctable as its proponents suggest. In particular, we show that *even if* shareholders enjoy a comparative advantage over managers in assessing and reacting to hostile bids, giving shareholders control over defensive tactics may nonetheless work against their own interests. The intuition behind our argument lies in recognizing that the allocation of control rights over defensive tactics not only affects the firm after a tender offer is announced, but also may affect how managers manage the firm *ex ante*.¹⁰ Subjecting managers to a shareholder choice regime would not remove their desire to deter hostile bids; if anything, managers

⁶Examples of such post-bid defenses that may also serve legitimate purposes include a friendly merger or post-bid restructuring.

⁷See *infra* Section 2 (discussing the current literature).

⁸Indeed, even when a ordinary decision entails a conflict of interest, corporate scholars generally prefer to vest authority over the decision in outside directors. E.g., Frank Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law* Chap. (1991). By contrast, in the case of tender offers, many corporate scholars advocate shareholder authority even when the firm has a majority of outside directors. See *infra* Section 2.

⁹See *infra* Section 2 (discussing the current literature).

¹⁰For a discussion of other *ex ante* considerations affecting the validity of shareholder choice, see, e.g., Marcel Kahan & Edward Rock, *Corporate Constitutionalism: Anti-Takeover Charter Provisions as Precommitment*, *Univ. Penn. L. Rev.* (forthcoming 2003).

under such a rule would have a stronger incentive to deter acquisitions activity, since an effective shareholder choice regime¹¹ maximizes the probability that the firm receives a hostile rather than a friendly offer. Consequently, managers would have an incentive to search for effective defenses that are not regulated by the rule.

As we demonstrate below, a wide range of such defenses appears to exist. Even under the strongest shareholder choice regime, managers will almost certainly have access to unregulated (and unregulable) defenses.¹² For example, if managers were precluded from pursuing either pure defenses or post-bid defenses (as defined above), it would still be possible to “embed” defenses into a host of seemingly ordinary business transactions, with the effect of deterring subsequent bids. A notable example of such embedded defenses is the inclusion of “change of control” provisions in everyday business contracts (such as lease, joint ventures, licenses, employment contracts and debt instruments) that imposes costs on the firm in the event of a change of control.¹³ These provisions, particularly when employed in a variety of the firm’s contracts, can be sufficient to deter most (if not all) bids. A strong shareholder choice rule, when it encourages this form of substitute defense, may have the unintended effect of reducing firm value not only by deterring takeovers (both friendly and hostile) but also by inefficiently altering the very operating profile of the firm.¹⁴

There a number of reasons to believe that embedded defenses (such as those described above) would pose a bona fide threat under a shareholder choice regime. First, as even proponents of shareholder choice concede, courts are poorly positioned to regulate day-to-day managerial decisions made outside of the context of a tender offer, and which likely have legitimate business justifications. This very difficulty in second-guessing managerial decisions lies at the core of the business judgment rule, which is itself a cornerstone of American corporate law.

Second, managers would almost certainly have the strong incentive to employ (indeed invent) unregulated embedded defenses under a share-

¹¹In this article, we focus on the strongest shareholder choice regimes that grant shareholders ultimate authority to determine the fate of all pure and post-bid defenses. E.g., Lucian Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 *Univ. Chi. L. Rev.* 973 (2002).

¹²See *infra* text accompanying notes __ - __ (discussing why these defenses would be so difficult to regulate).

¹³See *infra* Section III (discussing the availability of pre-bid embedded defenses).

¹⁴While others have noted the possibility of defense substitution, they have not examined either the breadth of available substitutes or whether managers can be expected to adopt these substitutes, even if doing so could decrease the probability of friendly deals. See *infra* note __ (discussing other articles that recognize the possibility of defense substitution).

holder choice regime. From management's perspective, a shareholder choice regime would effectively transform all acquisitions into hostile ones, as acquirers would no longer need to bid for managerial support of a takeover bid, thereby eliminating most of the private benefits managers might reap from friendly acquisitions. This transformation would increase the benefit to managers of deterring acquisitions because hostile acquisitions present a real threat of termination. It also would reduce the cost to managers of using blanket defenses, as managers now would gain little from permitting acquisitions.

Consequently, while shareholder choice proponents are correct to point out that limiting managerial control would increase the gain to shareholders of those takeovers that *do* occur, we show that it also would provide managers with increased incentives to employ substitute embedded defenses, including blanket defenses that deter hostile and friendly deals alike. While the former would increase shareholder value, the latter would reduce it. The case for shareholder choice, therefore, depends on which of the above two effects is likely to predominate at the firm level. This question is difficult to answer on a priori grounds.

Accordingly, we contend that it is not possible to make a general case for the superiority of shareholder choice over rules granting boards considerable veto power over hostile tender offers. In those situations where managers have little ability to use strategic embedded defenses, shareholder choice has much to commend it. However, in situations where managers can (and would) employ embedded defenses to deter bids, the imposition of shareholder choice could prove counter-productive. We therefore doubt that an immutable, one-size-fits-all rule is appropriate in such heterogeneous contexts. Rather, courts may wish to give increased deference to the choices shareholders themselves have made to grant managers power over takeovers whenever such choices appear to be clear.¹⁵

Before commencing with our argument, four caveats deserve specific mention. First, it is important to note that under the prevailing legal regime, pre-bid, embedded defenses (as we have described them) are probably not a particularly pervasive practice. This observation, however, does not detract from the legitimacy of our argument that such

¹⁵Thus, we are more cautious than others about whether courts can confidently invalidate antitakeover provisions that shareholders consented to (either at the IPO stage or through a shareholder vote). Compare with Ronald Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 *Stan. L. Rev.* 775 (1981-1982) (suggesting that courts invalidate certain pre-bid pure defenses notwithstanding shareholder approval). For a different argument favoring respect of shareholders' ex ante decisions to grant managers authority over takeovers see Kahan & Rock, *supra* note [corp constitutionalism].

embedded defenses are a potential threat. Indeed, the relative paucity of such defenses is in large part due to the fact that the current regime consciously permits managers to deter hostile bids through more targeted means. If courts adopted proposals to alter this regime to give shareholders greater voice over defensive measures, however, managers would have a strong incentive to adjust their own behavior towards such embedded defenses.

Second, a discussion of how managers may respond to enhanced shareholder choice should also take into consideration that shareholders too may anticipate this managerial response and alter their own conduct accordingly. In particular, shareholders might respond to the specter of embedded defenses by promulgating incentive schemes that tie managers' welfare more closely to that of the firm. Shareholders could be expected, for example, to increase managers' incentive compensation (stock ownership, options etc). Our analysis takes this possibility into account, and it demonstrates why such shareholder responses would not fully cure the problem. First, because such incentives must come from shareholders, there may be cases in which shareholders simply decline (or are unable) to make sufficient incentive payments to induce the efficient decisions.¹⁶ Second, we show that even when shareholders do offer managers appropriate incentive compensation, the amounts awarded are must be so large that non-managerial shareholders would be better off under a regime that simply granted managers the power to deter hostile bids.

Third, although we animate our arguments by comparing a strong shareholder choice regime to a polar opposite regime of strong managerial choice, this does not imply that the optimal default rule for a firm must be one of these extreme points.¹⁷ While the strongest shareholder choice regimes provide managers with excessive incentives

¹⁶Indeed, the arguments for shareholder choice are predicated on the idea that executive incentive compensation does not adequately ameliorate agency cost problems. See Ehud Kamar, (discussing the effect of executive compensation in more detail). Compare Kahan & Rock, *supra* note [chiLRev] (discussing adaptive mechanisms shareholders can use to mute the agency costs associated with a managerial veto regime) with Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 *Univ. Chi. L. Rev.* 917 (2002) (discussing the limits of adaptive solutions).

¹⁷See Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 *Univ. Chi. L. Rev.* 917 (2002) (discussing that courts have the capacity to adopt some controls that shareholders cannot replicate by contract); see also Luca Anderlini, Leonardo Felli, & Andrew Postlewaite, *Courts of Law and Unforeseen Contingencies*, Pennsylvania Institute of Economic Research Working Paper No. 01-010 (making this point generally).

to adopt value-reducing defenses, unalloyed managerial veto rules may not adequately discipline managers' efforts to misappropriate private benefits. In most general settings, the optimal rule is likely to be an intermediate one, disallowing certain value-reducing defenses, but nevertheless granting managers some latitude to favor friendly bidders over hostile ones.¹⁸

Finally, while our central argument is based on intuitive arguments and economic theory, it is nonetheless important to assess its "fit" by situating our analysis within existing empirical knowledge about corporate governance. As we demonstrate below, many of our arguments may provide a useful explanation of a number of quandaries within corporate scholarship. Some recent studies, for example, have found that the inclusion or preclusion of anti-takeover protections in an initial charter does not appear to be "priced out" in the form of a discount at the IPO stage.¹⁹ While some have interpreted these findings as evidence of irrationality — or at least inattentiveness — within capital markets, our analysis suggests a possible more systematic explanation: That market participants accurately priced both the costs of antitakeover protections (realized at the takeover stage) and their benefits (realized further upstream, at the embedded defense stage). Under this view, the net effect of such measures may be both indeterminate and empirically insignificant. Additionally, our findings may help shed light on other studies that find executive incentive compensation to be negatively related to takeover impediments.²⁰

This remainder of this article proceeds as follows. Section 2 examines the existing debate over shareholder choice and determines the limits of shareholder choice. It then reveals a previously unexamined zone of unregulable pre-bid embedded defenses.²¹ Section 3 establishes the existence of a wide variety of existing pre-bid embedded defenses that managers would employ to deter bids, free from effective court oversight. Section 4 summarizes our findings that shareholder choice would induce managers to adopt value-reducing pre-bid embedded defenses that they would not otherwise adopt. Section 5 presents a more formal analysis of shareholder choice. Section 6 provides some empirical support in

¹⁸This paper does not determine the optimal scope of such a rule. Its central contribution is to introduce an additional consideration that must be taken into account in the design of an optimal shareholder choice rule.

¹⁹Daines & Klausner; Klausner (Penn Symposium Piece).

²⁰Kieth Harvey & Ronald Shrieves, Executive Compensation Structure and Corporate Governance Choices, __ Journal of Financial Research __ (2003) (finding, for example, that the relative absence of directors is negatively related to high powered incentive compensation).

²¹See *infra* note .

support of our findings. Section 7 concludes.

2 Defining the Limits of Shareholder Choice

This section examines more specifically the arguments favoring shareholder choice. While the various incarnations of this approach are far from homogeneous, we argue that there are nonetheless at least a few guiding principles that limit the domain of authority that shareholders can justifiably claim over takeover decisions. For instance, we argue that even the strongest proponents of shareholder choice would likely stop short of advocating shareholder scrutiny in decisions pertaining to ordinary course of business (i.e., long before a bid is imminent) that may nonetheless have the effect of deterring certain types of takeovers. Yet to the extent this zone remains unregulated, adoption of shareholder choice may simply cause managers to switch from existing defenses into these unregulated defenses. This could have adverse consequences for firms.²²

2.1 Managerial Control versus Shareholder Choice

Corporate law scholars generally subscribe to the proposition that professional management of corporations is usually superior to shareholder management of everyday business decisions. In the case of everyday business transactions, disaggregated shareholders have neither the incentives to acquire — nor the capacity to analyze — the information needed to make good business decisions.²³ Moreover, even when shareholders are in possession of all relevant information, a host of related

²²Indeed, both U.S. proposals and European law both fall short of regulating most pre-bid defenses. Although the U.K.'s City Code tightly restricts managers' ability to implement "defensive measures" once a takeover bid is imminent, it does not regulate managers' adoption of "protective measures" implemented well in advance of a takeover. In response, many European, especially Continental companies, adopted strong protective devices that significantly impede takeovers. Eddy Wymeersch, *Problems of the Regulation of Takeover Bids in Western Europe: A Comparative Study*, in *European Takeovers: Law and Practice*, 95, 122 (Klaus Hopt & Eddy Wymeersch, eds.) (1992); see *infra* note __ [discussing Golden Share arrangements].

Moreover, Europe's experience with the 13th Directive reveals some of the difficulties associated with pre-bid defenses. Germany's veto of the proposed 13th Directive in December, 2001 was in part based on the claim that it was not a good idea to regulate post-bid defenses if pre-bid defenses remained unregulated. Subsequent efforts to address this issue by the High Level Group of Company Law Experts appointed by the European Commission would somewhat reduce the problem of pre-bid defenses, while leaving untouched the main group of pre-bid defenses identified in this paper.

²³Indeed, the very reason publicly held corporations exist is to exploit the advantages of vesting control of the firm in professional managers who do not own the firm.

coordination and collective action problems conspire to plague collective decision making.²⁴

While few corporate law scholars would contest this general proposition, there is considerably more debate about the degree to which it applies to managers' adoption of takeover defenses. Proponents managerial control over takeovers argue that the same concerns are equally applicable in the takeover context. Shareholders are not sufficiently well informed about the future value of the firm to evaluate a takeover bid, and do not have the requisite incentives to obtain the necessary information, they argue. Moreover, even if shareholders are informed, they likely lack the capacity and business acumen to evaluate it properly. Consequently, proponents contend, shareholders are far better off vesting authority over tender offers in the hands of expert managers (just as they do with other decisions).²⁵

By contrast, shareholder choice proponents concede the desirability of professional management in ordinary business transactions,²⁶ but contend that in the context of a tender offer the costs of professional management exceed its benefits. In particular, because hostile acquisitions frequently presage managerial turnover,²⁷ managers can become con-

²⁴See generally Frank Easterbrook and Dan Fischel, *The Economic Structure of Corporate Law* (1991).

²⁵See, e.g., Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 *Bus. Law.* 101 (1970); Martin Lipton, *Pills, Polls, and Professors Redux*, 69 *Univ. Chi. L. Rev.* 1037 (2002); see also Kahan & Rock, *supra* note , at __ [around note 30] (discussing the view of "Hamiltonian" corporate scholars who assert that managerial decisionmaking is better because they have private information about future value than cannot optimally or effectively be shared with shareholders); Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 *Nw. Univ. L. Rev.* 521 (2002) (hidden value justifies some managerial power to defend).

Some scholars present arguments for board control for reasons other than relative shareholder incompetence at evaluating takeover bids. E.g., Marcel Kahan & Edward Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions As Pre-Commitment*, *U. Penn. L. Rev.* (2003) (shareholders may precommit to granting boards control over tender offers because boards are better able to implement a selling strategy); Lynn Stout, [this issue] (commitment to board veto power may promote team production) [To ed: can I see the most recent version of this article]; see also Roberta Romano, *The Political Economy of Takeover Statutes*, 73 *Va. L. Rev.* 111 (1987) (certain antitakeover provisions may benefit small shareholders).

²⁶For example, Lucian Bebchuk, who probably takes the most expansive view of the proper scope of shareholder authority nevertheless accepts the importance of professional managerial control over general business operations (as opposed to charter amendments and mergers). See Lucian Bebchuk, *Empowering Shareholders* (unpublished 2003).

²⁷E.g. Kenneth Martin & John McConnell, *Corporate Performance, Corporate Takeovers, and Management Turnover*, 46 *J. Finance* 671 (1991).

sumed with self-preservation,²⁸ either resisting hostile deals altogether or favoring ‘friendly’ acquisitions that provide managers with either continued job security or an attractive buyout (at shareholders’ expense). This not only can reduce shareholder welfare ex post, it also reduces it ex ante by muting the disciplining effect of the market for corporate control.²⁹ Accordingly, they argue, control over the corporate decision-making regarding tender offers should devolve to shareholders if, and to the extent that, shareholders can be relied upon to make informed judgments concerning tender offers, proponents of shareholder choice argue.³⁰

Scholars seeking to define the limits of shareholder choice generally agree that shareholder choice should not supplant managerial control unless shareholders can be expected to be sufficiently well informed to make the requisite business decisions. Thus, in this view, the proper contours of shareholder choice depends on shareholders’ incentives to obtain and capacity to evaluate the information necessary to choose between the hostile tender offer and the option presented by management’s defenses (e.g., leaving the target as is). As takeover defenses vary in their complexity, and shareholder choice proponents differ in their faith in shareholder decisionmaking capacity, shareholder choice proposals also vary in their view as to when shareholders should be permitted to invalidate managers’ defenses in order to accept a hostile offer.

2.2 The Scope of Shareholder Choice

To assess shareholder decisionmaking capacity, it is useful to distinguish takeover defenses based on two criteria: (1) whether the defense is a

²⁸E.g., James Cotter & Marc Zenner, How Managerial Wealth Affects the Tender Offer Process, 35 *J. Fin. Econ.* 63 (1994) (offering empirical support for the claim that managerial resistance to tender offers appears to be driven by managers’ self-interest, rather than shareholders’ interests); Ralph Walking & Michael Long, Agency Theory, Managerial Welfare, and Takeover Bid Resistance, 15 *RAND J. Econ.* 54 (1984) (same).

²⁹E.g., Lucian Bebchuk, The Case Against Board Veto in Corporate Takeovers, 69 *Univ. Chi. L. Rev.* 973 (2002).

³⁰Scholars who advocate some form of shareholder choice include, e.g., Lucian A. Bebchuk, The Case for Facilitating Competing Tender Offers, 95 *Harv. L. Rev.* 1028 (1982); Lucian Bebchuk, John Coates IV & Guhan Subramanian, The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, 54 *Stan. L. Rev.* 887, 949 (2000); Bernard Black & Reinier Kraakman, Delaware’s Takeover Law: The Uncertain Search for Hidden Value, 96 *Nw. U. L. Rev.* 521 (2002); Frank Easterbrook & Daniel Fischel, The Proper Role of Target’s Management in Responding to a Tender Offer, 94 *Harv. L. Rev.* 1161 (1981); Ronald Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 *Stan. L. Rev.* 819 (1981).

pure defense (that only affects the likely success of a hostile offer) or is an embedded defense that is incorporated into a business transaction that might be in the firm’s best interests notwithstanding the tender offer; and (2) whether the defense is adopted in the course of an ordinary business transaction (with no imminent or existing bid) or in response to an actual or imminent bid. This permits us to represent the defenses that managers may employ a two-by-two matrix, pictured in Table 1 below. In the matrix, the *effect* of the defense is represented on the vertical axis while the *timing* of the defense is on the horizontal axis:

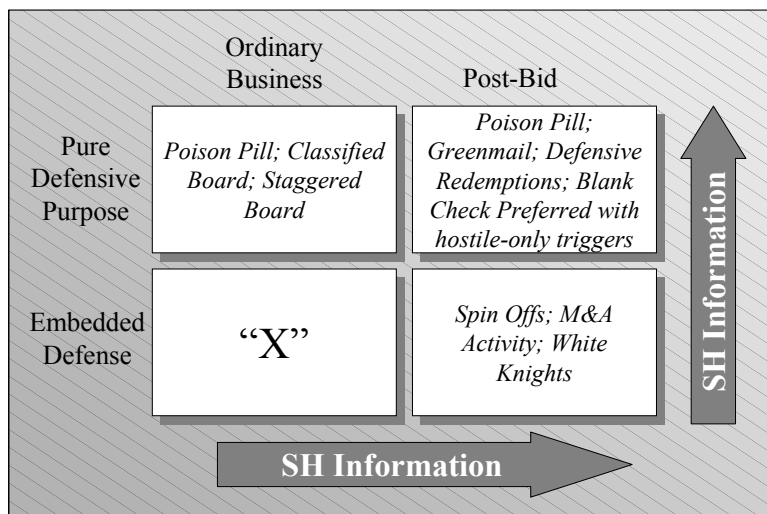


Table 1: A Simple Taxonomy of Defenses

Moving from left to right along the horizontal axis – i.e., from pre-bid defenses taken in the “ordinary course of business” to post-bid defenses – likely correlates to a move towards greater shareholder information. Indeed, shareholder choice proponents themselves generally base their claims for shareholder authority over post-bid defenses in part on the grounds that shareholders’ incentives and ability to obtain and evaluate information increase dramatically once a bid has emerged.³¹ A takeover bid occurs rarely in the life of a firm and has enormous potential consequences for shareholders. These high stakes provide shareholders with adequate incentives to become informed. Moreover, shareholders’ costs of obtaining information are likely lower post-bid than in the course of ordinary business transactions because the heat of a tender offer results in scrutiny by arbitrageurs, investors, research analysts and the press. Moreover, shareholders’ decisionmaking capacity may be greater because firms subject to tender offers often end up with proportionately

³¹E.g., Bebchuk, *supra* note [chi 1 rev]; see Gilson, *supra* note .

more informed investors, such as arbitrageurs, investment banks and institutional investors. Thus, while shareholders generally cannot make business decisions in the ordinary course of business, they can do so in the heated crucible of the post-bid environment.³²

A move from bottom to top along the vertical axis – from embedded defenses to pure defenses – also represents a move towards a decision shareholders have greater capacity to make. A "pure defense" is a measure whose only purpose and effect is to deter hostile bids. Thus, an effective pure defense has the equivalent effect on firm value of granting managers a similarly effective veto right over tender offers. A classic example of such a measure is the poison pill, which has no effect on firm value except to the extent that it discourages hostile acquisitions.³³ The second type of defense is an embedded (or mixed-motive) defense. Embedded defenses are actions the board purports to take for legitimate (non-defensive) business reasons that also have the effect of deterring tender offers (either hostile bids or generally). The decision by a board to spin-off a subsidiary, or to merge with a firm other than the hostile bidder, are examples of embedded defenses. These measures *do* affect firm value independent of any effect on the hostile bid.³⁴ The effect, moreover, may be positive or negative.

Shareholders' capacity to assert authority over a tender offer is lower when the firm has an embedded defense than when it has a pure defense because the decision to overturn an embedded defense imposes far greater informational demands on shareholders. To select between a tender offer and maintenance of a pure defense, shareholders need only compare the merits of the acquirer's bid against their best estimate of the value of the status quo. In such situations, when management is seeking to maintain status quo against a raider, shareholders can obtain relatively good information about company value by analyzing the existing prospects that firm enjoys. Furthermore, even in the case of pre-bid pure defenses, shareholders can wait to evaluate the defense until after a tender offer has materialized, since, by definition, the pure defense neither imposes legitimate reliance interests in third parties, nor

³²E.g., Bebchuk, *supra* note ([chicago piece])

³³The poison pill discourages acquisitions by causing the firm to disgorge value to non-acquirer holders of the firm's securities when an acquiring firm crosses a pre-specified threshold level of ownership. Poison pills are designed to discourage acquiror from obtaining the triggering ownership amount, and thus are not triggered. Cf. William Carney & Leonard Silverstein, *The Illusory Protections of the Poison Pill* (unpublished manuscript) (questioning whether acquirors should be so wary of triggering pills).

³⁴This includes that such defenses may deter both hostile and friendly deals alike. See *infra* Section 3.

does it impose irreversible sunk costs on the company. Accordingly, shareholders can evaluate pure defenses in the informationally-rich context subsequent to a bid.³⁵ By contrast, to evaluate the merits of an embedded defense, shareholders must compare the value of a tender offer bid against the value of the firm as altered (indeed restructured) by the embedded defense. This comparison imposes far greater requirements on shareholders, forcing them to anticipate not only the future trajectory of the firm (which may change after the embedded defense is installed). Moreover, the informational demands are amplified further when the embedded defense is adopted at a pre-bid stage, as it would force shareholders to forecast the probability, timing and value of some future tender offer under the status quo.

The matrix above can be used to delineate the debate *among* shareholder choice proposals as to the proper scope of shareholder choice. Most choice advocates agree that the case for shareholder choice is strongest when managers seek to employ pure defenses.³⁶ Indeed, most choice proponents would agree that given managerial agency costs on the one hand, and shareholders' strong incentives and capacity to obtain good information on the other, managers should not be permitted to maintain such pure defenses to thwart a hostile offer. Perhaps the only circumstances under which managers should be allowed to maintain a pure defense, advocates argue, are when it is used to as bargaining leverage negotiate a better deal for shareholders. Once the raider has made its tender offer, proponents contend, management should be required to submit the decision to shareholders and should be forced to remove all pure defenses if shareholders vote to approve the deal.³⁷

³⁵E.g., Bebchuk, *supra* note . But see Kahan & Rock, *supra* note , at __ [around note 30] (discussing the view of "Hamiltonian" corporate scholars who assert that managerial decisionmaking is better because they have private information about future value than cannot optimally or effectively be shared with shareholders); Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 *Nw. Univ. L. Rev.* 521 (2002) (hidden value justifies some managerial power to defend).

³⁶In the case of the poison pill, there is no distinction between pre-bid and post-bid pure defenses because even if the pill is adopted pre-bid, the board must decide whether to redeem the pill post-bid.

³⁷E.g., Bebchuk, *supra* note ; Gilson, *supra* note . A debate within shareholder choice concerns whether shareholders should decide the fate of a raider's offer by tendering their shareholders or by a shareholder vote. Compare Ronald Gilson & Alan Schwartz, *Sales and Elections as Methods for Transferring Corporate Control*, 2 *Theo. Inq. in L.* 783, 790-92 (2001) (straight tender offer is preferable to requiring shareholder voting on tender offers), with Bebchuk, *supra* note [chi] (shareholder voting on tenders offers is preferable to deciding through the tender offer process). One milder proposal that favors shareholder voting holds that boards should be permitted to use a poison pill to "Just Say Not Now," but not to "Just Say No,

Embedded defenses, on the other hand, present a more difficult issue for shareholder choice advocates. Indeed, advocates are largely divided on whether shareholders should be given authority to invalidate embedded defenses even when adopted after a hostile bid is imminent. Post-bid, embedded defenses are actions that the board arguably could adopt, within its business judgment, even were there no hostile bid, such as a post-bid corporate restructuring or defensive mergers with another firm. In other words, they may serve legitimate non-defensive business purposes, in addition to deterring a hostile bid. These decisions place greater demand on shareholder decisionmaking capacity because they require shareholders to choose between the tender offer bid and remaining with a firm that will be altered by the embedded defense. In other words, shareholders must evaluate the future prospects of a firm which has no controlling history – only aspirations and expectations.³⁸

Notwithstanding these added informational problems, at least some commentators advocate granting shareholders veto power to defeat such defenses. Those who take this position conclude that managers are so infected by self interest once a bid has occurred that they cannot be left in control of those business decisions that can be used to defeat a hostile offer. Moreover, as noted above, shareholders likely have a greater capacity to make such business decisions at the post-bid stage than in the course of ordinary business.³⁹ Accordingly, these scholars conclude that once a hostile bid is imminent, shareholders, not the board, should have the ultimate authority to decide the fate of *post-bid* embedded defenses.⁴⁰

Never.” Under this proposal, the board could maintain the pill in the face of a hostile offer unless, and until, the raider mounts, and wins, a proxy contest. If the raider wins the proxy contest, then the board should be forced to remove the pill, even if the raider did not gain control of the entire board because the board is staggered. See Bernard Black & Reinier Kraakman, Delaware’s Takeover Law: The Uncertain Search for Hidden Value, 96 NW. Univ. L. Rev. 521 (2002).

³⁸The greater the impact of the embedded defense, the more difficult it will be for shareholders to compare the merits of the firm with defense to the value offered in the bid. For defenses that do little to alter the existing firm, shareholders may be similarly situated to shareholders facing a pure defense. For those firms considering a real change, like a merger with a similarly-sized or larger firm, it is considerably more difficult for shareholders to evaluate the future of the target in the new world occasioned by the defense.

³⁹See *supra* text accompanying notes __-__ [para. on pre-bid vs post-bid]

⁴⁰This is can be made operational through several means. For example, boards contemplating a business decision that would defeat the hostile bid could submit the decision to shareholders as to whether to accept the bid or proceed with management new business plan. In doing so, managers can provide shareholders with information and arguments supporting their preferred course of action. See, e.g., Bebchuk, *supra* note ; Gilson, *supra* note . But see Black & Kraakman, *supra* note (discussing the

2.3 The Unexamined Fourth Quadrant

Existing scholarship promoting shareholder choice generally has assumed that if shareholders have sufficient capacity to evaluate the relative merits of a tender offer bid and a defense, shareholders should be granted authority to make this decision. This focus on shareholder capacity has led those with the greatest faith in shareholder decisionmaking to favor a particularly strong form of shareholder choice which grants shareholders authority to determine the fate of all pure defenses and (less commonly) all post-bid embedded defenses.⁴¹ Yet, in focusing on these defenses, shareholder choice proponents have paid little attention to the southwest – or fourth – quadrant in Table 1: the pre-bid embedded defense.⁴² Even

problem of hidden value and proposing a more moderate rule).

⁴¹See Bebchuk, *supra* note [chi article]

⁴²A few scholars have observed that the shareholder choice might induce managers to employ substitute defenses, but they generally have not explore the degree to which this possibility does indeed undermine the case for shareholder choice. E.g., Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 *Univ. of Chicago L. Rev.* 917, 920, 928 (2002); Marcel Kahan & Edward Rock, *How I Learned to Stop Worrying and Low the Pill: Adaptive Responses to Takeover Law*, 69 *Univ. of Chicago L. Rev.* 871, 903 (2002) (“as long as board retain the power to manage the company...a unilateral board-opposed governance measure is likely to induce a strategic response by the board.”) see also Atreya Chakraborty & Richard Arnott, *Takeover Defenses and Dilution: A Welfare Analysis*, 36 *J. Fin. & Quan. Analysis* 311 (2001) (suggesting hostiles may provide less disciplining effect than theory suggests in that the primary gain from hostile tender offers may be to undue the effects of value-reducing defenses that managers would not adopt if not subject to the threat of hostile offers); cf. Ronald Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 *Va. L. Rev.* 807 (1987)(concluding that examination of dual class common stock requires consideration of substitutes that accomplish the same result); Ronald Gilson, *The Claim Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 *Stan. L. Rev.* 775 (1981-1982)(recognizing the impact of unregulated pre-bid shark repellents on the merits of regulating post-bid defenses, but not considering the impact of pre-bid embedded defenses on the merits of pre-bid regulating shark repellents). Previous analyzes have not examined the breadth of available pre-bid embedded defenses nor whether managers can be expected to adopt these substitutes, even if doing so could decrease the probability of friendly deals.

Concern that managers subject to extensive regulation of pure defenses and post-bid defenses simply induce managers to substitute into pre-bid defenses (otherwise known as preventive measures) has dominated much of the European debate over takeover law. E.g., Paul Davies & Klaus Hopt, Chap. 7, *Control Transactions*, in *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2002) (A weakness of existing EU shareholder choice proposals is that they regulate post-bid defenses, yet management can act effectively against potential offers in advance of any particular offer materializing. “However, to apply a pre-bid requirement of shareholder approval... would be too great an interference with the operation of centralised management.”). To our knowledge, these analyses have not examined

under the strongest shareholder choice proposals, managers' authority to employ most pre-bid embedded defenses remains unchallenged.⁴³

In many respects, the scholarly neglect of the fourth quadrant is perfectly understandable, for at least two reasons. First, the use of pre-bid, embedded defenses is not particularly common under existing law. As noted above, Delaware law currently grants managers enormous discretion to fashion much more tailored takeover defenses: managers who are not selling control of the firm, for example, can employ defenses in any of the four quadrants to "Just Say No" to an acquirer.⁴⁴ Given this discretion to employ defenses in any quadrant of the matrix, managers can be expected to favor those defenses that deter an unwanted bid at minimal cost. This suggests that managers should favor pure defenses. These defenses are effective against hostile bids⁴⁵ and yet preserve managers' ability to enter into friendly deals, with their associated gains to management. Moreover, pure defenses – especially those with targeted effects (such as the poison pill) – deter hostile bids without otherwise negatively affecting company structure or operations.⁴⁶ By contrast, at present embedded defenses are more costly because, by definition, they alter the firm's operations or structures in ways management would not agree to but for the fear of a hostile takeover. Thus they are potentially

the welfare implications of substitution for shareholder choice, as in this Article.

⁴³E.g., Bebchuk, *supra* note [chi]; see *supra* note __ (discussing Europe).

Although choice proponents have not examined pre-bid embedded defenses general, some scholars have particular individual pre-bid embedded defenses. E.g., Jeff Gordon, *Ties That Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, *Colum. L. Rev.* [get full cite][chk]; Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 *Geo. Wash. L. Rev.* 687, 724 (1986) (dual class structures should be prohibited for companies registered under Section 12(g) of the Securities Exchange Act of 1934); see also Kahan & Klausner, *supra* note (questioning the legitimacy of debt covenants with change of control puts triggered only by a hostile offer).

⁴⁴See *Time/Warner; QVC; Unitrin*. This is not to say that they can employ whatever defense they choose within each quadrant. Limits do exist. See, e.g., *Quickturn*. But managers have available to them valid defenses in each of the quadrants.

⁴⁵See Bebchuk, Coates & Subramanian, *supra* note .

⁴⁶In addition, the poison pill has several advantages over other defenses in this quadrant (such as defensive share redemptions or greenmail). First, the poison pill – particularly when combined with a classified and/or staggered board – is a very effective defense. A hostile raider faces little chance of over-coming this combined defense. Second, the pill is targeted in purpose and effect. The pill is targeted in purpose in that the pill is redeemable by the board and thus can be targeted to hostile bids without affecting friendly deals. The pill is targeted in effect in that it has no operating effect, aside from deterring a hostile bid (assuming it is never triggered). Thus the pill deters hostile raiders without requiring an expenditure by the firm. This makes it superior to share redemptions, green mail, and other such measures.

more destructive of firm value. Moreover, some embedded defenses may deter not only hostile bids but also friendly deals as well.⁴⁷ This lowers managers' welfare as managers generally can expect to profit from a friendly deal. Accordingly, under existing law, managers generally should avoid embedded defenses except as a last resort. Moreover, when they do employ embedded defenses, they can be expected to favor post-bid embedded defenses which they can implement only when a takeover is imminent. Given their existing authority, managers have little reason to favor strong pre-bid embedded defenses that may be more destructive of firm value (including the ability to do friendly deals) than is the poison pill.⁴⁸

Nevertheless, the fact that managers currently do not rely regularly on pre-bid embedded defenses does not mean that their existence can be ignored when evaluating the merits of shareholder choice. Indeed, the normative case for shareholder choice may turn crucially on the viability of this fourth quadrant, and specifically on whether managers would respond to greater shareholder interference by simply substituting into pre-bid embedded defenses.⁴⁹

This is a potentially serious concern, for shareholder choice proposals do not remove managers' incentives to entrench themselves or ensure managerial passivity. All they do is regulate certain *forms* of managerial entrenchment: the use of pure and post-bid defenses. Managers would retain other methods of entrenchment, under proposed shareholder choice regimes: pre-bid embedded defenses. Moreover, managers could be expected to employ these unregulated defenses to protect their tenure. Thus, rather than simply ceding their discretion, we argue, managers subject to shareholder choice may simply relocate their entrenchment activities further upstream, embedding defenses in pre-bid

⁴⁷See *infra* Section 3 (discussing blanket defenses).

⁴⁸Nevertheless, even under current law managers may employ pre-bid embedded defenses that are truly targeted only at hostile deals. See Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment*, 40 *UCLA L. Rev.* 931 (1993) (discussing managements' defensive use of penalty change of control provisions in bond covenants triggered only by a hostile offer in the years before the RJR-Nabisco deal). Nevertheless, the pill coupled with the effective classified board generally will be more effective than such measures, and appears to have supplanted them. See *Id.* (discussing the decreased use of such targeted defenses post RJR-Nabisco); Bebchuk, Coates & Subramanian, *supra* note (discussing the rise of, and effectiveness of, the poison pill coupled with an effective classified board).

⁴⁹In other words, we argue that shareholder capacity to make the decisions required to override NE, NW and SE quadrant defenses is a necessary, but not a sufficient, condition to establish that shareholder authority in those quadrants is value enhancing.

decisions that arguably have non-retrenchment justifications.⁵⁰

The possibility of board substitution into pre-bid embedded defenses significantly affects the merits of shareholder choice proposals because these defenses cannot simply be regulated away by expanding the scope of shareholder choice. The possibility of substitution is particularly troubling because many pre-bid embedded defenses are likely to be more costly for the firm than are pure defenses. Thus shareholder choice might only increase the cost to firms of entrenchment measures without significantly reducing their effectiveness.

Pre-bid embedded defenses are extraordinarily difficult to regulate because (1) they are adopted within the abstract, information-poor context of everyday business, often far before a tender offer might ever emerge; and (2) they ostensibly serve legitimate business interests and may confer benefits on the firm that exceed any negative effects associated with their effect on takeovers. Courts, therefore, cannot blithely prohibit such measures, nor can they easily evaluate them on a case-by-case basis. In order to preserve the value of these measures to the firm, courts (or shareholders) would need to assess their validity at the time they were adopted (or establish rules that enable shareholders to predict their validity at the moment of contracting).⁵¹ Yet neither shareholders nor courts are particularly good at rendering such judgments. Indeed, in order to evaluate such defenses one would need to compare the expected benefits of the embedded defense against their expected costs in terms of deterring future bids *at the time the defense was adopted*. This inquiry is fraught with speculation, possible error, and complexity even for the business executives who made the decision. Shareholders and courts are likely to be even worse at performing such comparisons.

⁵⁰See supra note . [other scholars]

⁵¹Although the validity of some of these defenses could be determined ex post, the validity of most of them cannot effectively be determined ex post without adversely affecting firm value. The value to the firm of many pre-bid embedded defenses depends on the corporation knowing that they are enforceable. This is particularly true of embedded defenses that grant rights to third parties that affect third parties willingness to contract with the corporation, as well as the contract price. Accordingly, courts could not assess their validity on an ex post basis without seriously undermining their value to the firm.

Moreover, assessing their validity ex post would not solve the information problem. The proper measure of the validity of pre-bid embedded measures is whether the measure plausibly enhanced firm value at the time it was adopted, when the threat of a hostile bid was an unknown probability and not a certainty. For the reasons discussed below, courts could no better do this than they could make any of the other business decisions that most corporate scholars conclude courts are ill-equipped to make. Cf. Frank Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law*, Chap. (1991)(discussing the benefits of the Business Judgement Rule).

Thus, arguments favoring professional management and the Business Judgment Rule more generally would operate with particular force to counsel against aggressive shareholder or court oversight of most pre-bid embedded defenses.⁵²

3 Availability of Pre-Bid Embedded Defenses

The case for shareholder choice accordingly depends in part on whether managers could be expected to respond to a shareholder choice regime by employing pre-bid embedded defenses, all else equal. It is therefore important to establish that such actions are both available and plausible as a practical matter. This section examines existing corporate practices to determine whether potent pre-bid embedded defenses are practically available to managers. We argue that they are available, and we catalogue a cornucopia of alternative measures that managers could employ either to retain control or deter acquisitions should they be prevented from employing pure defenses or post-bid defenses.⁵³ Moreover, this section reveals that courts could not prohibit – or invalidate – these measures without potentially reducing firms’ value because many of these defenses serve legitimate non-defensive business goals, providing benefits that may justify their costs for some firms.⁵⁴

⁵²Even the strongest proponent of shareholder authority accept that shareholders should not be vested with the authority to determine everyday business transactions, such as third party contracts. See Lucian Bebchuk, *Empowering Shareholders*, Harvard Working Paper (2003).

⁵³Such as the one proposed by Bebchuk, *supra* note .

Board efforts to retain control need not be limited to rearranging internal corporate affairs. Managers can be expected to respond to any effort by the Delaware Court to implement shareholder choice by seeking antitakeover protection from legislators. This could take the form of lobbying the Delaware legislature for stronger antitakeover protections. Alternatively, it could take the form of remaining in, or opting into, other states with stronger antitakeover protections. Cf. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, Harvard NOM Research Paper No. 01-10 (December 2001) (evidence suggests that managers migrate to, and avoid migrating away from, states with stronger – though not super strong – antitakeover protections).

⁵⁴Nor can shareholders rely on non-legal restraints on managers’ behavior – such as the threat of a proxy contest – to deter managers from adopting such value-reducing measures. The case for shareholder choice itself is predicated on the idea that the proxy process alone does not place sufficient constraints on managers to deter them from taking actions that benefit themselves at the expense of shareholders. To the extent that this view is correct, it should also apply to managers’ use of pre-bid embedded defenses. Moreover, many of the pre-bid embedded defenses we examine are particularly unsuited to regulation through the discipline of shareholder voting. Shareholders incentives to change management depend on the change producing a sufficient improvement in firm value to outweigh the costs of a proxy contest. To the extent that management adopts effective pre-bid embedded defenses but other-

3.1 Targeted Versus Blanket Embedded Defenses

To evaluate the risk of managerial substitution into pre-bid embedded defenses it is necessary to distinguish these defenses based on their deterrent effect, the cost to the firm of their adoption, and the ease with which courts or shareholders could regulate their use. Viewed from this perspective, it is helpful to distinguish between two different types of pre-bid embedded defenses. The first are "targeted" embedded defenses, that effectively give the managers control over which bid succeeds, without imposing any costs on friendly deals. Targeted embedded defenses thus only deter hostile tender offers, leaving the firm's ability to enter into a friendly transaction unchanged. A debt covenant with a change of control put triggered only by a hostile acquisition is an example of a targeted pre-bid embedded defense. The second category are "blanket" embedded defenses. These are measures that could deter any corporate combination. A blanket embedded defense include debt covenants with a change of control put triggered by any corporate combination, friendly or hostile.

Managers subject to shareholder choice would find targeted defenses particularly attractive as they would enable them to deter hostile offers while maintaining their ability to enter into friendly deals. Of course, these defenses also are the least likely to serve bona fide non-defensive interests, and thus are the most vulnerable to court regulation. Nevertheless, this section will show that many targeted defenses would be difficult for courts to regulate. To the extent managers are able to employ these defenses, shareholder choice would do little to achieve increased shareholder control over hostile acquisitions.

The second type of defense, blanket defenses, increases the costs of all acquisitions. Such defenses thus potentially deter hostile and friendly deals alike, and therefore impose greater costs on both managers and shareholders than targeted pure defenses, such as the poison pill, that impede hostile deals alone. This section will show that although blanket defenses are more costly, they generally also would be more difficult for courts to regulate. Managers are better able to assert that blanket defenses serve a legitimate non-defensive business purpose because, while there are few legitimate non-defensive reasons to condition a transaction on whether a tender offer is hostile, there are many legitimate

wise successfully attempts to maximize firm value, shareholders would have little to gain from replacing them. Unlike the poison pill, changing management would not change the deterrent effect of many of the pre-bid embedded defenses we outline because many are contained in contracts that management no longer controls. Thus, shareholders cannot eliminate these defenses by changing management. See *infra* note __ (discussing change of control provisions).

reasons to condition a corporate transaction on a change of control generally. Managers' claim that such provisions serve a legitimate purpose is enhanced by the price managers pay for adopting blanket defenses: blanket defenses also deter friendly deals. Accordingly, even under the strongest shareholder choice regime, courts should be reluctant to invalidate these measures *ex ante*, for fear that many companies would be hurt – precluded from entering into value-enhancing arrangements to preserve shareholder control of a tender offer that might never arise. Nor should courts simply reserve judgment until after a bid has materialized. *Ex post* decisionmaking by courts would undermine the value of many of these arrangements by leaving their validity uncertain.⁵⁵ Finally, the problem of pre-bid defenses – and in particular blanket pre-bid defenses – cannot be resolved by requiring *ex ante* shareholder vote on all pre-bid embedded defenses. Shareholders would have to evaluate these transactions in the cool climate of ordinary business, when shareholders have neither sufficient incentive nor capacity to make the complex business decision entailed in determining whether the benefits associated with a pre-bid defense exceeds the expected costs of deterring a potential takeover.⁵⁶

The next two parts discuss examples of pre-bid embedded defenses that managers might be able to use to entrench themselves. In dis-

⁵⁵The problem with *ex post* evaluation of pre-bid defenses is worse than those surrounding *ex post* analysis of post-bid embedded defenses under the existing regime. First, at present, managers can employ a wide variety of post-bid embedded defenses quite certain of how the court will rule. Second, many post-bid embedded defenses only affect parties to the takeover contest. Thus, any uncertainty surrounding post-bid defenses only affects contracting behavior during a takeover contest. By contrast, pre-bid defenses are embedded in many everyday business transactions. Thus, uncertainty regarding the validity of pre-bid defenses would affect a wide range of transactions. Finally, the duration of the uncertainty and the possibility of managers possessing private information is less in the case of post-bid defenses, because post-bid it is clear that a bid has happened and that the court will evaluate the transaction. Defenses adopted pre-bid may not be evaluated for years; moreover, managers may have private information on the likelihood of an acquisition, which further complicates contracting over such clauses when their validity is uncertain.

⁵⁶The business decisions associated with many of the blanket pre-bid defenses we discuss – such as change of control provisions – are likely to be even more complex than those associated with shareholder approval of many shark repellents (such as fair price provisions) to the extent that the benefits of the former are entail more firm specific considerations. Corporate scholars have suggested that ordinary shareholders may not have sufficient incentive and capacity to make even the more simply decisions associated with shark repellent amendments, and institutional shareholders tend not to intervene on issues that are corporation-specific, as compared corporate governance issues where a given rule outcome likely applies to most firms. Cf. Gilson, *supra* note [shark repellent] (discussing problems associated with vesting control over shark repellent amendments in shareholders).

cussing specific examples of managers' use of these defenses, we are not claiming that managers in those cases were injuring their firms to entrench themselves. Indeed, just the opposite: In the case of many of the pre-bid embedded defenses we discuss, particularly the instances of blanket defenses, we expect that managers employed these defenses in situations where they benefitted the firm. After all, under current law, managers seeking takeover defenses need not resort to expensive blanket measures to entrench themselves; they can entrench themselves effectively at lower cost by adopting a pure defenses, such as the poison pill and effective classified board.⁵⁷ Thus, the examples we discuss illustrate that (1) legitimate business reasons do exist for many of these defenses such that regulating them could hurt many firms and (2) managers who want to use these measures to entrench themselves can do so under circumstances where the costs may exceed the benefits. Moreover, while managers can be expected to design pre-bid embedded defenses in ways that minimize their adverse consequences for tender offers – at least for friendly deals – it is important to remember that managers subject to shareholder choice would have good reason to modify standard pre-bid embedded defenses to increase their deterrent effect.⁵⁸ If this occurs, shareholder choice could reduce firm value by causing managers to employ defenses that impose greater costs than do existing defenses. To frame our discussion, we shall refer back to Table 2, below.

⁵⁷Pure defenses are lower cost because they defend managers from a hostile bid without distorting firm value. Moreover, in contrast with "blanket" embedded defenses (which deter all deals), pure defenses are targeted only at hostile deals. Post-bid embedded defenses are lower cost than similar pre-bid defenses because the firm only bears the cost of the defensive measure if a bid occurs. Also, in contrast with "blanket" pre-bid embedded defenses, post-bid embedded defenses can be targeted to only hostile deals.

⁵⁸While we focus on existing defenses, it is important to remember that these would not be the board's only options. The history of takeover defenses is one characterized by continual innovation in the face of necessity as boards endeavour to devise mechanisms for retaining control over takeovers in the face of periodic efforts by the courts to regulate board control.

Targeted Defenses	Super-Majority Votes for Corporate Combination
	“Sweetheart” Preferred
	Concentrated Power / Info. In Management
	Spin Off with Shares in Voting Trust
Blanket Defenses	Blank-Check Preferred (w/ Change of Control Puts)
	Change of Control Triggers in 3 rd Party Contracts
	Generous Golden Parachutes
	Idiosyncratic “Corporate Culture”

Table 2: Examples of Pre-Bid Defenses

3.2 Targeted Defenses

Managers subject to a shareholder choice regime that eliminates their ability to deter hostile bids through pure defenses or post-bid embedded defenses potentially could employ a variety of pre-bid embedded defenses that enable them to retain control of the tender offer process. Through these defenses, managers thus could deter hostile bids and yet permit the friendly acquisitions which often yield considerable managerial profit. As previously discussed, courts could readily invalidate many pre-bid targeted defenses without concern that they are interfering with otherwise legitimate business arrangements. Yet managers would retain the authority to employ others that courts could not so easily invalidate. This part discusses some of these arrangements.⁵⁹

Managers can alter how the corporation is structured and financed in ways that enable them to retain considerable control over which, if any, takeovers succeed. Moreover, because shareholders often explicitly approve the power granted to boards to employ these mechanisms, courts could not easily invalidate them.

Boards can retain control over the takeover process through the use of different classes of stock. For example, managers can employ dual class

⁵⁹Some of the arrangements we discuss – such as dual class common stock or sweet heart preferred – arguably are pure defenses. We discuss them here because they are arrangements that might be difficult for courts to regulate. Many defenses embedded in capital structure would be difficult to regulate because they are done with shareholder approval. Sweet heart preferred is difficult to regulate because courts could not easily decide that certain institutional shareholders are too friendly with management to retain their full voting rights.

stock. For example, management can issue two types of common stock, one of which is publicly traded, and the other of which is in the hands of management (or confederates thereof); this latter class would be a strong deterrent to a hostile offer to the extent that consent of a majority of the shares of this class is required for any corporate combination.⁶⁰ Alternatively, managers could (and do) obtain shareholder approval for “blank check preferred” charter provisions. Blank check preferred stock contains open terms can be specified by the board when it is issued. The vast majority of publicly held firms currently have such charter provisions.⁶¹ Boards with this power can issue preferred stock with terms that deter bids. Although under a strong shareholder choice regime courts would likely invalidate the use of blank check preferred stock issued post-bid, managers subject to such a regime could issue the preferred stock well before a bid.

Managers could use this power to deter hostile deals by issuing preferred stock can be issued that has veto rights over any corporate combination, and then placing a significant amount in friendly hands (“sweet heart preferred”).⁶² This defense would be particularly effective if

⁶⁰[E.g., Ford’s Class B stock, comprising around 6% of outstanding equity, but accounting for roughly 40% of voting rights]. Coca Cola and General Motors also have dual class stock.

In the United Kingdom, until recently British companies increased the effectiveness of dual class stock as a deterrent to a foreign buyer by selling these “golden shares” to the British government. At present, the UK government has “golden shares” of at least 26 companies. Local city governments (e.g., London) and other European governments also have had “golden shares” in important firms. Paul Hofheinz, EU Seems Set for a Takeover Makeover, *Wall Street Journal*, A11 (June 6, 2002). Recently, the European Court of Judges issued a series of decisions that restricts companies’ ability to employ golden shares. Managers retain the ability to adopt a wide variety of protective devices – adopted before a bid is imminent – to thwart takeovers. Johannes Adolff, Turn of the Tide: The “Golden Share” Judgement and the Liberalization of the European Capital Markets, 3 *GLJ* No. 8 (August 2002), <http://www.germanlawjournal.com/print.php?id=170>.

⁶¹In 2000, for example, over 90% of publicly listed firms had some form of blank check preferred stock. Source: Investor Responsibility Research Center database, at wrds.wharton.upenn.edu.

⁶²See Edward Rock, Controlling the Dark Side of Relational Investing, 15 *Cardozo L. Rev.* 987 (1994).[add discussion]

Alternatively, preferred stock can be issued with change of control puts, enabling (for example) the holder to redeem the stock at a considerable premium upon the acquisition by any shareholder of some threshold ownership amount, or a change in control of the board following a proxy contest. Such a redemption premium would drive up the cost of any such acquisition, making hostile acquisitions considerably less attractive than friendly deals. The deterrent effect of such provisions can be enhanced to the extent that the firm employs standard debt covenants limiting the redemption of capital stock. Moreover, these provisions would be considerably more difficult for

Delaware's anti-takeover statute survived the adoption of shareholder choice.⁶³ Under Delaware § 203, a hostile raider that is unable to obtain 85% of the shares cannot effect a corporate combination for three years following its purchase of 15% of the target's stock without getting board approval.⁶⁴ Thus, management can significantly increase the cost of a hostile deal by placing even 10-12% of the voting power in friendly hands.⁶⁵ With this much power in friendly hands, managers can be confident that a hostile raider will be unable to obtain the 85% necessary to permit a corporate combination following a hostile acquisition.⁶⁶ For example, in an effort to defend against a hostile bid from Shamrock, Polaroid sold two special series of preferred stock to Corporate Partners, representing approximately 10% of all votes. Corporate Partners, an investment fund managed by Lazard Freres, advertised itself as providing insulation from hostile deals. Thus, it bonded itself to management through its desire to preserve this reputation. Management further ensured Corporate Partners' loyalty by retaining the right to call the stock and by giving Corporate Partners the right to sell the stock back to the firm for an annual return of 28-30% should Polaroid be acquired by any one other than Shamrock. Faced with a voting stock in management-friendly hands, Shamrock abandoned its hostile bid.

Similarly, Salmon, Gillette, US Air, and Champion International have each defended against hostile acquisitions by granting significant (8-12%) voting power to Warren Buffett through the sale of preferred stock (apparently at a discount).⁶⁷ While courts might be able to reg-

a court to invalidate than a poison pill, granting rights, as they would, to third parties who presumably would have paid good value for them. It is likely, however, that preferred stock with "hostile only" change of control provisions would be invalidated by a court pursuing a strong form of shareholder choice. Preferred stock with blanket change of control puts might be more difficult to invalidate, however. Such blanket provisions are discussed in the next part.

⁶³See Del. Gen. Corp. Law § 203 (2003). Even without Delaware 203, management can a similar power to use sweet heart through charter provisions requiring super-majority consent for any corporate combination. See *infra* (next para).

⁶⁴Specifically, under Delaware 203 a raider who acquires 15% of the stock cannot do a corporate combination within three years of the acquisitions unless (1) the board of the target approved the deal prior to the raider acquiring 15%; (2) the raider acquirers 85% of the vote in the transaction that causes it to acquire more than 15% or (3) subsequent to acquiring 15% the raider get the corporate combination approved by the target's board and the vote of 66 2/3% of outstanding disinterested shares.

⁶⁵*Id.* at 1001.

⁶⁶Managers can reduce the risk of a toehold proxy contest through the use of a staggered board.

⁶⁷Edward Rock, *Controlling the Dark Side of Relational Investing*, 15 *Cardozo L. Rev.* 987, 991-994 (1994).

ulate the issuance of post-bid sweet heart preferred, it could not easily regulate the issuance of sweetheart preferred issued during the course of ordinary business, as this would entail a determination that certain shareholders (e.g., Buffet) should be prohibited from certain types of preferred stock.⁶⁸

Even without sweetheart preferred, managers can considerably strengthen their control over tender offers through charter provisions requiring super-majority consent for any corporate combination. Fair price amendments requiring, for example, approval of the voting power of 85% of the stock for any combination can significantly increase the costs of an acquisition.⁶⁹ Moreover, such provisions also increase managers' power to control the tender offer process to the extent that shareholders are inclined to defer to management's recommendations. Most importantly, such provisions can enable managers to block a deal if managers have a sufficient stake that managerial approval is also needed to obtain the 85%.⁷⁰

The discussion above only lists a few of the mechanisms managers could use to retain considerable control to defeat hostile acquisitions. Courts would likely be reluctant to interfere with many of them as they each entailed shareholder consent.⁷¹ The fact that these measures garnered ex ante shareholder approval is not sufficient to ensure that they will only be used to when they improve firm value, however. Often managers obtain the requisite approval at the IPO stage. If the IPO market is not efficient, as some suggest, then managers may be free to adopt such terms even when they are inefficient.⁷² Moreover, even post-IPO,

⁶⁸As in these cases, managers can ensure the loyalty of its "sweet heart" through a variety of means: selling to an investor with a well-developed (and profitable) reputation for being friendly to management; inserting contractual provisions that limit defection; retaining the option to call the investor's position; or profitable side contracts (e.g., consulting deals) which could be lost in an acquisition. *Id.* at 1004-1005.

⁶⁹While less common than blank-check preferred super-majority and fair price provisions are present in between 15 and 20 percent of publicly traded firms. See IRRC, *supra* note __.

⁷⁰BAE Systems and Rolls-Royce have employed the opposite approach to thwart a hostile tender offer: they limit any single shareholder to owning 15% of the company. In addition, BAE requires that half the board, the chairman and the chief executive be British. Paul Hofheinz, *EU Seems Set for a Takeover Makeover*, *Wall St. J.* A11 (June 6, 2002).

⁷¹See Kahan & Rock, *supra* note [this issue](discussing why courts should respect shareholder votes to give managers control over tender offers).

⁷²See, e.g., Bebchuk; Klausner [Penn Eds: Can we see the most recent version of Bebchuk and Klausner's contributions to this symposium to be sure they still make this claim]; cf. Bernard Black & Ron Gilson *Banks v. Stock Markets*, *J. Fin. Econ.* (the existence of defensive charter provisions in IPOs can be explained by the ex

corporate contracting may not be efficient as a result of informational asymmetries and other transaction costs. These inefficiencies may result in shareholder approval of inefficient terms;⁷³ yet courts probably do not possess adequate information to determine what course of action shareholders should have taken.

Moreover, managers can retain considerable control through mechanisms that do not require shareholder approval. Shareholders have no say over the structure of deals such as spin-offs, or strategic acquisitions that may make a subsequent tender offer more difficult. For example, a company can deter bids by placing the firm's most valuable operating assets (or "crown jewels") in a spin off subsidiary governed by a voting trust. In this case, even if the board of the subsidiary changes, identity of those in the voting trust does not.⁷⁴

In addition, managers can discourage hostile bidders by refusing to share private information (or to do so only grudgingly). Private information is particularly important for companies with numerous off balance sheet arrangements and for companies whose value depends to a considerable degree on the results of new initiatives (for example, new drugs).

Management also may be able to structure their own contracts to impose significant costs on hostile raiders, for example, by incorporating change of control provisions in their employment contracts that permit managers to leave immediately upon a change of control with substantive severance packages.⁷⁵

Augmenting this threat is the fact that managers may be able to make decisions that accentuate their idiosyncratic value to the firm.⁷⁶ For example, managers may be able to set up organizational structures, establish internal lines of communication and implement corporate cultures that depend critically on centralized managerial skills. So doing renders

ante deal between venture capitalists and entrepreneurs that gives entrepreneurs a call option on control).

⁷³See Lucian Bebchuk, [arguing that shareholders may approve provisions granting boards control over takeovers that are not efficient]

⁷⁴Cf. *Thompson v. Enstar Corp.*, 1984 WL 8240 (Del Ch. 1984) (Enstar locks up a deal with Unimar by giving Unimar voting control of its most valuable asset, Enstar Indonesia, through use of a voting trust even if deal not consummated; court did not invalidate).

⁷⁵At present, many executive severance arrangements give the executive a right to leave – and collect a hefty severance – some period after the change of control (for example, six months to one year).

⁷⁶Thus, for example, an acquiror considering an acquisition of Donna Karen International would be unlikely to attempt a hostile acquisition given that Donna Karen's own employment contract is terminable upon a change of control.

existing managers less dispensable to a hostile acquirer.⁷⁷ Accordingly, a bidder faced with a threatened mass exodus of top management – the so-called “Jonestown defense” – might be reluctant to proceed with a hostile bid even if the bidder had planned to fire management eventually, because of the benefits to the acquirer of using existing management to train new management. The threat of mass exit, moreover, could significantly influence shareholder voting on tender offers particularly if these clauses define change of control to include a turnover of a majority of the board within a year. These clauses would raise the costs to shareholders of accepting a hostile offer because shareholders would know that should the merger be approved and yet fail to be completed⁷⁸ they would be left with a severely weakened firm. This would reduce the expected value to shareholders of any hostile bid, providing management the ability to discourage hostile bidders and favor friendly ones.⁷⁹

⁷⁷Although it is difficult to garner hard evidence about the degree to which firms engage in such practices, a recent study of employee involvement in Fortune 1000 firms is suggestive. See Lawler et al., *Organizing for High Performance* (Center for Effective Organizations 2001). From 1987 and 1996, while overall hostile acquisition activity was ebbing in the wake of Delaware’s anti-takeover statute, firms became increasingly likely to involve their employees in quasi-managerial power and information sharing practices. Such programs include Job Enrichment or Redesign programs, Self-management teams, Minibusines units, and Employee Policy Committees. *Id.* [Add descriptive statistics]. During the late 1990s and early 2000s, however, just as hostile bid activity began to approach its pre-1987 levels, such employee management initiatives fell from favor, decreasing in frequency to their pre-statute levels. One interpretation of this trend (though certainly one of many) is that the credible threat of hostile acquisitions gives managers an incentive to centralize information management and decision-making authority, in order to make themselves indispensable.

⁷⁸The risk of nonconsummation of hostile deals is significant. We can get a sense of the magnitude of the risk of noncompletion of hostile deals under a shareholder choice regime by considering the data on noncompletion of friendly deals where there is no lock-up or break-up fee. A study of negotiated mergers between 1988-1999 found that 24 percent of these deals were not completed if there was no lock-up or break-up fee. Even with both a lock-up and break-up fee, 5 percent were not completed. See John C. Coates IV and Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 *Stan. L. Rev.* 307, 347 (2000).

⁷⁹Hostile bidders could, of course, reduce managers’ incentives to employ this defense by offering appropriate incentives for managers to remain. Yet this does not eliminate the problem created by the threat of managerial exodus. First, in those circumstances where shareholders are choosing between a hostile bid and a friendly one, the hostile bidder would in effect have to offer management the equivalent of the value of their jobs under the friendly deal in order to induce them to abandon the Jonestown defense. Second, even where there is no other bidder, the amount management is able to extract from a hostile raider will reduce hostile bidders incentives to bid – and will enable managers to appropriate as private benefits some of the gains from the deal.

3.3 Blanket Defenses

Outside the context of targeted, pre-bid defenses, managers could alternatively employ pre-bid embedded defenses. These arrangements deter costs on all acquisitions, friendly and otherwise, usually by imposing substantial costs on the firm in the event of a change of control. While currently managers rarely make aggressive use of blanket defenses because they want to preserve the possibility of a friendly deal, managers could use blanket defenses much more aggressively than they do now if precluded from using more targeted defenses.

3.3.1 Change of Control Provisions in Third Party Agreements

An under-appreciated strategic option for managers is to use the firm's contractual arrangements with third parties to deter bids. Managers can deter bids through the use of change of control provisions in generic commercial arrangements. Blanket change of control provisions either terminate the contract or impose costs on the target in the event of a change of control or corporate combination,⁸⁰ either friendly or otherwise.⁸¹ The simplest terminate the contract on a change of control. Others effectively impose a penalty on the firm (for the benefit of the third party) in the event it experiences a change of control. These contracts would be particularly difficult for courts to regulate because (a) they generally are adopted well in advance of a tender offer, and (b) they serve (in addition to possibly entrenching) the legitimate goal of protecting third party interests.⁸²

⁸⁰Change of control provisions vary as to how they define the triggering event. Managers can draft them to ensure they cover any transaction a hostile raider might wish to accomplish.

⁸¹In this part, we focus on blanket change of control provisions. Nevertheless, many firms have employed change of control provisions targeted at only hostile takeovers, primarily in their debt covenants. Indeed, analysis of bond covenants employed in the late 1980s and early 1990s reveals that many often were designed both to protect bondholders and to entrench managers. Indeed, almost all the bonds issues prior to the RJR Nabisco leveraged buyout contained covenants which encumbered only hostile takeovers and proxy contests, usually without regard to their effect on bond values. After the RJR Nabisco deal, covenants continued to protect management, while providing more protection for bondholders. Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment*: 40 UCLA L. Rev. 931 (1993). We focus on blanket change of control provisions as these would be the most difficult for courts to regulate, as these clearly serve legitimate third party interests.

⁸²The latter makes them more difficult to invalidate than say lock-ups, whose primary purpose is to favor one bidder over another. To the extent one accepts shareholder primacy post-bid, shareholders should determine which bidder to favor. Shareholders cannot assess the merits of change of control provisions in pre-bid con-

Change of control provisions can be – and currently are – incorporated into a variety of contracts, including intellectual property licenses, leases, joint ventures, union contracts, Employee Stock Option Plans, debt financing and equity financing.⁸³ These provisions generally either terminate the contract or impose a penalty on the target in the event of a change of control. These provisions serve important, legitimate, non-defensive purposes to protect third party interests. Third parties contracting with firms often have good reasons for insisting on change of control provisions. Many contracts are long-term and thus necessarily incomplete. In such cases, the value of the contract depends critically on the trustworthiness and reliability of the contracting party. A party to such a contract make seek to protect itself through a change of control provision that lets it terminate the contract should the other party's management change. Alternatively, a party granting a license might seek to protect its own market position by seeking to control the identity of those who use its license. For example, it could want to ensure that a competitor did not obtain the license.

At present, managers generally attempt to avoid incorporating strong blanket change of control provisions into corporate contracts. As managers benefit from friendly deals, they eschew strong blanket provisions that could deter friendly deals. They employ such measures only when the third party insists, and the price of not doing so exceeds the expected cost of the provision. Managers who accept such terms often limit the effect of such provisions through narrowing the definition of "change of control," or attempting to ensure that the impact of such a change is not too onerous.

Managers could be expected to adopt a very different approach to blanket change of control provisions if precluded from using pure defenses, post-bid embedded defenses and targeted pre-bid embedded defenses. In this case, blanket defenses may appear an attractive last resort. Should managers reach this conclusion, a review of existing change of control provisions suggests that managers could indeed effectively use these provisions to deter takeovers. They could employ them in a variety of contracts and could increase their strength. As third parties currently seek such protections, third parties would happily accept these expanded protections – and even agree to insist on them.

tracts, however – at least not if the presumptions underlying Dela 141(a) and the Business Judgment Rule are correct.

⁸³See supra note [discussing change of control puts in preferred stock]. Although there is not, to our knowledge, a reliable database detailing all variations on change of control provisions, in 2000 nearly two thirds of all publicly traded firms had some sort of provision in their employment contracts or collective bargaining agreements. See IRRC database, supra note __.

Termination Clauses The simplest change of control provisions give the third party the right to terminate the contract upon a change of control. For example, many intellectual property licenses, joint venture agreements and leases have change of control provisions that terminate the license on change of control.⁸⁴ Other change of control provisions impose a penalty on the target in the event of a change of control.

Termination clauses are a particularly effective deterrent in those circumstances where the target can rely on the third party not to assign the contract to the acquirer.⁸⁵ The risk of non-assignment is significant in at least three situations. The first is where the value of the license is substantially higher now than it was when originally issued. This is particularly likely when long-term license was issued at an early stage in the product development – for example of a drug – before the true value was known. In this case, the licensor may well view the change of control as an opportunity to appropriate the rents associated with the successful development of the product which otherwise would have gone to the licensor. In this situation, the change of control provision may ensure that the firm is more valuable unacquired than acquired.

Second, a termination clause may operate as an effective deterrent where the contract is material and the licensor is unlikely to assign the license because it competes with the other potential acquirers.⁸⁶ Indeed, examples currently exist where such provisions have impacted takeover.⁸⁷

⁸⁴Indeed, even without a change of control provision, many licenses are presumed to terminate in the event of a merger where the acquiror is the surviving firm. Elaine Ziff, *The Effect of Corporate Acquisitions on the Target Company's License Rights*, 57 *Bus. Lawyer* 767 (2002).

⁸⁵By contrast, termination clauses are not a significant deterrent to a takeover if the third party would willingly assign the contract to the acquiror.

⁸⁶Similarly, companies can use joint ventures with other firms in the same industry to impose similar impediments to acquisitions. Parties to a joint venture also can to deter bids by including noncompete agreements in the joint venture, that prohibit either the company or an affiliate from competing without termination of that company's rights under the venture. This would deter acquisition of the firm by companies in the same industry as the venture.

⁸⁷Change of control termination clauses do not always deter acquisitions. For example, British American Tobacco Group (BAT) acquired Rothman's International notwithstanding the risk that this deal would trigger the change-of-control termination clause in Rothman's license with Phillip Morris, granting Rothmans the right to market Marlboro cigarettes and other Phillip Morris brands in the United Kingdom. It is unclear whether BAT would have purchased the subsidiary if it had been sure the deal would trigger the clause. BAT and Rothmans tried to structure the deal to avoid triggering the clause. Phillip Morris claimed the deal did trigger the clause, in large part because Phillip Morris and BAT are world-wide competitors, being the largest and second largest companies in the world. See *Phillip Morris v. Rothmans International Enterprises, Ltd.*, Chancery Division, (July 19, 2000). Phillip Morris prevailed in the British courts and dissolved the joint venture with Rothmans.

For example, efforts to acquire Hershey were hindered in part by a change of control provision in Hershey's license from Nestles S.A. granting it the right to manufacture and sell Kit Kat – one of the most popular chocolate bars in the world. Nestles has not looked favorably on attempts to acquire Hersheys that might improve Hershey's competitive position, and has threatened to terminate the license in the event Hersheys experiences a change of control.⁸⁸ Moreover, it appears that some foreign firms have employed such provisions for defensive aims. Labatt Ltd., Canada's second largest beer manufacturer, apparently fended off a hostile offer by Onex in part through the use of partially-disclosed third party contracts and licenses terminable upon a change of control for Labatt. These third party agreements included the Canadian Budweiser license and the license for the Mexican brewer, Femsa Cerveza SA.⁸⁹

Finally, founding shareholders or managers of certain firms can use their own licensing agreements with the firm to ensure their continued ability to determine to whom the firm is sold, even if the founding shareholder no longer owns a majority of the shares. For example, rather than grant valuable intellectual property to the firm outright, the founding shareholder can license the property to the firm, with a contract that provides for termination of the license upon change of control. An example of a firm that has employed this type of defensive measure is Donna Karan. When Donna Karan International went public in 1996, Ms. Karan and her husband retained control of the trademarks for most of the product lines – including "Donna Karan," "Donna Karan New York," "DKNY" and "DK" – under a wholly owned corporation, Gabrielle Studies. Gabrielle then licensed the trademarks to Donna Karan Corporation, but subject to a provision terminating the license in the event of a change of control of Donna Karan Corp.⁹⁰ The employee contract with Donna Karan herself also terminates upon change of control. Thus, a hostile acquirer could buy the physical assets of the firm, but much of the firm's goodwill evaporates upon a change of control, ab-

Phillip Morris later awarded the license to another company. Rosie Murray-West, City-Imperial Land Marlboro Delivery Deal, *The Daily Telegraph* (Aug. 15, 2001).

⁸⁸Gordon Fairclough and Erin White, Shake-Up in Candyland. Sale of Chiclets, Dentyne, and Nestle's Hold on KitKat Make Hershey Bidding Sticky, *Wall Street Journal*, July 26, 2002.

The Nestle's deal has not been the only impediment to the sale of Hersheys. The sale also has been impeded by the political objectives of Hershey Trust Company, the major Hersheys shareholders. See

⁸⁹Larry Greenberg, Onex Pressures Labatt to Disclose Third-Party Pacts, *Wall Street Journal*, May 25, 1995.

⁹⁰In this case, a *change of control* was defined as the purchase by a third party of 30% of the stock of Donna Karan Corporation.

sent Ms. Karan's explicit consent.⁹¹ Similarly, FAO Schwartz licenses the right to the use the name FAO Schwartz from the Schwartz brothers through a contract that terminates the license should the brothers be removed from management.⁹²

Penalty Provisions While termination clauses operate as effective deterrents only in particular circumstances, managers need not restrict themselves to change of control provisions with termination clauses. Instead, managers can employ change of control provisions that impose grant the third party the ability of obtain substantial financial benefits from the target in the event of a change of control – in effect imposing a change of control “penalty” on the target. These penalties, if large enough, can operate to deter acquisitions. Moreover, they are much more resistant to renegotiation, since the acquirer must be willing to compensate the rights holder for the lost chance of receiving the penalty.

An examination of existing “penalty” change of control provisions reveals their potential defensive power, should managers ever need to exploit them more aggressively for this purpose. For example, non-investment grade debt often contain a change of control put that gives the creditor the right to put their bonds back to the issuer at a premium upon a change of control. Firms could employ these, and other similar provisions, to substantially increase the costs of acquisitions.⁹³

Moreover, firms can, and do, incorporate penalty change of control provisions into other contracts, including leases, licenses, union agreements and joint ventures. Joint venture agreement change of control provisions often grant to one party the right to buy the other's interest in the venture for less than its fair market value upon a change of control by the latter.⁹⁴ Thus, change of control can result in a loss

⁹¹Wendy Bounds, Donna Karan International Finds Its Slip Is Showing, Wall Street Journal, May 8, 1997; see Donna Karan International Prospectus, SEC 333-3600 p. 70, 76.

⁹²[get cite; To eds: we just learned about this and need to get the cite and the exact language].

⁹³Analysis of bond covenants employed in the late 1980s and early 1990s reveals that many often were designed both to protect bondholders and to entrench managers. Indeed, almost all the bonds issues prior to the RJR Nabisco leveraged buyout contained covenants which encumbered only hostile takeovers and proxy contests, usually without regard to their effect on bond values. After the RJR Nabisco deal, covenants continued to protect management, while providing more protection for bondholders.

⁹⁴Examples of joint ventures that have (or had) such clauses include the joint ventures between Guinness and LVMH; General Mills and Nestles to market Haagen-Daz in the US; Heineken and Quisa to brew and distribute Heineken beer in Argentina; Texaco and Shell to market refine and market gas in the U.S.; PacDun and Goodyear;

to the target of the value of the joint venture. For example, in the shadow of speculation that Schering-Plough was ripe for a hostile bid, Schering-Plough entered into a joint venture with Merck & co. to cooperate in the developing and marketing of a new anti-cholesterol drug, Zetia – a drug many concluded was Schering-Plough’s best hope for future profits. This agreement provides that if a third company buys Schering-Plough, Merck can purchase Schering-Plough’s interest in the joint venture, at a price unlikely to reflect its actual value.⁹⁵ Given that Zetia is Schering-Plough’s best hope for a profitable future, this joint venture agreement effectively discourages bids. Similarly, the joint ventures between Wackenhut and SERCO grants the latter the right to buy out Wackenhut’s interest in a joint venture between them, for less than its fair market value in the event of a change of control of Wackenhut. Penalty joint venture clauses also impacted Guinnesses merger with GrandMet. LVMH claimed that the merger triggered change of control clauses in its joint ventures with Guinness. These change of control provisions allowed LVMH to buy back Guinness’ stake in their 17 joint ventures at asset value if Guinness experiences a change of control; they also entitled LVMH to buy Guinness’s 34 percent stake in Moet Hennessy at a discount of up to 15 percent.⁹⁶ In return for a payment from Guinness of 250 million, LVMH eventually agreed to withdraw its effort to block the merger. Had LVMH pursued its claim in arbitration, the firm stood to gain as much as 1 billion pounds had it prevailed.⁹⁷

Boards could make greater use of all such penalty change of control provisions were courts to adopt shareholder choice. If the board adopted blanket provisions that apply to friendly and hostile deals alike, this could have the effect of reducing the number of acquisitions.⁹⁸ Moreover,

and Phillip Morris and British American Tobacco to market tobacco in Great Britain.

⁹⁵Peter Landers, Merck Sacrificed Right to Make Buyout Offer to Schering-Plough, Wall Street Journal B3 (October 22, 2002).

⁹⁶Alasdair Murray, LVMH Move Threatens Points 23bn Guinness Merger, Times of London (May 29, 1997).

⁹⁷Major Obstacle Cleared in (pounds) 24 bn Guinness Deal, The Irish Times (Oct. 14, 1997).

⁹⁸Moreover, managers need not necessarily employ only blanket change of control provisions. Change of control provisions can be easily drafted to provide that the change of control penalty is imposed only in the event of a hostile change of control: for example an acquisition not preceded by board consent or a change in the majority of the board in a single year. Such a provision would, in effect, replicate the effects of the poison pill. Indeed, such hostile-trigger change of control provisions were prevalent in debt contracts in the 1980s. Many debt covenants in the 1980s included change of control provisions that provided that the change of control provision was triggered only by a hostile deal: defined as either the acquisition of a large block of a corporation’s shares or the replacement of a majority of the board through a proxy challenge. See Kahan & Klausner, *supra* note , at 947, 970. While manage-

managers could employ stronger provisions than those used at present, justifying it by a greater need to protect third parties. They also include increase their deterrent effect by inserting such provisions into many separate types of contracts. Change of control provisions in a variety of firm contracts would be particularly troublesome for a bidder, as the bidder might know some such provisions exist but the precise terms would not necessarily be subject to disclosure requirements — a danger that dramatically increases the uncertainty and cost accompanying a hostile bid.⁹⁹

ment subsequently reduced their use in the late 1980s, one would expect adoption of shareholder choice to cause managers to reconsider the need for hostile-trigger debt covenants that impose penalties on the firm in the event of a change of control.

Moreover, under a shareholder choice regime such provisions could effectively grant the board greater power to deter hostile bids than would the poison pill. Courts can regulate the board's use of a redeemable poison pill by requiring boards to submit all bids to the shareholders for a vote. The pill would not alter the outcome of that vote. The same cannot be said for hostile-trigger change of control provisions, however. Hostile-trigger change of control provisions enable managers to impose costs on the target firm in the event of a change of control even if shareholders approve the deal. Classic hostile-trigger change of control provisions are drafted so that the provision is triggered if there is either a change in the composition of the board or an acquisition without board approval. Under such terms, the board can guarantee that the provision is triggered simply by resisting the deal, even if the board does not interfere with shareholders' ability to replace them through a proxy contest. Such a provision would thus increase the costs of the deal. Moreover, it significantly increases the costs to shareholders of supporting a proxy contest. Even the best deals have associated with them a risk of noncompletion. Hostile-trigger covenants decrease the expected gains to shareholders of a hostile acquisition by raising the costs to shareholders of deal non-completion. Hostile-trigger change of control provisions are a particularly powerful deterrent to hostile deals because they are triggered by the outcome of the proxy contest, not the completion of the deal. Thus, if the board resists a hostile deal as not in the firm's best interests — thereby requiring a proxy contest in order to get the deal approved — shareholders evaluating the deal must recognize that voting for the insurgents will immediately trigger the change of control penalty, which must be paid whether or not the acquirer is able to complete the acquisition. This raises the potential cost to shareholders of supporting a proxy contest, as the cost is borne with certainty yet the benefits are not certain.

The use of these hostile-trigger covenants would present courts with a difficult choice. Permitting managers to employ them would, in effect, render a shareholder choice regime ineffective. Yet invalidating such contracts would require the courts to interfere with contracts between the company and third parties, contracts with rights that the third parties paid for. Moreover, the firm would not necessarily be better off if the court precluded such targeted, hostile-only provisions as managers might instead employ blanket change of control provisions. If so, the implementation of shareholder choice could significantly reduce firm value.

⁹⁹The board need not disclose the terms of nonmaterial contracts. Managers thus can create a secret impediment to hostile bidders by including change of control provisions in each of their third party contracts — where each individual contract is

Limits of Court Capacity to Regulate Courts could not confidently prohibit the use of change of control provisions without imposing significant costs on the firm. Courts cannot simply invalidate these clauses because they often increase firm value by protecting legitimate interests on contracting parties, thereby lowering the firms' costs of entering into various arrangements.¹⁰⁰ Indeed, courts should be particularly wary of prohibiting such penalty change of control provisions because – even in the current legal environment – numerous existing contracts employ penalty change of control provisions. The use of such provisions, notwithstanding management's access to low cost defenses such as the poison pill and classified board, lends credence to the claim that these provisions serve legitimate goals: why would management use these more expensive measures when the lower cost poison pill is available?¹⁰¹ Nor can courts reliably separate legitimate from illegitimate (defensive) termination clauses because courts are not well positioned to measure the relative benefit and cost to the company of granting the third party such protection. Courts also could not separate legitimate from illegitimate change of control provisions by requiring shareholder consent to such contracts. These contracts are adopted as part of everyday business operations – outside the glare and heightened scrutiny associated with tender offers. Shareholders are not sufficiently informed to oversee reliably the terms of these contracts. Thus, under shareholder choice courts would have to accept the defensive use of such clauses or risk excessive regulate of legitimate business transactions.¹⁰²

not material in and of itself, even though the collective effect of all these contracts might be quite material indeed.

¹⁰⁰See, e.g., Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?* 40 *UCLA Law Rev.* 931 (1993) (discussing how change of control provisions in bonds can benefit shareholders).

¹⁰¹For a possible explanation of why board's might not employ optimal takeover defenses see John Coates IV, *Lawyers....*

¹⁰²Change of control provisions not only are difficult for courts to regulate, but are particularly bad candidates for regulation through the shareholder proxy process. Shareholders may be unwilling to respond to such provisions by replacing management for two reasons. First, depending on how the change of control provisions are written, a successful proxy contest itself may trigger the change of control provision. See Kahan & Klausner, *supra* note (describing debt covenants with this feature). Second, shareholders have little to gain from such a proxy contest since, unlike in the case of redeemable poison pills, shareholders of firms with strong change of control provisions may not be able to make the firm more takeover friendly by changing management. These change of control provisions effectively cede control over these arrangements to the third party. Thus, managements adoption of such provisions will not necessarily provide shareholders with an incentive to replace management.

3.3.2 Managerial Relationships

Boards subject to shareholder choice also might attempt to both deter bids and increase their own private benefits from a bid by through the design of change of control provisions in executive compensation agreements (Golden Parachutes).

Typical executive compensation arrangements provide that on a change of control senior management gets severance pay equal to 3 years salary, bonuses and options.¹⁰³ In additions, the change of control often vests the executives stock options. These severance payments – particularly when coupled with executive stock options and Employee Stock Option Plans that accelerate vesting upon change of control – can significantly raise the cost of a tender offer. Taken together, these provisions entitle executives to reap considerable private benefits from a takeover.¹⁰⁴ These provisions also impose an additional cost on the bidder not otherwise borne by the firm. This substantial transaction cost of a tender offer can give managers considerable latitude to pursue private benefits without fear of a hostile offer.

Moreover, while currently executive severance packages are not sufficiently large to deter deals, there is no reason to assume they would remain at current levels. Executives sheltered by the pill and the ECB have had little reason to use these mechanisms primarily as a serious takeover defense, and have every reason not to discourage friendly deals. Yet there is little reason to believe the structure of such plans would remain fixed following implementation of shareholder choice. Executives facing a greater risk of termination could legitimately insist on larger severance packages. If high enough, these packages could deter acquisitions at the margin.¹⁰⁵ In addition, even if they did not deter acquisitions, such arrangements would grant to executives ex ante the disproportionate share of the takeover premium that proponents of shareholder choice seek to wrest from them in favoring shareholder over managerial control

¹⁰³The cost of these payments may be greater than other executive compensation if the cash amount exceeds IRS limitations on cash compensation, resulting in the firm being unable to deduct these amounts. See *Nomad Acquisition Corp v Damon*, 1988 Del. Ch. Lexis 133 (Del. Ch. 1988).

¹⁰⁴Employee stock option plans (ESOPs) also are employed to deter bidders. These plans grant stock options to employees with vesting periods that may be as long as ___ years. ESOPs commonly have change of control provisions which accelerate the vesting of these stock options. This imposes a significant additional cost on an acquirer, who buy out all these additional shares at the bid price.

¹⁰⁵Courts would likely invalidate compensation that is completely unreasonable. Moreover, courts might be particularly likely to invalidate Golden Parachutes that subject the firm to tax penalties imposed on excessive severance packages.

over tender offers.

3.4 Implications for Shareholder Choice

The preceding discussion demonstrates a wide variety of corporate arrangements that managers could employ to thwart tender offers if managers are precluded from using pure defenses and post-bid embedded defenses by shareholder choice. At present, managers employ most of these measures (if at all) primarily for legitimate non-defensive purposes. The evidence of legitimate use of these measures suggests that they serve important value enhancing goals, and cannot simply be prohibited. Yet, examination of these measures reveals their potential to thwart tender offers – either hostile or friendly.¹⁰⁶

Should a mandatory shareholder choice regime induce managers to employ pre-bid embedded measures – particularly blanket embedded measures – this could reduce firm value by reducing the probability of both hostile and friendly acquisitions. Moreover, courts would not be capable of meeting the threat of manager substitution into these defenses. While courts might detect the most egregious tactics, courts could not broadly regulate these measures without the risk of negatively impacting firm value through court interference with the management of the firm.

Accordingly, having determined that managers could employ pre-bid embedded defenses, it remains to be seen whether a managerial threat to do so would be credible or not. It is to this question that we now turn.

4 The Incentive to Employ Embedded Defenses

This section evaluates whether a serious risk exists that managers would indeed employ embedded defenses at the pre-bid stage if subject to a shareholder choice regime. In order to consider this question, we consider the strongest version of shareholder choice under which managers cannot employ either pure defenses or post-bid defenses to retain control over tender offers.¹⁰⁷ Indeed, because managers would have no reason not to substitute into *targeted* pre-bid embedded defenses if permitted to do so, we focus on the more difficult question: if subject to a strong shareholder choice regime that removed all other defenses except pre-bid

¹⁰⁶Moreover, managers seeking to use these measures to thwart tender offers could easily increase their effectiveness in a variety of ways.

¹⁰⁷We are focusing on the proposal of Lucian Bebchuk who argues in favor of requiring boards to submit all tender offers to shareholders for a vote, and forbidding boards from implementing any post-bid defensive measures without shareholder approval. See Bebchuk *supra* note [chicago].

embedded blanket defenses, would managers be willing to adopt these defenses, even at the obvious cost to themselves of decreasing the probability of a friendly deal.

Of course, an affirmative answer to this question would not imply that shareholder choice is value reducing. Many of these pre-bid embedded defenses may themselves be value-enhancing. In other words, managers entering into such contracts may be taking actions that they would take anyway, even absent shareholder choice. For example, certain joint ventures may be sufficiently attractive to a firm to justify its acquiescence to a punitive change of control provision, even they deter acquisitions. Thus, the critical issue for evaluating managerial responses to shareholder choice is not to ask whether managers would *ever* adopt pre-bid mixed motive defenses (since many would anyway), but rather whether managers might do so in instances where such defenses are value reducing (all things considered) from shareholders' perspective.

From managers' perspective, of course, there are also costs and benefits to the use of a blanket defense. The benefits of such measures are relatively clear, as they can deter the likelihood of a hostile acquisition — with the resulting extinction of the manager's ability to reap private benefits of control. It is important to be mindful, however, of the fact that pre-bid blanket defenses impose a cost on managers as well for at least two reasons. First, because such defenses work to deter both hostile and friendly deals alike, they can reduce the expected gains managers might realize from a friendly acquisition. But second, to the extent that managers have incentive packages (through stock compensation, for example), such defenses may also preclude managers from reaping whatever pro rata gains they might have enjoyed *qua* shareholders from friendly or hostile acquisitions. The credibility of a manager's threat to implement embedded defenses when they are value-reducing will thus turn on whether the manager's private gain from doing so would justify her private costs. This determination in turn depends on both the nature of the pre-bid defenses available to management, and how (and whether) shareholders can respond to the threat by altering the manager's compensation package.

As previously discussed, management potentially has available to it a host of pre-bid mixed motive defenses which currently are not regulated by the courts. A number of these defenses enable managers to impose costs on bidders *only* in the event of a hostile acquisition. Should courts implementing shareholder choice still permit such "hostile-only" defenses, managers would certainly implement them. Indeed, by so doing the manager could protect her private benefits from a hostile deal, while simultaneously preserving her rights under friendly deals. In this

instance, a shareholder choice regime would do little more than replace one type of poison pill with another – with no resulting increase in shareholder control over tender offers. Thus, if shareholder choice proposals are to have any effect whatsoever, it would require that courts could comfortably prohibit all hostile-only defenses, even those that ostensibly were requested by third parties.

Assuming that courts did so, the question becomes one of whether the managerial threat of implementing an embedded defense is, in the end, be a credible one. If it were, then a shareholder choice regime might result in managers adopting defenses that either (1) reduce the total number of acquisitions below their status quo frequency, (2) reduce the amount that acquirers would be willing to pay even in successful acquisitions, or (3) both. Alternatively, the fear of these repercussions might induce shareholders to gross up the incentive pay of the manager to deter her from selecting the embedded defense. But even here, it may be necessary to increase the manager’s pay so much that shareholders are made worse off. In any event, the bottom line effect of a shareholder choice regime would be, ironically, to reduce shareholder value.

The next section of this article employs a formal model to consider the question of whether managers subject to shareholder choice would resort to embedded blanket defenses at the pre-bid stage if precluded from employing those targeted to hostile bids alone. While we leave the formal analysis for the next section, a nontechnical analysis of managers’ incentives under shareholder choice suggests that there exists a serious threat that while managers would have little reason to adopt blanket defenses under managerial choice, under shareholder choice they could credibly threaten to adopt such blanket defenses, even when doing so reduces firm value. Under a managerial veto rule, management has no reason to adopt a blanket defense that deters hostile and friendly deals alike. Management can use targeted defenses to deter hostile deals alone, and has no reason to deter friendly deals because management a friendly deal can only make management better off than otherwise (or else the managers would not approve the deal). Thus, management subject to managerial choice will eschew blanket defenses because they would be unwilling to pay the price, in terms of the decreased expected private benefits from a friendly deal.

By contrast, management would be willing to adopt blanket pre-bid defenses under shareholder choice (if precluded from employing hostile-only defenses). Moreover, managers might well implement such defenses even if such actions were value reducing for the firm. Shareholder choice dramatically increases the benefits of such defenses and reduces their costs. Under an effective shareholder choice regime – with no board

defenses – acquirers would compete with each other to win shareholder’s favor – not that of the board. This means that acquirers would effectively structure deals as hostile deals, in that they would pay all the gains to shareholders. Managers thus would view all prospective acquisitions as hostile acquisitions, in the sense that managers would not be compensated for their foregone private benefits. Thus, managers would view acquisitions as imposing a cost – in terms of decreased private benefits – with little upside, except to the extent managers benefit as shareholders. Therefore, managers would have considerably more to gain – and much less to lose – from adopting blanket defenses than they would under managerial choice. More important, because such defenses would increase manager’s ability to retain private benefits, managers would be willing to adopt pre-bid blanket defenses to deter acquisitions even when doing so is value reducing. In this case, shareholder choice could reduce firm value below that available under managerial choice.

Thus, shareholders’ apparent disinterest in campaigning aggressively for shareholder choice may not be a product of collective action problems, lack of information, or failures of the IPO markets. Rather, shareholders may fail to insist on shareholder choice because they recognize that it is not *actually* available to them – not at least, under a regime of professional managerial control of day-to-day business decisions. Shareholders could block certain defenses, but not all defenses. As the defenses shareholders can block – such as the poison pill – are, in the end, less destructive of firm value than other blanket defenses managers might employ, shareholders may live with the pill (and ”Just Say No”) for fear the alternative would be worse.

5 Formal Analysis

In this section, we turn to a more formal demonstration of our claim that the imposition of shareholder choice may give managers an enhanced incentive to adopt pre-bid blanket embedded defenses, even if such actions reduce firm value. As noted above, such defenses may impose greater costs on the firm than existing targeted defenses, such as the poison pill, since they deter both hostile and friendly deals alike. As we demonstrate below, the unabated ability to “just say no” at a tender offer stage can certainly deter some tender offers (as shareholder choice advocates claim). But at the same time, a managerial choice regime does not give managers a perverse incentive to pursue value-reducing projects solely in the interests of preserving their positions. In such situations, the move to a shareholder choice regime can be value reducing.

In order to focus our inquiry, we will employ a stylized, theoretical model of firm management in a takeover setting. As with any model,

our analysis will present a simplified portrait of the world, but one that reflects a minimal set of characteristics that we believe to be critical to the institutional context of takeover defenses. In particular, we want to capture the following details of the acquisitions market that — given our discussion above — appear to be the most salient:

- First, managers of corporations should be able to derive private benefits from control, which in turn give them a strong incentive to either preserve their positions (in the case of a hostile bid) or demand compensation from an acquirer (in the case of a friendly bid);
- Second, our model should allow for there to be an active market for corporate control, so that some component of firm value comes from the prospect of a future takeover (hostile or friendly);
- Third, we should operate under the provisional assumption that shareholders are sufficiently sophisticated and coordinated to make payoff maximizing decisions about whether to sell their shares to a bidder (indeed, if they were not, it would constitute an independent argument against shareholder choice);
- Fourth, managers should matter – that is, they should be in a position to affect dramatically the investment choices and activities that a firm conducts long before any takeover attempt is imminent, and that these decisions can affect the costs of an acquisition;
- And finally, our model should presume that neither shareholders nor courts are sufficiently informed to determine which pre-bid embedded defenses are value increasing and which are not (otherwise there would be little justification for either professional management or the Business Judgement Rule).

5.1 Framework

Consider a business enterprise (or “firm”) that exists for two periods and is (at least initially) owned by a homogenous group of shareholders. We assume that all of the firm’s share holdings are initially vested in either a single entity, or if dispersed, that shareholders suffer from no collective action problems that would disable them from acting in a coordinated fashion, and thus can be treated as a homogenous entity.¹⁰⁸ The ex

¹⁰⁸This assumption enables us to examine shareholder choice the light most favorable to its success. If shareholders were subject to large collective action problems, it would constitute an independent argument in favor of managerial control.

post value of the firm has a random component, and is realized only at the end of the second period. Explicitly, the value of the firm could be either “high” (and equal to V_H) or “low” (and equal to $V_L < V_H$), with probabilities and values specified below.

The shareholders of the firm are unable to manage the firm themselves, and they therefore hire a liquidity constrained, risk neutral manager (denoted by M) to manage the firm. The manager has a specific *quality characteristic*, denoted as $q \in [0, 1]$, which we equate with the probability that the firm has a high value rather than a low value. Thus, the firm’s expected gross payoff is $qV_H + (1 - q)V_L$. This quality characteristic is assumed to be uniformly distributed and not known initially, but it is realized and observed by both the shareholders and manager just prior to a bid being made¹⁰⁹.

In managing the firm, the manager is in a position to make an important investment decision on behalf of the company. In particular, she must decide between pursuing one of two projects. Project 1 represents the “status quo” – that is, an activity that does not materially change the existing profile of the company. If the firm pursues this project, we normalize the firm’s ex post value to be either $V_H = 1$ or $V_L = 0$. Project 2, in contrast, represents a blanket embedded defense that affects both firm value and also the probability/terms of a tender offer. As to the former, we assume that Project 2 can potentially be either value increasing or decreasing. Specifically, under the second project, the firm’s ex post values are either $V_H = \Delta$ or $V_L = 0$. We allow Δ to be any non-negative value, and in particular, Δ could be greater than or less than 1. The expected value of the project under current management is therefore equal to q for P1 and Δq for P2. Thus, so long as the firm remains under current management, it is value maximizing for M to choose P2 if $\Delta \geq 1$ but not if $\Delta < 1$.¹¹⁰

Beyond the difference in payoff, however, P2 differs from P1 another important respect: what happens in the event of a takeover. In particular, under the status quo Project 1, we shall presume that an acquirer

¹⁰⁹It is possible to alter this assumption and suppose that shareholders never learn the manager’s quality. But once again, such an assumption would stack the deck against a shareholder choice regime, as the manager would have strictly better information about the merits of an outside tender offer.

In addition, it would be possible to alter the model to allow the manager to know her quality ex ante, and have the shareholders learn it later. In the interests of simplification (and to avoid analysis of a number of signalling considerations that are not germane to our inquiry), we have opted for a simpler framework.

¹¹⁰Interestingly, as will become clear below, it might also be inefficient to choose P2 even when $\Delta > 1$, since the adoption of project 2 would also deter some future takeovers.

who purchases controlling interest in the firm¹¹¹ can appropriate the entire post-acquisition value of the firm. By contrast, under Project 2, the acquirer (friendly or hostile) is only able to appropriate some fraction $c < 1$ of firm value upon the successful acquisition. In other words, the $(1 - c)$ fraction of the firm value that the acquirer cannot appropriate represents an extra cost of the acquisition.

In practical terms, P2 could represent any of a variety of actions that managers can take to drive a wedge between their own costs of managing the firm and those of an outsider. These include the various blanket embedded defenses discussed in the previous sections, including preferred stock with change-of-control penalty puts, third party contracts with change of control provisions, managerial contracts with severance clauses, idiosyncratic organizational structures, and the like. As noted above, some of these actions might be perfectly justifiable from an organizational perspective (in that they have a sufficiently large Δ that the associated benefits exceed the costs); others, however, have little value and impose net costs on the firm. As such, we shall assume that, in the ex ante period where project selection occurs, neither shareholders nor courts can effectively regulate the manager's project choice (or otherwise regulate the choice of P2).¹¹²

In addition to making the organizational choices noted above, M is assumed to be in a position to divert a fraction of firm value, denoted by β , for her personal gain. This diversion is wasteful, however, in that the manager actually receives only $(\beta - \frac{1}{2}\beta^2)$, which is less than the amount of value diverted.¹¹³ Consequently, non-managerial shareholders (and society) will possibly be interested in giving the manager some incentives to prevent such value diversion. Indeed, without such incentives, M

¹¹¹In what follows, we shall equate controlling interest with outright ownership of the firm. This is done solely for the sake of simplifying the analysis.

¹¹²In technical terms, then, we assume that project choice is not contractable. (We shall elaborate more on B's available strategies and constraints later).

¹¹³This assumption captures the idea that private benefits may be more than just a transfer payment – imposing no efficiency losses – but may indeed be value reducing.

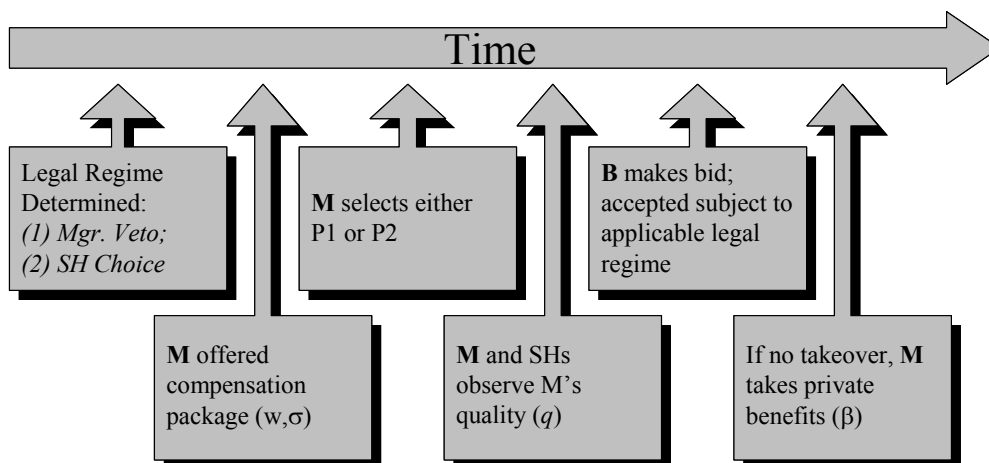
This expression can be generalized in many ways without loss of generality. For example, Bebchuk (2002) uses a similar expression, where the manager's private benefits are given by $(\beta - \frac{1}{2\gamma}\beta^2)$. The parameter γ captures the efficiency with which M can siphon off value; when γ is relatively large, M is an efficient appropriator of value; conversely when γ is relatively small, M does not especially benefit from appropriating value (either because she is not terribly good at it, or because she feels remorse at doing so, and so forth). Nevertheless, note that marginal benefit to the manager of value appropriation is $(1 - \frac{\beta}{\gamma}) < 1$. M is presumed to set β after project type selected and any control transactions are decided, but before final realization of the project value. We have chosen a simpler form to focus on other conceptual details.

will choose to divert the entire value of the firm.¹¹⁴

In what follows, we shall analyze the features of a contract with the manager containing two possible terms. The first component of the contract is a simple salary, denoted by w . The second term is an incentive component of the contract: a fractional ownership share of the company, denoted by σ , representing restricted stock, stock options, and so forth. Clearly, once this incentive compensation is paid, the non-managerial shareholders retain only a $(1 - \sigma)$ ownership share of the firm's net value.

To simplify things, we normalize the best payoff that the manager could get working outside the company to be zero, and assume that the manager has no existing wealth. This means that the values of w and σ can never be negative (which accords with reality).

Finally, in order to compare the takeover effects of a shareholder choice regime against a managerial choice regime, it will also be necessary to introduce a market for corporate control. Consequently, in later subsections we shall also allow a third party, denoted by B , to make a bid for the entire corporation. Depending on the underlying legal regime, B 's bid must be acceptable to both managers and shareholders (under a managerial choice regime), or only to shareholders (under a shareholder choice regime). We shall elaborate more on B 's preferences and strategies below. Summarizing, then, the sequence of the game is as follows:



¹¹⁴To see this, note that the marginal value of taking private benefits is equal to $(1 - \beta)$. This is positive for all $\beta < 1$, and thus without any countervailing incentive, M will appropriate the whole value of the firm.

5.2 No Market for Corporate Control

As a baseline for later comparison, it is useful to begin by considering a special case in which no takeover market exists. Note that in the absence of a takeover market, P1 and P2 differ only through their effect on V_H , since no acquirer will ever have to confront the additional costs imposed by P2. (As such, P1 can be thought of as a special case of P2, in which $\Delta = 1$; we shall therefore concentrate on the more general case of P2 in what follows.)

First consider the parties' respective payoffs. Given her quality parameter q and level of benefit extraction β , the total value of the firm (or $\pi_F(q, \beta)$) consists of the expected value of the project less the fixed component of the wage paid to the manager:

$$\pi_F(q, \beta) = \underbrace{(1 - \beta) \cdot \Delta q}_{\text{Exp. Val. of Project}} - \underbrace{w}_{\text{Fixed Wage}} \quad (1)$$

This value will generally correspond to the total capitalized stock value of the company. Of this value, nonmanagerial shareholders enjoy a $(1 - \sigma)$ share, while M receives a σ share. But in addition to her pro rata ownership share, M receives additional private benefits and her flat wage. Thus, the expected payoff of M is as follows:

$$\begin{aligned} \pi_M(q, \beta) &= \underbrace{\sigma \cdot ((1 - \beta) \cdot \Delta q - w)}_{\text{Share ownership component}} + \underbrace{\left(\beta - \frac{1}{2}\beta^2\right) \cdot \Delta q}_{\text{Private Ben. Component}} + \underbrace{w}_{\text{Wage}} \quad (2) \\ &= \left(\sigma \cdot (1 - \beta) + \beta - \frac{1}{2}\beta^2\right) \cdot \Delta q + (1 - \sigma) \cdot w \end{aligned}$$

The manager will therefore set β to maximize her expected payoff, which yields an optimal level of value diversion of $\beta^* = (1 - \sigma)$. Note that this optimal choice is independent of either the expected value of the project chosen (Δq) or on the manager's fixed wage (w).

Substituting this value into the parties' various payoffs yields the following Table. The columns of the Table correspond to the project chosen by the manager (i.e., P1 or P2). The rows of the Table correspond to different slices of the total payoff created from the selected project. The first row reflects the manager's expected payoff (which includes her private benefits, wages, and her pro rata earnings as a shareholder). The second row reflects the expected payoff of non-managerial shareholders. The third row reflects the total capitalized value of the company (that is, the sum of all the parties' share values). And finally, the fourth row reflects the sum of the

managers, and non-managerial expected payoffs.

	Expected payoff under P1	Expected payoff under P2
Manager	$\left(\frac{1+\sigma^2}{2}\right) q + (1 - \sigma) w$	$\left(\frac{1+\sigma^2}{2}\right) \Delta q + (1 - \sigma) w$
Non-M SHs	$(1 - \sigma) \sigma q - (1 - \sigma) w$	$(1 - \sigma) \sigma \cdot \Delta q - (1 - \sigma) w$
Firm Value	$\sigma q - w$	$\sigma \Delta q - w$
Social Value	$\left(\sigma + \frac{1-\sigma^2}{2}\right) q$	$\left(\sigma + \frac{1-\sigma^2}{2}\right) \Delta q$

(3)

Table 3

In the discussion below, we will frequently use the term μ_0 as a shorthand for the term $\left(\sigma + \frac{1-\sigma^2}{2}\right)$. Note that $\mu_0 \geq \sigma$ and $\mu_0 \geq \frac{1}{2}$.

The optimal compensation package for M is one that attempts to maximize the non-managerial shareholder's payoff subject to participation and incentive constraints of M. Analyzing this problem yields the following proposition (which is proved in the appendix).

Proposition 1 *In the absence of a market for corporate control, the optimal incentive compatible, individually rational contract is given by $w^N = 0$ and $\sigma^N = \frac{1}{2}$. Under this contract, the manager sets $\beta^N = \frac{1}{2}$, and chooses the project P1 (P2) if and only if $\Delta < 1$ ($\Delta \geq 1$).*

A few details bear note about Proposition 1. First, the optimal incentive contract compensates M through share ownership, and selects the minimum feasible wage level $w = 0$ needed to induce participation by M. (This will turn out to be true for the remainder of the discussion, and thus without any loss of generality, we suppress the analysis of a flat wage and simply impose the condition $w = 0$). This result follows naturally from the assumptions that the shareholder-manager contract is infected by a moral hazard problem and that M is risk neutral. On the other hand, the manager has relatively significant incentive compensation. In particular, the optimal contract pays a manager one half of the firm's shareholdings in order to incentivize her away from taking private benefits.¹¹⁵

¹¹⁵Although this level of compensation may seem a bit unrealistic, with added complexity it is possible to generalize M's private benefit function to get different results. For instance, if M's private benefits were equal to $\beta - \frac{1}{2\gamma}\beta^2$, the optimal incentive scheme would pay M a share component of $\sigma = \max\left\{0, 1 - \frac{1}{2\gamma}\right\}$. Thus, for small values of γ , the manager receives very little incentive compensation because he is not sufficiently talented at diverting value.

Second, as we shall see below, the introduction of a market for corporate control will tend to reduce the optimal share compensation below this level.

Second, and perhaps most importantly, Proposition 1 reveals that, in the absence of takeovers, shareholders can perfectly align the managers incentives with their own. In this case, the manager always chooses the highest value project from the shareholders’ perspective, and does not select project P2 when it is inefficient (from the non-managerial shareholders’ perspective) to do so. Indeed, without any takeover market to worry about, the manager evaluates project P2 solely based on its ability to increase firm value (over which she has a fractional claim).

5.3 Market for Corporate Control

Consider now M’s incentives when faced with the possibility of a takeover. As noted above, we assume that after M makes a project choice, a single bidder (denoted by B) emerges as a potential acquirer. Similar to M, player B has some ability to run the firm, and is thus assumed to draw her own quality parameter θ from a $U[0, 1]$ distribution, which is independent of M’s. Thus, the bidder may be better than the incumbent, but is not so. The buyer must decide on her bid without knowing the manager’s quality – although she does know the distribution of q . She bids on control of entire firm, then, making conjecture about existing managerial quality.¹¹⁶

This subsection will analyze and then compare two alternative rules for regulating takeovers. Under the first, the manager has the right to veto a tender offer before other shareholders are allowed to vote on it. This rule effectively requires that a takeover offer be a friendly offer which compensate both the manager and the shareholders for their reservation values. Such a rule would correspond to permitting managers to “Just Say No.” Under the second, shareholders alone have the right to approve or disapprove a tender offer. This rule, therefore, effectively allows either friendly or hostile bids (though in our framework all such bids will be hostile). In order to give the shareholder choice rule a fair hearing, we shall assume that shareholders can make an informed choice about whether to sell, and thus that the shareholders learn about the incumbent manager’s quality before voting on a tender offer under either rule.

5.3.1 Managerial Choice Regime

Consider first the impact of the takeover market on firm value – and in particular on the manager’s choice between P1 and P2 – under a managerial choice regime. Under such a rule, both M and the non-managerial shareholders must approve a tender offer in order for B to succeed in

¹¹⁶Note that since M has chosen the project prior to the realization of q , the observed project choice signals nothing to B about the manager’s quality.

acquiring the firm. Thus, the acquirer must compensate both the manager and the shareholders to gain their approval. Consequently, then, under a managerial choice (or alternatively, managerial “veto”) rule, all tender offers must by definition be friendly ones. In this case B will offer two prices in making her bid: one for the purchase of all outstanding shares (denoted as p_S), and the other functioning as an additional “side payment” that goes to incumbent management to purchase their approval (denoted as p_M).¹¹⁷

For B’s tender offer to be successful, then it must be sufficiently high to satisfy both the incumbent shareholders’ and the incumbent manager’s expected payoffs under the status quo. In particular, managers must reap gains from the deal equal to those she would have received from continuing with the firm. Similarly, shareholders must be as well off under the acquisition as they would be otherwise. Consequently, necessary and sufficient conditions for a successful bid are that:

- The total bid, $(p_S + p_M)$, must be equal or exceed the total social value under the chosen project (i.e., the sum of the shareholders’ and M’s combined expected payoffs), or $\mu_0 \cdot \Delta q$ from Table 3.
- Of this total bid, the fraction directed to shareholders $\frac{p_S}{p_S + p_M}$, must be set equal to $\frac{\sigma}{\mu_0}$, where recall that $\frac{\sigma}{\mu_0}$ represents the fraction of firm value to social value under the chosen project.¹¹⁸

As previously noted, the total value of the project is $q\Delta$ if managed by incumbent manager M, where $\Delta = c = 1$ if the manager has selected P1. Should B acquire the firm, however, the expected value of the firm is $\theta\Delta c \leq \theta\Delta$ (since by assumption, $c \leq 1$).

The bidder will therefore set its bid b so as to maximize expected profits, where these are given by the probability that the bidder offers a bid sufficiently high to induce both the manager and shareholders to accept the bid, multiplied by the expected returns to the bidder of the

¹¹⁷The amount paid to managers could take the form of a lucrative post-acquisition employment contract. Note that by virtue of her share ownership, M also stands to gain a σ -fraction of the price paid to shareholders.

¹¹⁸To see this, note from Table 3 that the ratio of firm value to total social value is precisely equal to $\frac{\sigma}{\mu_0}$. If price ratio offered by B were not set at this level, B could get a more successful acceptance rate at no additional cost by setting the price ratio accordingly.

acquisition¹¹⁹:

$$\pi_B(b; \theta) = \min \left\{ \frac{b}{\mu_0 \Delta}, 1 \right\} \cdot (\theta \Delta c - b)$$

Analysis of this problem implies that the profit maximizing bid¹²⁰ for B is $b^* = \frac{\theta \Delta c}{2}$. In other words, the bidder will offer an amount equal to half the expected value of the firm under B's management.

Now consider the probability that a takeover occurs when B follows this bidding strategy. The prospects of a takeover clearly depend on the value q , the incumbent manager's quality. The greater the incumbent's quality, the lower the likelihood that the bidder will be able to increase the value of the firm beyond that of current management, and thus the lower the likelihood that the bidder will be able to make a successful bid. By contrast, the lower the quality of the incumbent manager, the greater the probability that the bidder will be able to find a bid that will induce both managers and shareholders to accept the deal. Mathematically, the probability of a takeover for a given q is:

$$\Pr \{Takeover|q\} = \max \left\{ \left(1 - \frac{2\mu_0}{c} q \right), 0 \right\}$$

A couple of points are worth some brief mention at this juncture. First, as noted above, if q is sufficiently high, there is no chance that a takeover will occur, and thus the bidder cost parameter c never is at issue. Thus, for these situations at least, it is clear that M's incentives relatively better aligned with those of the shareholders. In particular, these managers are in effect in a "no takeover" regime, and thus such a high quality manager would never select a project solely to ensure a lower chance of a takeover. By contrast, a lower quality managers (i.e., those

¹¹⁹To see this, note that

$$\begin{aligned} \pi_B(b; \theta) &= \Pr \{b \geq \mu_0 \cdot q \cdot \Delta\} \cdot (\theta \Delta c - b) \\ &= \Pr \left\{ q \leq \frac{b}{\mu_0 \Delta} \right\} \cdot (\theta \Delta c - b) \\ &= \max \left\{ \frac{b}{\mu_0 \Delta}, 1 \right\} \cdot (\theta \Delta c - b) \end{aligned}$$

¹²⁰Explicitly, the first order conditions yield the following:

$$b^* = \begin{cases} \frac{\theta \Delta c}{2} & \text{if } \theta \leq \frac{2\mu_0}{c} \\ \mu_0 \Delta & \text{otherwise} \end{cases}$$

But because $\mu_0 \geq \frac{1}{2} > \frac{c}{2}$, we know that $\theta \leq 1 \leq \frac{2\mu_0}{c}$, and thus the optimal bid is always interior, and is that given in the text.

for which $q \leq \frac{c}{2\mu_0}$) does face a risk of a tender offer and thus we must consider whether such a manager might select project P2, even when it is not efficient, in order to deter tender offers. Brief consideration, and analysis below, suggests that she will not do so under managerial choice because managerial choice ensures that a tender offer can never make her worse off than otherwise.

Given the likelihood of a takeover discussed above, we are now in a position to characterize the total payoffs (that is, shareholders and M's expected payoffs) that could be expected under a managerial choice rule. Given that shareholders and the manager are guaranteed their total non-acquisition gains under a managerial choice rule, the expected total payoffs to the shareholders and a managers are the non-acquisition value of the firm plus the expected premium arising from a friendly deal. Taking expectations yields the following expected total payoff¹²¹:

$$Total\ Social\ Value = \left(\frac{\mu_0}{2} + \frac{c^2}{24\mu_0} \right) \Delta$$

Of this sum, recall that shareholders as a group receive a $\frac{\sigma}{\mu_0}$ portion of the total payoff, while M's private benefits constitute the remaining $\left(1 - \frac{\sigma}{\mu_0}\right)$ portion. Dividing these up after accounting for the manager's shareholdings in the firm, the manager's and non-managerial shareholders' expected payoffs under each respective project are:

	Payoff under P1	Payoff under P2
Manager	$\left(1 - \frac{\sigma}{\mu_0} + \frac{\sigma^2}{\mu_0}\right) \left(\frac{\mu_0}{2} + \frac{1}{24\mu_0}\right)$	$\left(1 - \frac{\sigma}{\mu_0} + \frac{\sigma^2}{\mu_0}\right) \left(\frac{\mu_0}{2} + \frac{c^2}{24\mu_0}\right) \Delta$
Non-M SHs	$\frac{\sigma}{\mu_0} (1 - \sigma) \left(\frac{\mu_0}{2} + \frac{1}{24\mu_0}\right)$	$\frac{\sigma}{\mu_0} (1 - \sigma) \left(\frac{\mu_0}{2} + \frac{c^2}{24\mu_0}\right) \Delta$
Firm Value	$\frac{\sigma}{\mu_0} \left(\frac{\mu_0}{2} + \frac{1}{24\mu_0}\right)$	$\frac{\sigma}{\mu_0} \left(\frac{\mu_0}{2} + \frac{c^2}{24\mu_0}\right) \Delta$
Social Value	$\left(\frac{\mu_0}{2} + \frac{c^2}{24\mu_0}\right)$	$\left(\frac{\mu_0}{2} + \frac{c^2}{24\mu_0}\right) \Delta$

Table 4

Analysis of this table leads to the following proposition (whose proof can be found in the appendix).

Proposition 2 *Consider a market for corporate control subject a managerial choice rule. Regardless of the terms of the contract, M's choice of project coincides precisely with that favored by the shareholders. The optimal contract (w^V, σ^V) sets $w^V = 0$, and $\sigma^V < \frac{1}{2}$.*

¹²¹This is derived by noting that the total expected payoff is equal to $E_q [\mu_0 q \Delta + E_\theta [\max \{0, \frac{\theta \Delta c}{2} - \mu_0 q \Delta\}]]$.

The intuition behind Proposition 2 is straightforward but important. The first part of it essentially states that when tender offers are governed by a managerial choice regime, essentially nothing is needed to incentivize the manager to choose the “right” project for the firm. In other words, *allowing a managerial choice ensures that the manager’s incentives over project choice are exactly aligned with those of shareholders, regardless of the manager’s incentive compensation.* This result is fairly easy to understand: because the prospective acquirer must approach both the incumbent shareholders and M with an offer, the manager’s private benefits of control must be accounted for in any successful takeover bid. While this certainly may chill some takeover bids (by making them more expensive), it removes the manager’s incentive to choose P2 solely to chill takeover activity. In effect, the choice rule perfectly insures her against such an outcome. As we shall see below, this aligning of incentives does not necessarily occur under a shareholder choice rule.¹²²

The second part of Proposition 2 characterizes the optimal contract for the manager. Like before, the optimal fixed wage for the manager is zero. The optimal share compensation, σ^V , on the other hand, is positive but smaller than it would be in the absence of a market for corporate control. The reason for this is a bit less obvious, but also straightforward: unlike the case where no takeover market exists, in this case shareholders know that at least with some probability their payoff will come in the form of a buyout rather than through M’s management. Consequently, shareholders would like to increase the share of any takeover premium that they (as opposed to M) receive. By decreasing σ (and thereby increasing their own share of firm value), non-managerial shareholders can claim a larger fraction of the buyout price when it occurs. On the other hand, decreasing σ causes M to behave more wastefully in situations where a takeover doesn’t occur, and could even reduce the purchase price when a buyout occurs. Hence, shareholders will decrease σ up until the point where the marginal benefit of claiming a larger share of the buyout surplus is exactly offset by the marginal cost of weakening the manager’s incentives.

5.3.2 Shareholder Choice Regime

We now transition to consider an alternative legal regime, in which the success of tender offers hinges solely on shareholder approval, with no managerial veto rights. In particular, consider an alternative rule in

¹²²Because it is technically tedious, we put off discussion the precise terms of an optimal contract for the this case until the example discussed in a later section. Nor is such a discussion necessary here, since Proposition 2 applies to all incentive compatible contracts, and not just the optimal one.

which a takeover bid requires the approval solely of the non-managerial shareholders, who hold a $(1 - \sigma)$ fraction of the firm.¹²³ Assume, moreover, further that managers cannot take any post-bid actions to affect the probability that the shareholders approve the deal. The strategic effect of this regime is to induce all takeovers to be hostile ones. Indeed, because the manager is no longer needed for approval, the buyer need not give her any special treatment in making a bid, and thus p_M is equal to zero. (Recall, however, that the manager may still benefit from a takeover to the extent that she owns a σ fraction of the firm).

As before, we shall consider how such a scenario would play out for project P2 (noting that P1 is a special case where $c = \Delta = 1$. Recall from above that, ignoring any value diversion, the expected value of the firm's project is $q\Delta$ if managed by M, and $\theta\Delta c$ if by the bidder. Once private benefits are accounted for, the total shareholder value of the company under P2 is $\sigma q\Delta$. Accordingly, under a shareholder choice regime, B will set its bid b to maximize expected profits:

$$\pi_B(b; \theta) = \min \left\{ \frac{b}{\sigma\Delta}, 1 \right\} \cdot (\theta\Delta c - b)$$

Analysis of this problem yields the profit maximizing bid for B of ¹²⁴ $b^* = \min \left\{ \frac{\theta c}{2}\Delta, \sigma\Delta \right\}$. The probability of a takeover, in turn, depends on the relative values of σ and c . Following the analysis from the previous section, the probability that a takeover will occur is given by:

$$\Pr \{Takeover|q\} = \max \left\{ \left(1 - \frac{2\sigma}{c}q \right), 0 \right\}$$

Note that the probability of a takeover is decreasing in c ; and thus, as intuition would suggest, the greater the negative impact of P2 on the gains

¹²³Note that our focus here is on non-managerial shareholders, and not all shareholders. Of course, under both state acquisitions law and the Williams Act, tender offers are open to all shareholders (managerial or non-managerial). Nevertheless, our focus on non-managerial shareholders is justified for a number of reasons. First, if M does not own a majority of the company's shares, it is the non-majority shareholders whose votes are critical. Second, even if M held a majority of shares, because this decision may have some elements of an interested transaction, it would possibly require the vote of nonmanagerial shareholders to cleanse it anyway. And finally, if M owned a majority of shares, she would be unlikely to approve a tender offer that did not also give her side compensation for her own private benefits, and thus a shareholder choice regime would be no different from a managerial veto regime.

¹²⁴Or equivalently,

$$b^* = \begin{cases} \theta \cdot \frac{c}{2}\Delta & \text{if } \theta \leq \frac{2\sigma}{c} \\ \sigma\Delta & \text{otherwise} \end{cases}$$

Only if $\sigma \leq \frac{c}{2}$ would B's optimal bid exhibit a kink at $\theta = \frac{2\sigma}{c}$.

to a bidder the lower the probability of a takeover. Note also, however, that the probability of a takeover is invariant to Δ , however. Because the benefits of P2 are a common value, they would be fully realized by both bidder and incumbent symmetrically. As such, only the costs of P2 are reflected in the above expression through c .¹²⁵ Comparing this probability to its analog from the managerial choice section generates the following proposition:

Proposition 3 *The choice of P2 over P1 strictly decreases the probability of a takeover under either shareholder choice or managerial choice. Moreover, holding compensation terms and choice of project constant, whenever there is a positive probability of a takeover, it is larger under a shareholder choice regime than it is under a managerial choice regime.*

Proposition 3 reveals that if managers select the same projects under shareholder choice as under managerial choice, then shareholder choice will indeed increase the probability of a serious tender offer. We understand this argument to constitute a principal claim for most proponents of shareholder choice. Indeed, so long as the underlying regime does not affect the upstream managerial decisions that M makes at the firm, shareholder choice allows incumbent shareholders to claim the sole share of the takeover premium, thereby facilitating the incidence of a takeover bid. Yet Proposition 3 also reveals why shareholder choice need not necessarily increase the probability of a serious tender offer: in those circumstances where the manager selects P1 under a managerial choice rule – because P1 maximizes overall firm value – but selects P2 under shareholder choice rule, the likelihood of a takeover may be smaller under shareholder choice. In this circumstance, it is less clear that the shareholder choice rule would augment either the probability of a takeover or the takeover value of the company. Consequently, in order to evaluate the impact of shareholder choice we need to determine whether managers would select project P2, even if doing so does not improve firm value (and thus they would not select P2 under managerial veto).

Now consider the expected value of the firm (or equivalently, total share value) under the shareholder choice rule. Suppressing some tedious algebra, the ex ante expected value of the firm under shareholder choice is:

$$Firm\ Value = \begin{cases} \Delta\sigma \left(1 - \frac{2\sigma}{3c}\right) & \text{if } \sigma \leq \frac{c}{2} \\ \Delta\sigma \left(\frac{1}{2} + \frac{c^2}{24\sigma^2}\right) & \text{if } \sigma > \frac{c}{2} \end{cases} \quad (4)$$

¹²⁵explain

Note that this expression is increasing in both Δ and c . This is intuitively sensible, since increases in Δ mean a higher overall project payoff, while increases in c mean a more viable market for corporate control. Either of these is good news for the firm's shareholders. Non-managerial shareholders, therefore, reap a $(1 - \sigma)$ fraction of the above payoff. M, on the other hand, enjoys her pro-rata payoff as a shareholder (i.e., a σ -share of the sum calculated above) plus her private benefits should no takeover occur. Once again suppressing some algebra, the following tables represent the parties respective payoffs depending on project choice.

When the contract is such that $\sigma \leq \frac{c}{2}$:

	Payoff under P1	Payoff under P2
Manager	$\sigma^2 \left(1 - \frac{2\sigma}{3}\right) + \sigma \frac{(1-\sigma^2)}{3}$	$\left(\sigma^2 \left(1 - \frac{2\sigma}{3c}\right) + \sigma \frac{(1-\sigma^2)}{3c}\right) \Delta$
Non-M SHs	$\sigma(1 - \sigma) \left(1 - \frac{2\sigma}{3}\right)$	$\sigma(1 - \sigma) \left(1 - \frac{2\sigma}{3c}\right) \Delta$
Firm Value	$\sigma \left(1 - \frac{2\sigma}{3}\right)$	$\sigma \left(1 - \frac{2\sigma}{3c}\right) \Delta$
Social Value	$\sigma \left(1 - \frac{2\sigma}{3} + \frac{1-\sigma^2}{3}\right)$	$\sigma \left(1 - \frac{2\sigma}{3c} + \frac{1-\sigma^2}{3c}\right) \Delta$

When the contract is such that $\sigma > \frac{c}{2}$:

	Payoff under P1	Payoff under P2
Manager	$\left(\frac{1}{4} - \frac{1}{48\sigma^2}\right) + \sigma^2 \left(\frac{1}{4} + \frac{1}{16\sigma^2}\right)$	$\left(\left(\frac{1}{4} - \frac{c^2}{48\sigma^2}\right) + \sigma^2 \left(\frac{1}{4} + \frac{c^2}{16\sigma^2}\right)\right) \Delta$
Non-M SHs	$\sigma(1 - \sigma) \left(\frac{1}{2} + \frac{1}{24\sigma^2}\right)$	$\sigma(1 - \sigma) \left(\frac{1}{2} + \frac{c^2}{24\sigma^2}\right) \Delta$
Firm Value	$\sigma \left(\frac{1}{2} + \frac{1}{24\sigma^2}\right)$	$\sigma \left(\frac{1}{2} + \frac{c^2}{24\sigma^2}\right) \Delta$
Social Value	$\sigma \left(1 - \frac{2\sigma}{3} + \frac{1-\sigma^2}{3}\right)$	$\sigma \left(1 - \frac{2\sigma}{3c} + \frac{1-\sigma^2}{3c}\right) \Delta$

Comparing M's payoff with the non-managerial shareholders' payoff in the two tables above, one is immediately struck by the fact that unlike in the managerial choice case, the manager's and the non-managerial shareholders' payoffs are no longer strictly proportionate to one another. Indeed, because a shareholder choice regime gives shareholders a unique advantage over M when a takeover bid occurs, the manager has less to lose by choosing P2 over P1, and may have something significant to gain: the preservation of her private benefits of control. Consequently, M has a greater incentive to choose P2 in situations where other shareholders would strictly prefer P1. This observation leads to the following proposition:

Proposition 4 *Consider a market for corporate control subject a shareholder choice rule. For any contract (w, σ) , M will choose to pursue project P2 in strictly more circumstances than the shareholders*

would prefer. In other words, the manager may select P2 even when doing so reduces total shareholder value.

The intuition behind this result is relatively simple to understand. Under a shareholder choice regime, managers with relatively low quality fear the loss of their private benefits of control. Because such managers are not able to exercise a veto right at the time of the tender offer, they use the one tool available to them for avoiding a tender offer: the choice of project P2 over P1. Even if such a project does not yield significant gains to the firm, the fact that it imposes costs on acquirers makes it valuable to the manager in a shareholder choice regime, though not necessarily good for overall firm value.

Recognizing this added agency cost imposed by a shareholder choice regime, shareholders can choose to compensate in one of two ways. First, shareholders could simply live with the manager's wasteful attraction to P2, and simply set M 's assuming that she will choose that project. Alternatively, shareholders could attempt to increase M 's incentive compensation to induce her to select the optimal project from the shareholders' perspective. By inspection of the above expressions, however, it is clear that the only way to fully align M 's incentives with that of shareholders for every possible combination of c and Δ is to set $\sigma = 1$, effectively giving the firm to the manager. Thus, depending on the characteristics of P2, shareholders might opt for one of these strategies over the other. Nevertheless, regardless of which strategy shareholders take, there are range of situations in which a shareholder choice regime makes non-managerial shareholders worse off than they would be under a managerial choice regime. More formally, this argument is as follows:

Proposition 5 *Consider a market for corporate control subject a shareholder choice regime, and an optimal incentive compatible contract (w^{SC}, σ^{SC}) . When the costs imposed on the acquirer by project P2 are sufficiently large (that is, c is sufficiently small), there exists a range non-empty interval (Δ_L^c, Δ_H^c) such that whenever $\Delta_L^c < \Delta < \Delta_H^c$, non-managerial shareholders would do better under a managerial choice rule.*

The above proposition formalizes our central argument in this paper. Even if one assumes that shareholders are fully equipped and coordinated to evaluate and act upon a tender offer, a shareholder choice regime need not make shareholders better off (and may make them worse off) after controlling for the up-front managerial decisions that M makes and optimal compensation packages. On the one hand, shareholder choice allows existing shareholders to capture the entire value of the premium paid by

an acquirer, without being forced to split it with incumbent management. On the other hand, a shareholder choice rule can tempt M to select projects that specifically prevent takeover bids from materializing, particularly when the value of c is relatively small (and the divide between managerial and shareholder incentives is the greatest). To be sure, shareholders could attempt to stem this added incentive problem by increasing M's share compensation (σ). But so doing requires shareholders to surrender value to M *regardless of whether a takeover ever occurs*. Such a loss can easily eclipse any speculative gain shareholders would enjoy in the more remote circumstance of a takeover bid.

It should be noted, of course, that Proposition 5 does not suggest that shareholder choice is systematically worse than managerial choice. To the contrary, either regime may be optimal, depending on the relative values of c and Δ . That observation, however, is precisely our point: while some firms may flourish *ex ante* under a shareholder choice regime, others would be better off under a managerial choice rule. The likely heterogeneity of circumstances firms face thus renders questionable any proposition that a blanket rule of shareholder choice (or, for that matter, managerial choice) is a prudent or efficient policy to pursue.

5.4 A Numerical Example

Perhaps one of the best ways to understand the analysis above is to examine a concrete example. Thus, consider a specific case drawn from the above model in which $V_H = \$1$ million, $\Delta = 1$ and $c = 0$. Note that because $\Delta = 1$, P1 is always the optimal choice for this example, since selecting P2 gives a benefit only to the manager of the firm who is better able to stave off a takeover. In fact, in this example, the choice of P2 is particularly severe, and it is able to deter all takeovers (an admittedly extreme case, but one that underscores our point).

The table below presents the basic structure of the optimal contract and the parties behavior in each case. Under a managerial choice rule, M always picks the efficient project. Under shareholder choice, however, this need not be so, as demonstrated above. In this case, however, the negative repercussions of choosing P2 are so severe that the shareholders find it worthwhile to incentivize M to choose the efficient project (P1). So doing, however, requires that M be paid a greater number of shares in his compensation package. Indeed, under shareholder choice, M receives 58% of the firm in incentive pay, while under managerial choice, she receives only 48%. While this gives the firm a higher total share value under shareholder choice (\$360,700 to \$266,700), a much smaller fraction of this goes to the non-managerial shareholders. Indeed, the non-managerial shareholders have to compensate M so heavily

in a shareholder choice environment that they are left with a smaller amount (\$134,300) than they would have in a managerial choice world (\$134,300) under a lower power incentive contract). In fact, in this example, managerial choice is pareto superior to shareholder choice, in that the manager as well prefers managerial choice, notwithstanding the fact that she receives more incentive compensation under shareholder choice.

	σ	Proj.	Soc. Val.	Firm Val.	Non-M Val.	M's Payoff
Mgr. Choice	.48	P1	\$480,600	\$266,700	\$138,700	\$341,900
SH Choice	.58	P1	\$467,500	\$360,700	\$134,300	\$333,200

Table 7: Numerical Simulation

Finally, an interesting feature of the table above worth noting is that notwithstanding the pareto superiority of managerial choice, shareholder choice gives rise to a higher total share value for the company (\$360,700) than does managerial choice (\$266,700). This observations provides a cautionary note for those who would assess the efficiency of any legal regime based on share value alone. In this case, the increase in share value under shareholder choice is largely diverted to the manager, leaving non-managerial stakeholders worse off.

To be sure, this example is a particularly stark one, chosen to highlight our arguments in this paper. But nevertheless, this section has demonstrated more formally the possibility (and a reasonable one at that) that shareholder choice proposals often have unintended effects when one considers distortions to ex ante behavior.

5.5 Hybrid Regimes

In order to illustrate our points, the previous two sections have focused on two polar extremes: (1) Managerial Choice, allowing managers unmitigated freedom to choose among which (if any) potential acquirers the firm will consider; and (2) Shareholder Choice, according shareholders with the ultimate authority to veto any defense that is either targeted or erected after a bid. While this comparison is probably the most intuitive, it leaves open the possibility that some intermediate hybrid regime might be better than both of these extremes. This subsection briefly considers such a possibility, focusing on four types of hybrid regime.

First, one might consider hybrid regimes that allow shareholders some limited ability to defeat only certain types of defensive measures, such as those (for example) that are specifically targeted at resisting hostile bids and are undertaken only after a bid has been made (the

northeast quadrant of Figure 1 above). If shareholders were given this limited veto right, one could conceivably argue, it might force a middle ground between a strong shareholder choice rule and unmitigated managerial freedom.¹²⁶ While this type of hybrid regime seems possible in theory, its ability to stake out a middle ground in practice is questionable. Indeed, were shareholders given the right to overturn post-bid, targeted defenses, a well-advised board of directors would be able to evade such a restriction by simple advance planning. Far in advance of a takeover bid, such a board could (for example) amend its bylaws to include a poison pill that would automatically become activated upon a later acquisition, without requiring any board action. Indeed, as we demonstrated in Section 2, one of the problems with regulating post-bid, targeted defenses is the ease with which managers can alter their strategy to other substitutable strategies, such as pre-bid, targeted defenses. Viewed in this sense, a limited shareholder veto right may be little more than a slightly more elaborate managerial choice regime. If so, then our analytical approach from the previous section may be more realistic than it appears on first blush.

Second, it is possible that the internal governance system of the firm itself provides a form of hybridization of a different species. For example, even under a strong shareholder choice regime, the threat of a proxy contest among existing shareholders may deter managers from systematically pursuing value-reducing projects for self preservation purposes. Viewed in this sense, a shareholder choice regime may be a prudent choice for firms who also have active participants in firm governance. It strikes us that this possibility is certainly a real one (indeed, direct corporate governance is a much more common method for influencing directorial behavior than hostile takeovers, which occur rarely). Nevertheless, we remain dubious that the proxy system can fully rectify the problem we have pinpointed. Indeed, as we have shown above, the most salient difficulty with pre-bid embedded blanket defenses is that shareholders are not sufficiently informed or motivated to assess the overall costs and benefits that stem from such a defense. Consequently, a shareholder would not have a very good sense whether to challenge such a blanket measure. It is difficult to understand how this same shareholder might become enlightened when the decision at issue moved from challenging a transaction to removing a director. Indeed, it is this same difficulty that underlies the numerous prohibitions provisions in state and federal law that prohibit shareholders from using the proxy system to alter ordinary business decisions.¹²⁷

¹²⁶Cite Black, Gilson.

¹²⁷See DGCL § 141(A); Securities Rule 14a-8 (cite subrules).

A third type of hybrid regime might call on courts to consider only the costs that a given embedded defense imposes on potential acquirers without taking into account the benefits that it may confer on the company. In terms of the previous subsection's model, this would mean allowing shareholders to veto any defensive measure for which the value of c is sufficiently low. Prudently executed, such a regime might well be able to stem some of the moral hazard problems that we identified above. At the same time, however, it is far from clear that either shareholders or courts would be any better at assessing c than they would be at assessing Δ , the firm-specific benefits of an embedded defense. Indeed, both assessments require one to consider abstract, prospective effects of a particular business plan. Whether one characterizes those effects as costs or benefits would not obviously seem to affect how skilled or motivated shareholders are at gleaning such information. But moreover, it is extremely difficult to engage in any form of efficiency calculus by examining only one side of a cost-benefit trade-off. Without significant knowledge about the likely distribution of benefits from pre-bid embedded defenses, courts would have little hope of formulating and executing a prudent policy.

Finally, one might imagine that a court would implement a hybrid regime not through specifying which types of defenses are challengeable, but rather by deliberately obscuring exactly what the legal regime is for any defense. While such legal indeterminacy and opacity may, on first blush seem unwise, it may give courts a way to award shareholders a partial ability to restrain managerial resistance. Indeed, if managers are uncertain whether a specific defense will ultimately be upheld, they may be willing to allow bids that do not fully compensate them for their lost private benefits. Moreover, so long as managers had at least some confidence that a defense might be upheld, they might also be willing to make value maximizing project choices notwithstanding the legal uncertainty.¹²⁸ To see this, consider a version of the example from the previous subsection in which there is some uncertainty about whether the ultimate rule will be one favoring managerial choice or shareholder choice. In particular, suppose that there is a 75% chance that a court will allow managers to veto a bid, versus a 25% chance that shareholders will ultimately be allowed to accept a bid. Note that because the manager is still much more likely than not to be allowed to select among bidders, she is not tempted (as she would be under shareholder choice) to select (inefficient) Project 2. Consequently, the optimal contract would award

¹²⁸For another analysis of how legal uncertainty can augment allocational efficiency through bargaining, see Ian Ayres & Eric Talley, Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade, 104 Yale L. J. 1017 (1994).

the manager with a 47% share of the firm (down from 48% under a managerial veto and 58% under a shareholder choice regime). More importantly, non-managerial shareholders would expect a payoff of \$149,540 under this hybrid regime, up from \$138,700 under the managerial choice rule. Managers, on the other hand would lose slightly, expecting a payoff of \$340,700 (down from \$341,900). Yet on the whole, this type of hybrid regime would increase total social welfare above that of either extreme rule. Consequently, while our analysis points out an important cost of shareholder choice that is worth appreciating, in many circumstances an optimal policy may lay somewhere between the two extremes studied above.

6 Empirical Fit

Before concluding, it is perhaps prudent to situate our conceptual argument within the growing empirical literature on corporate governance. So doing will allow us to gauge the “fit” of our claims as a practical matter. As it turns out, many of the points we have made above have some support in the empirical data, and may even offer alternative explanations for phenomena that legal and finance scholars have found curious.

Perhaps most directly, our results may help to explain the rather tepid response that shareholder choice proposals have had among investors. If strong-form shareholder choice proponents are correct, one would expect shareholders of many, if not most, firms to support such proposals. Such support would be manifest in many ways, such as widespread resistance to tender offer defenses in IPO charters; support for charter provisions restricting board’s ability to adopt the poison pill (or requiring boards to redeem the pill if shareholders support a deal); and support for shareholder proposals seeking to declassify boards of existing firms. Moreover, one would expect the percentage of firms that limit board power over tender offers to have increased over time, with the rise of institutional investors.

The existing evidence does not demonstrate consistent, growing, pressure for shareholder choice. Indeed, much of the existing evidence has found exactly the opposite. For example, study by Robert Daines and Michael Klausner of over 300 initial public offerings between 1994 and 1997 found that a majority explicitly included anti-takeover provisions in their charters.¹²⁹ Indeed, over 60% of the IPO firms had charters that

¹²⁹Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPO Charters, 17 J. Law, Econ. & Organ. 83 (2001); see Laura Casares Field & Jonathan Karpoff, Takeover Defenses of IPO Firms, 107 J. Finance 1857 (2002) (53% of industrial firms going public between 1988-1992

explicitly strengthened the poison pill by either establishing a staggered board or by making it difficult for shareholders to replace the board between annual meetings.¹³⁰ No firm included a provision to either limit board authority to adopt anti-takeover provisions in the future, or to prohibit or limit the use of poison pills.¹³¹ Moreover, the proportion of firms going public with staggered boards appears to have increased over time. A study by John Coates found that the percentage of firms going public with staggered boards increased from 34% in the early 1990s to 82% in 1999.¹³² Moreover, this increased use of staggered board occurred over the very period in which shareholders have come to understand the tremendous power of the staggered board as a defensive mechanisms.¹³³

Nor have shareholders of existing firms actively campaigned for shareholder choice. Notwithstanding the rise of institutional investors, shareholders of existing publicly held firms have not campaigned vigorously to either limit power control over tender offer defenses or to restrict boards' use of the pill. Despite early interest in precatory shareholder resolutions seeking to control board use of the pill, since 1996 the number of such resolutions has declined to an average of less than 10-15 per year. Moreover, these resolutions generally fail (although they have garnered more shareholder votes than previously).¹³⁴ Institutional shareholders

employed at least one antitakeover defense).

¹³⁰Kahan & Rock, *supra* note 885 (discussing a study by Robert Daines and Michael Klausner and subsequent analysis of their data).

¹³¹Daines & Klausner, *supra* note , at 95. This results are consistent with those obtained by John Coates, [lawyer paper] , at 1353, 1376; Field & Karpoff, *supra* note

¹³²John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 Cal. L. Rev. 1301, 1376 (2001).

¹³³See, e.g., Kahan & Rock, *supra* note ; Lynn Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 Stan. L. Rev. 845, 854 (2002); see also Bebchuk, Coates & Subramanian, *supra* note , (showing the significant effect of staggered boards on the expected success of a hostile acquisition).

Similarly, new firms appear more willing to incorporate in states with relatively strong anti-takeover laws than in those with weak anti-takeover laws. Incorporators of such firms would not be expected pursue such protections if they expected to be penalized by the IPO market. Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice in the 1990s: Evidence on the "Race" Debate and Antitakeover Overreaching*, 151 U. Pa. L. Rev. 1795 (2002); see Lucian Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, John M. Olin Working Paper No. 352 (2002). Shareholders' willingness to accept antitakeover restrictions is not unlimited, however. While new firms' are more likely to incorporate in states with moderate anti-takeover protections, they are less likely to incorporate in jurisdictions with "severe" antitakeover laws. Subramanian, *supra*, at 1844.

¹³⁴Kahan & Rock, *supra* note , at 885-86.

Shareholders of existing firms have started to attempt to limit the use of one defense

– including state pension funds – also have not used their considerable political power to advocate for legislative adoption of shareholder choice regimes.

What is at the root of this lack of shareholder interest in maximizing their choice? There are many plausible explanations. One possibility is that the proponents of board control are right: board control is optimal because boards may well negotiate better than shareholders¹³⁵ and shareholders can reduce boards’ agency costs through “adaptive mechanisms” – such as compensation packages – to provide boards with an incentive to sell the firm to the highest bidder, thereby muting the agency cost problem. This explanation seems plausible, and may be part of the answer. Another possible explanation may be found in deficiencies in the IPO market and in the process process.¹³⁶

Our analysis present an additional explanation: shareholders recognize that “shareholder choice” would not, in fact, result in shareholders control over tender offers, because managers will respond to shareholder choice by implementing other defenses, not regulated by the shareholder choice regime. Thus, shareholders of many firms do not campaign against the pill and ECB because eliminating these defenses would not result in true shareholder choice, but would only induce managers to substitute into other defenses which are likely to impose greater costs on the firm than existing targeted pure defenses, such as the poison pill and ECB. In other words, shareholders might well rationally accept board control because they recognize that they cannot, in fact, preclude

– staggered boards – by resisting charter amendments to establish staggered boards and voting in increasing numbers for shareholder resolutions seeking to declassify existing classified boards. Kahan & Rock, *supra* note , at 886-887. But this is far from a general move to establish shareholder choice. Shareholders have not similarly moved to restrict boards’ ability to adopt poison pills. Moreover, these anti-staggered board efforts have not been part of a general movement, but have been targeted at particular firms. *Id.* Moreover, they have either failed or have prevailed only in a precatory form. *Id.*

¹³⁵Marcel Kahan and Edward Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, *Univ. of Pennsylvania Law Review* (forthcoming).

¹³⁶Recently, Lucian Bebchuk has offered an alternative potential explanation for shareholders’ apparent disinterest in voluntarily adopting shareholder choice. He shows that when managers have private information about firm value, and when private benefits to managers are positively correlated with firm value, then firms going public might not offer a charter provision restricting defenses even though such a provision would be optimal. See Lucian Arye Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* (October 2002). This result turns on the firms being unable to signal firm value through mechanisms other than the charter provision of takeovers, and on the assumption that private benefits are positively correlated with firm value.

the use of defensive measures, and given this would prefer to accept the costs associated with targeted measures such as the poison pill and ECB in order to avoid the greater evil of the alternative defenses managers would employ.

Additional evidence exists to support our claim. Another stylized fact that our analytical approach may help to explain is the puzzling relationship that many scholars have observed between corporate governance and executive compensation. Conventional logic would suggest that firms which have fairly significant antitakeover barriers would be more likely to award their executives with incentive pay in order to provide managerial discipline not available through the market for corporate control. Surprisingly, however, many scholars have found just the opposite. A recent study by Keith Harvey and Ronald Shrieves,¹³⁷ finds that incentive pay is positively related both to the presence of independent directors and inversely related to leveraged financing. Both of these tendencies seem to cut against the conventional logic story.

Moreover, we find that the pattern identified by Harvey & Shrieves appears to hold true for other measures as well. Consider, for example, the correlation matrix below, drawn from a data set pairing executive compensation data with corporate governance data of 1200 publicly traded firms in the year 2000. The variable in the first row (and column) represents the percentage of outstanding shares owned by the firms highest paid executive (usually the CEO), and represents a measure of incentive pay. The remaining variables designate the existence of (2) blank check preferred stock; (3) classified boards; (4) a poison pill provision in the firm's bylaws; (5) the cross product of classified boards and poison pills; and (6) the existence of change of control provisions in executive stock options. Variables (2) through (6) are all measures of how resistant a corporation is to hostile bids.

	% Shrs (CEO)	Blank Check	Class. Bd	Pois. Pill	(Cl.Bd)x(PP)	CoC (Options)
% Shrs (CEO)	1.0000					
Blank Check	-0.1132	1.0000				
	<i>0.0114</i>					
Class. Bd	-0.0008	0.1056	1.0000			
	<i>0.9863</i>	<i>0.0002</i>				
Pois. Pill	-0.2978	0.1394	0.2535	1.0000		
	<i>0.0000</i>	<i>0.0000</i>	<i>0.0000</i>			
(Cl.Bd)x(PP)	-0.1985	0.1467	0.6701	0.7153	1.0000	
	<i>0.0000</i>	<i>0.0000</i>	<i>0.0000</i>	<i>0.0000</i>		
CoC (Options)	-0.2599	0.0572	0.1801	0.2994	0.2493	1.0000
	<i>0.0000</i>	<i>0.0474</i>	<i>0.0000</i>	<i>0.0000</i>	<i>0.0000</i>	

Table 8: Exec. Share Ownership vs. Corp. Gov. Indicia¹³⁸

¹³⁷See Harvey & Shrieves, supra note __.

¹³⁸Correlations done on a pair-wise basis; P-values in italics. Sources: Compustat Executive Compensation Data for 2000; IIRC Governance Data for 2000.

Note that every antitakeover provision in the Table is positively correlated with every other one at least a 95 percent level, suggesting that such provisions are often complements rather than substitutes for one another. What is more surprising, however, the negative correlation that each of these variables has with executive share ownership. Indeed, every single antitakeover protection is negatively correlated with share percentage, and all but one are statistically significant. Moreover, the magnitudes of many these correlations are also moderately high.

Although this negative correlation between antitakeover protections seems, on first blush, to be counter-intuitive when measured against conventional logic, it is completely consistent with our arguments in this paper. Indeed, if one interprets the absence of antitakeover protection as a form of shareholder choice at the organizational level, then the trends identified in the Table mimic exactly those identified in the example from the previous section. In particular, shareholder choice creates an additional agency cost at the an ex ante stage, when managers select among projects that may include embedded blanket defenses. Grossing up the manager's share compensation is one way to deter her from opting for a value-reducing project that insulates her position.

Finally, the debate in Europe over anti-takeover measures suggests that many firms in the U.K. and otherwise have indeed responded to restrictions on managers' use of the poison pill by employing substitute defenses. Indeed, the problem of embedded defenses is considered sufficiently serious that German cited this as one reason not to adopt the 13th Directive, which would seriously restrict managers' ability to employ pure and post-bid takeover defenses.¹³⁹

Although this is but a sampling of how our framework might be tested empirically, it nonetheless suggests that the analytical arguments presented above may help explain behavior in publicly traded companies.

7 Conclusion

Delaware's embrace of a "Just Say No" defense grants managers considerable ability to insulate themselves from the disciplining effect of the market for corporate control. This deference almost certainly results in managers misappropriating far greater private benefits – and providing shareholders less value – than they would if subject to a well functioning takeover market.

Proponents of shareholder choice argue that the solution to this problem is for the courts to insist that shareholders be given ultimate authority to determine whether an acquisition should proceed. Such a

¹³⁹See supra note __ & ___.

measure would permit shareholders to approve the hostile acquisitions most likely to discipline management. These hostile acquisitions would themselves increase shareholder welfare. Shareholder welfare also would be increased to the extent that the increased threat of hostile acquisitions reduced managers' incentives to misappropriate private benefits.

These arguments for shareholder choice have considerable merit. Yet they are not enough to win the day. The existing analysis generally presumes that managers subject to shareholder choice will remain passive in the face of a challenge to their historical discretion. There is no reason to expect that to be the case. Indeed, the history of acquisitions and tender offer defenses is one defined by managers continually adapting new defenses to meet new threats to their control.

Full analysis of shareholder choice thus requires that we consider the impact of this rule assuming that managers will act in their own self interests and seek ways to either deter hostile bids in particular, or friendly and hostile bids generally. In particular, consideration must be given to the availability of embedded defenses – adopted long before a tender offer – as these are the defenses courts would be least able to regulate without doing injury to the underlying premise that publicly held firms should be managed by professional managers, not shareholders (or courts).

An examination of existing pre-bid embedded defenses reveals a host of potentially legitimate arrangements that can be employed to deter takeovers. These include blank check preferred stock, management contracts, and change of control provisions in third party contracts. Moreover, these arrangements are sufficiently varied and flexible that one must assume that managers – if sufficiently motivated by a fear of hostile takeovers – could devise a variety of other pre-bid arrangements which could operate as a serious impediment to bids.

This article has considered the risk that managers would adopt such measures in response to shareholder choice. We conclude that although managers would not adopt blanket defenses – that deter all bids – under a managerial choice rule, managers could well respond to shareholder choice by adopting blanket defenses. Managers subject to shareholder choice would have much to gain from such defenses, as they would help block hostile deals; and they also would have less to lose as shareholder choice would squeeze out the friendly deals managers otherwise would seek to protect. Accordingly, in order to retain their private benefits, managers subject to shareholder choice would be more likely to either adopt blanket defenses that deter all acquisitions, or at least threaten to do so. In either case, shareholder choice can reduce the expected payoff of non-managerial shareholders.

Thus, shareholders' apparent disinterest in campaigning aggressively for shareholder choice may not be a product of collective action problems, lack of information, or failures of the IPO markets. Rather shareholders may fail to insist on shareholder choice because they recognize that it is not available to them – not at least, under a regime of professional managerial control of day-to-day business decisions. Shareholders could block certain defenses, but not all defenses. As the defenses shareholders can block – such as the poison pill – are, in the end, less destructive of firm value than other blanket defenses managers might employ, shareholders may live with the pill (and "Just Say No") for fear the alternative would be worse.

This is not to say that shareholder choice is invariably inferior to managerial choice. But the case for shareholder choice must depend on more than simply a partial equilibrium claim that shareholders may be better able to evaluate tender offers than managers. Rather, the case for shareholder choice must depend on a full comparison of the two regimes, as they would actually be implemented. In particular, we must consider shareholder choice recognizing that courts cannot regulate all defenses and that managers will adapt and seek out defenses in those zones beyond court regulation. Only if shareholder choice is superior under such circumstances should we be willing to embrace it.