

## THE MARKET FOR TAKEOVER DEFENSES

*Sharon Hannes\**

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### I. INTRODUCTION

This Article advocates a new market-based framework to analyze takeover defenses. While takeovers and takeover defenses are among the most heavily discussed topics in corporate law and corporate finance, the literature has never emerged as an organized, coherent body. The first purpose of the proposed framework is to expose that the existing literature provides only partial answers to the mysteries of takeover-defense practices. Second, and more importantly, this framework seeks to develop a novel theory of takeover defenses that supplements the existing, and incomplete, theories.

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Consolidating the theories, the unified framework solves previously unanswered questions and sheds light on the empirical puzzle.

As with any other product market, the market for takeover defenses consists of products, suppliers, and buyers. There are two types of “products” in this marketplace, the first being a firm without takeover defenses, or an unshielded target, and the second being a firm with takeover defenses, or a shielded firm. The producers are the controllers of the corporation at the time takeover defenses are considered, in particular prior to the initial public offering (“IPO”). Thus, the Article treats the decision to go public without takeover defenses as a decision to produce an unshielded target. The supply of unshielded targets is, hence, the result of the joint decision of multiple producers. The third component of the market for takeover defenses is buyers, or potential acquirers for both shielded and unshielded targets. Since takeover defenses make a target more elusive, shielded products are more expensive, but their individual business features will nonetheless appeal to some buyers. Consequently, shielded and unshielded targets foment different levels of demand, i.e., willingness to pay, on the part of potential acquirers.

Takeover defenses, as we know them today, emerged in the 1980s following an unprecedented surge in unsolicited takeover activity. The first wave of articles that followed the emergence of takeover defenses in the 1980s reflected diametrically opposed views regarding their merits. While advocates, such as Easterbrook and Fischel, eschewed such defenses, others, such as Lipton, lauded the advent of defenses against hostile takeovers.

These articles and the many others that followed, describe takeover defenses as either harmful or beneficial to all firms.<sup>1</sup> As discussed below, these arguments imply a fairly degenerated market for takeover defenses—a market in which either all producers should produce unshielded targets or none of them should.<sup>2</sup>

More nuanced theories emerged over the years, claiming that different firm characteristics make defenses useful for some firms and harmful for others. This branch of the literature has received a boost thanks to a new line of enlightening empirical papers regarding the adoption of takeover defenses at the IPO stage. These studies show that firms sharply diverge in

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<sup>1</sup> Another line of argument is that some mild level of antitakeover protection is warranted. *See, e.g.*, Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1028–56 (1982) (arguing for target’s managers’ ability to seek competing bids and for allowing them the necessary delay to achieve this goal); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23, 23–50 (1982) (same). *But cf.* Ronald Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defenses*, 35 STAN. L. REV. 51, 52, 66 (1982) (stressing the benefits of competing bids but insisting on the passivity of the target’s management).

<sup>2</sup> In economic terms and as will be graphically outlined below, one could say that both demand and supply are completely (infinitely) elastic. *See* ROBERT S. PINDYCK & DANIEL L. RUBINFELD, *MICROECONOMICS* 32–35 (6th ed. 2005) (defining and discussing elasticity).

their decisions regarding takeover defenses. For example, one theory posits that takeover defenses grant managers discretion that can ultimately benefit shareholders. Managers use this discretion to determine the timing and method of selling the company, to negotiate the price or to put off the bid in anticipation of another bid if a hostile bidder emerges.<sup>3</sup> However, not all firms require this level of managerial discretion.<sup>4</sup> For instance, in market sectors that experience frequent takeover activity, such as the media or hotels industries at certain times, competition amongst bidders may drive prices up and dissipate the benefits of managerial discretion.<sup>5</sup>

This theory and the remaining theories that concentrate on dissimilarities among firms evoke a richer picture of the market for takeover defenses. These explanations imply that firms differ in the cost of producing an unshielded target. Some firms have features that make defenses particularly valuable to them, and therefore the cost to them of producing an unshielded target is high. Those firms, the argument goes, are the ones most likely to adopt defenses. For instance, following the example above, firms in market sectors that do not enjoy much takeover activity, such as perhaps the utilities sector, can take advantage of takeover defenses and, as a result, should go public with defenses. Conversely, firms in takeover-frequent environments receive high premiums even in the absence of defenses and should therefore refrain from adopting them when going public, lest they seem less attractive than their competitors.

The results of recent empirical studies regarding antitakeover charter provisions in IPO-stage firms, however, do not support most existing theories and present a puzzle to corporate-law scholars.<sup>6</sup> Rather than undertake the all-or-nothing strategy espoused by traditional scholars, firms mysteriously diverge in their defense-adoption practices; while some companies adopt harsh and effective antitakeover charter provisions, others refrain from such provisions altogether.<sup>7</sup> One commentator recently formulated the challenge to traditional corporate law as follows: “Standing alone, Lipton’s position would suggest all companies should adopt defenses prior to an

<sup>3</sup> See Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Pre-Commitment*, 152 U. PA. L. REV. 473, 484 (2003) [hereinafter Kahan & Rock, *Corporate Constitutionalism*].

<sup>4</sup> *Id.* at 488–89 (“[T]he optimal allocation of decision-making power depends on several empirical factors that may vary from company to company. . . . For that reason, different companies may make different choices . . .”).

<sup>5</sup> See, for example, the famous litigation cases regarding mergers and acquisitions (“M&A”) in these market sectors: *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342 (D. Nev. 1997) (hotels); *Paramount Commc’ns, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989) (media); *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994) (same).

<sup>6</sup> See John C. Coates, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001); Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001); Laura Casares Field & Jonathan M. Karpoff, *Takeover Defenses of IPO Firms*, 57 J. FIN. 1857 (2002).

<sup>7</sup> Coates, *supra* note 6, at 1306–07.

IPO, and Easterbrook & Fischel's position would suggest that no firm should adopt a defense; yet, in reality, about half do and half do not.<sup>8</sup> Moreover, the firms in these studies that had opted for takeover defenses did not possess the special features identified by certain advanced theories as making defenses of particular value to a firm.

Following these empirical studies, researchers proposed a number of theories of market failure that provide alternative explanations for the adoption of takeover defenses.<sup>9</sup> A common theme of many of these theories is the rejection of the classic notion that the IPO-certification process achieves optimal corporate governance results.<sup>10</sup> One study suggests that the market does not price the costs of an antitakeover provision, and therefore, IPO-stage firms can often get away with adopting detrimental takeover defenses that protect managers from takeovers, at the expense of the public shareholders. A second study suggests that firms fail to select the optimal tactics due to biased legal counsel. Finally, a third study suggests that some pre-IPO firms have dominant managers who select takeover defenses at the expense of the pre-IPO shareholders.<sup>11</sup> In terms of this Article's framework, these theories implicitly reject the idea that supply-and-demand forces in the market for takeover defenses determine which firms adopt defenses.

In contrast to these new ideas, this Article argues that the seminal notion that IPO-stage firms select optimal governance terms may still hold.<sup>12</sup> Nonetheless it is necessary to develop a richer view of the market for takeover defenses than scholars have proposed thus far. While the literature focused on what I call supply-side considerations (or the cost of producing an unshielded target), it gave almost no consideration to demand-side factors.

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<sup>8</sup> *Id.* at 1328.

<sup>9</sup> *E.g.*, Daines & Klausner, *supra* note 6 (raising the possibility of market mispricing of takeover defenses); Field & Karpoff, *supra* note 6 (claiming that lax monitoring of managers prior to the IPO stage leads to detrimental adoption of takeover defenses).

<sup>10</sup> This classic notion is attributed to the seminal work of Jensen and Meckling. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 4 J. FIN. ECON. 305 (1976). Note that some recent papers have raised novel explanations that do not suggest that the IPO stage fails to yield optimal governance terms. For one such paper, see Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845 (2002) (arguing that takeover defenses encourage non-shareholder groups to make extra-contractual investments in corporate team production). Other papers are discussed below at length. *See infra* Parts III.B.1, III.B.3.

<sup>11</sup> The difference between this theory and the first one presented here is that the former posits that the public markets price takeover defenses well and know that they are detrimental to shareholders. Therefore, the public shareholders presumably pay less for firms with defenses, causing the pre-IPO shareholders to bear all the costs of adopting the takeover defenses.

<sup>12</sup> Other theories of takeover defenses, which do not accept the notion that defenses stem from a market failure, are discussed below. These theories recognize that the benefits of takeover defenses vary across firms due to a different rationale from the one presented in this Article. *See* Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003); Kahan & Rock, *Corporate Constitutionalism*, *supra* note 3.

Demand-side considerations emphasize the “price” that the market is willing to pay for an unshielded target. The implied assumption throughout the enormous body of takeover literature is that the market price for unshielded firms does not fluctuate with the number of firms on the market that adopt defenses. Put differently, firms need not consider the antitakeover practices of their peer firms since the market prices every target independently. Contrary to this hidden but pervasive assumption, I argue that the greater the number of firms that adopt defenses, the higher the price that the market is willing to pay for firms that reject defenses. Takeover defenses not only prevent takeovers; they also divert takeover activity to unshielded targets. In terms of demand, the more unshielded firms produced (and, therefore, the fewer firms adopting defenses), the lower the price that the market is willing to pay for the unshielded product. Conversely, the fewer the number of produced unshielded targets, the higher the price the market will pay for each existing unshielded target.

To understand this takeover diversion argument, which yields a downward sloping demand curve, one must first concede that the competition in the market for control is far from perfect.<sup>13</sup> In this reality of a limited number of suitable bidders and limited takeover opportunities, bidders compare the few relevant targets in their decision-making processes.<sup>14</sup> Since takeover defenses increase the cost of acquisition, the relative degree of anti-takeover shields of all relative targets must be taken into account. And, in turn, when targets weigh whether to adopt takeover defenses, they must consider the takeover defenses of their peers in order to get a complete picture of their own takeover prospects.

When most firms are shielded, unshielded targets receive much attention, which translates into frequent takeovers and relatively higher prices. The defensive decisions of the other firms divert takeover activity, which may, in turn, affect the average takeover premium that an unshielded target may reasonably expect.<sup>15</sup> Put differently, there is a positive externality to the decision to adopt shields.<sup>16</sup>

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<sup>13</sup> See, e.g., Lucian Arye Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911, 930 (1987) (“The threat of competing bids might be insufficient to secure a competitive price because the competition in the market for corporate acquisitions is far from perfect.”).

<sup>14</sup> This fact was clearly shown by an empirical study that found that termination of a planned merger creates vast stock gains for industry rivals, suggesting that industry rivals are takeover alternatives and may be purchased once a merger fails. See Aigbe Akhigbe et al., *The Source of Gains to Targets and Their Industry Rivals: Evidence Based on Terminated Merger Proposals*, 29 FIN. MGMT. 101 (2000).

<sup>15</sup> The discussion in this Article relies on the existence of a *corporate stagnation* effect regarding takeover defenses, a phenomenon that I have analyzed elsewhere. As the empirical evidence clearly indicates, seasoned firms that entered the 1990s with defenses do not tend to repeal them, but the rest of the mature firm population seldom adopts new defenses. This means that managers are potent enough to maintain defenses in the former type of firm and stockholders are potent enough to resist adoption of defenses in the latter type. See Coates, *supra* note 6, at 1308; Sharon Hannes, *The Determinants and*

In a sense, this externality argument is similar to a well-known diversion-of-crime argument<sup>17</sup>: placing bars on the windows of one's home increases the risk of burglary to one's neighbors. However, the externality resulting from the adoption of takeover defenses generally constitutes a positive externality to "neighboring" firms, at least if shareholders wish to promote takeovers. Thus, rather than increasing the risk of a burglary to one's neighbors, the added defenses would actually increase their property value.

Interestingly, incentive compensation and the private interests of managers play an important role in the demand-side factors. When takeover defenses grant managers the discretion to decide the fate of a takeover bid, managers will insist that the bidder compensate them for the loss of any benefit that they derive directly or indirectly from their stint as managers. It is usually assumed, however, that even in a friendly acquisition, managers cannot be directly compensated to the full extent.<sup>18</sup> Nevertheless, since current managers' compensation usually includes stock options and similar stock-based remuneration, the bidder can raise the premiums paid to all shareholders in the acquisition to further benefit the target's managers and quell their resistance. In turn, the argument goes, shareholders can calibrate managers' fractional holdings of the firm, through stock-based compensation, to the point where the managers will accept only high takeover bids.<sup>19</sup> This strategy is a credible commitment to extracting high premiums from high-value bidders at the cost of losing bids from low-value bidders, which cannot meet the threshold.<sup>20</sup>

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*Consequences of Corporate Stagnation: Discussion and Reform Proposal*, 30 J. CORP. L. 51, 73–81 (2004).

<sup>16</sup> This means that, unlike the hidden assumption in the existing literature, the takeover risk to an individual firm is not endogenous to its antitakeover decisions.

<sup>17</sup> Steven Shavell, *Individual Precautions to Prevent Theft: Private Versus Socially Optimal Behavior*, 11 INT'L REV. L. & ECON. 123, 126 (1991) (discussing externalities of protection measures taken by potential victims).

<sup>18</sup> I elaborate on this important assumption below. See *infra* Part III.C.2.

<sup>19</sup> This means that manager self-interest is manipulated to shareholder advantage. This result is prevalent in the principal-agent literature. See Chaim Fershtman, Kenneth L. Judd & Ehud Kalai, *Observable Contracts: Strategic Delegation and Cooperation*, 32 INT'L ECON. REV. 551, 551–52 (1991) (a survey of the principal-agent theory in relation to such manipulation of agent self-interest for the benefit of the principal); John Vickers, *Delegation and the Theory of the Firm*, 95 ECON. J. 138, 139–43 (1985) (modeling how empowering the agent can benefit the principal).

<sup>20</sup> This is the essence of a recent paper by Kahan & Rock. See Kahan & Rock, *Corporate Constitutionalism*, *supra* note 3. In an earlier paper, the same authors showed that the use of incentive pay (such as option grants) and other mechanisms can mute the effect of antitakeover mechanisms. See Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. CHI. L. REV. 871 (2002) [hereinafter Kahan & Rock, *How I Learned to Stop Worrying*]. However, in the more recent paper, the authors clarify that shareholders have no interest in muting the effects of takeover defenses, but, rather, use them to their advantage as a credible commitment. Put differently, shareholders have no reason to worry about defenses since defenses can be manipulated and not because defenses are silenced.

The demand-side theory carries forward the above-mentioned argument that already appears in the literature with its emphasis on takeover diversion. Although unshielded firms do not make the costly commitment in managers' compensation to extract high takeover premiums from high-value bidders,<sup>21</sup> they do enjoy diverted bids from shielded peers and, therefore, an intensified takeover frequency. Incentive pay and the desire of managers to receive compensation for their losses in a takeover event are, thus, taken into account by my framework. This Article shows that the demand-side argument—as well as additional arguments raised in the literature—do not hold if bidders can evade the higher premiums paid to all shareholders by fully compensating managers for their loss of private benefits in the takeover attempt.<sup>22</sup>

Taken together, the demand-side explanation complements the supply-side explanations previously raised in the literature to achieve a more profound and realistic picture of the market for corporate control. This unified framework could help solve the mystery of firm-behavior disparity at the IPO stage. Some firms possess features that cause them to derive greater benefits from adopting takeover defenses than those garnered by other firms. However, the more firms adopt defenses, the higher the expected premium their unshielded peers can expect. In the end, the market for takeover defenses reaches a balance where the marginal firm is indifferent to the adoption of defenses, since both tactics provide similar benefits.

The fact that the empirical studies could not find evidence that firms adopting defenses possess the special features that make defenses especially valuable is not a discouraging sign. Even if the supply-side effects were mild or theoretically non-existent, demand-side factors would still cause only some of the firms to adopt shields. Put differently, even if all firms are similar in all relevant features, they may diverge in their antitakeover decisions. The reason for this is that even if defenses provide similar benefits to all firms, an adoption trend will raise the benefits accruing to unshielded firms. Eventually, at some defenses-to-adoption ratio, the benefits of remaining unshielded will equalize those of adopting shields, and the market for takeover defenses will maintain this ratio.<sup>23</sup> And, in response to recent

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<sup>21</sup> This commitment is costly, as it requires that the firm forego low-value bidders and increase levels of incentive pay to its managers. However, incentive pay has its own unrelated benefits.

<sup>22</sup> For a model under which there is no limitation on the amount of direct compensation for the loss of private benefits, see Arlen & Talley, *supra* note 12.

<sup>23</sup> Interestingly, on the eve of the publication of this Article, a new empirical paper was posted on the Internet, presenting findings that closely fit the above prediction. See Thomas W. Bates, David A. Becher & Michael L. Lemmon, Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control (Aug. 1, 2006) (unpublished manuscript) (on file with SSRN at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=923408](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=923408)) (“Average target shareholder wealth effects are statistically equivalent for firms with and without classified boards across each of the modeled bid outcomes . . . . In light of these findings, we conclude that while classified boards alter the dynamics of takeover contests, the average gains to target shareholders in observed takeover bids do not vary with

non-market-based approaches, the divergent behavior of IPO-stage firms regarding takeover shields does not necessarily point to any market failure.

This Article progresses as follows. Part II discusses the takeover wave of the 1980s and the proliferation of takeover defenses in its wake. This part also briefly reiterates the main traditional arguments, raised by academics in the 1980s in response to the market developments. Finally, it discusses new empirical evidence regarding the diversity of takeover-defense practices of IPO-stage firms and the puzzle that such data present to corporate scholars. Part III is the heart of the Article, as it describes the market for takeover defenses. It starts by laying out the setup of the market and reframing traditional arguments about defenses in market terms. It then reconstructs nuanced arguments in the literature as multiple alternative supply-side explanations. To complement these theories, this part puts forth the demand-side explanation that has not been previously discussed in the literature. This unified setup allows a better understanding of firm behavior. Part IV submits a possible explanation for the mechanisms and process that evolve and sustain the equilibrium in the market for takeover defenses. Part V discusses alternative explanations in the literature, which deviate from the concept of the market for takeover defenses, i.e., non-market-based explanations. Finally, Part VI concludes the discussion.

## II. TAKEOVER DEFENSES

### A. *The Invention of the Poison Pill and Related Developments*

The poison pill, the most notorious of all takeover defenses, was devised in the 1980s.<sup>24</sup> Shareholder consent is not required for management to adopt a poison pill, since poison pills are generally special purpose “shareholder’s rights plans,” initiated as part of the board’s discretion to design and issue new securities.<sup>25</sup> The terms of those plans, crafted by corporate counsel intending to fend off unwanted bids, provide that the purchase of a specified amount of stock without the board’s approval will trigger special rights for the incumbent shareholders.<sup>26</sup> Once triggered, the poison pill allows incumbent shareholders to buy either the target’s stock (the so-called

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*board classification.*” (emphasis added)). Due to the time table of publication I will not conduct a full analysis of their findings in this Article.

<sup>24</sup> Coates refers to the poison pill as “the most common, controversial, and distinctive type of defense.” John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 277 (2000); see also ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 70–71 (1993) (reporting on the negative effects of takeover defenses, particularly the poison pill).

<sup>25</sup> See, e.g., DEL. CODE ANN. tit. 8, § 157 (2006) (empowering corporations to design and issue securities, as approved by a board of directors).

<sup>26</sup> See Wachtell, Lipton, Rosen & Katz, *The Share Purchase Rights Plan*, reprinted in RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 58–91 (2d ed. Supp. 2003–04) (describing common features of a typical poison pill).

“flip-in” poison pill feature) or the acquirer’s stock (the so-called “flip-over” poison pill feature) at substantially discounted prices.<sup>27</sup> The result could be a severe dilution in ownership for the hostile acquirer, thus rendering the entire acquisition prohibitively expensive.<sup>28</sup>

Poison pills are a relatively new development, but they are not sophisticated enough to be considered a watershed achievement. They were more of a reaction to the panic created by the 1980s takeover wave, in which almost one-third of the Fortune 500 companies faced a hostile bid.<sup>29</sup> And, poison pills had to go through a long process in which courts learned to accept them.

In the landmark *Moran* decision in 1985, the Delaware Supreme Court allowed the adoption of poison pills by potential targets, but left unsettled the conditions under which targets could refuse to redeem them once a bid emerged.<sup>30</sup> Indeed, in the 1988 *Interco* decision, Delaware’s Chancery Court ordered a target to redeem its poison pill when faced with a seemingly reasonable tender offer.<sup>31</sup> However, not long thereafter, the Delaware Supreme Court intervened in *Paramount* and clarified that boards can hold on to a poison pill in almost all circumstances.<sup>32</sup> Moreover, on other occasions, the Delaware Supreme Court stated that management can hold on to a

<sup>27</sup> A flip-in poison pill is generally a far more potent defense than a poison pill with a flip-over feature. Modern poison pills include both features. See RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 747 (2d ed. 1998).

<sup>28</sup> See Coates, *supra* note 24, at 287 n.62 (providing a detailed explanation of how poison pills operate).

<sup>29</sup> See Gerald F. Davis & Suzanne K. Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980–1990*, 37 ADMIN. SCI. Q. 605, 608 (1992). The takeover phenomenon was known and discussed before the 1980s, but no hostile takeover wave had ever been as fierce. The “market for corporate control” was famously described much earlier, in the seminal work of Henry Manne. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965) (considered the first in-depth academic discussion of the takeover phenomenon).

<sup>30</sup> See *Moran v. Household Int’l, Inc.*, 500 A.2d 1346 (Del. 1985) (first court decision finding poison pills legitimate). Commentators differed on whether the courts would scrutinize boards’ decisions to reject hostile bids with the assistance of the poison pill. See Ronald J. Gilson & Reinier Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 256–60 (1989) (suggesting substantive scrutiny by the courts of any board’s decision regarding unsolicited offers to purchase the firm). *But cf.* Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court’s Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994) (explaining that the Delaware law never intended and would not conduct such substantive scrutiny; in the event of an offer to purchase the firm, the board of directors is bound only to certain procedural requirements).

<sup>31</sup> *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988) (requiring redemption of a poison pill that could not withstand the proportionality test in the face of a non-coercive bid).

<sup>32</sup> *Paramount Commc’ns v. Time*, 571 A.2d 1140 (Del. 1989) (allowing wide discretion to the board in upholding a poison pill). See Jeffrey N. Gordon, “Just Say Never?” *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay For Warren Buffet*, 19 CARDOZO L. REV. 511, 522–30 (1997) (stating that, in most cases, courts had granted boards a very broad mandate as to whether they could reject acquisition offers).

poison pill even if shareholders explicitly disagree.<sup>33</sup> Finally, over time the Delaware courts have made clear that it would require redemption of a poison pill in only very narrow circumstances.<sup>34</sup>

The poison pill, however, has certain limitations on its ability to thwart bids. Poison pills work against accumulation of stock by a hostile bidder through a tender offer or otherwise.<sup>35</sup> Prior to the poison pill era, bidders could purchase control stakes in order to replace the board of directors and management. In fact, once bidders accumulated enough stock, bidders did not need to use formal proceedings to manifest their control, and targets' management usually resigned immediately.<sup>36</sup> The inevitability of their ultimate removal made further resistance pointless, even if managers could hang on to their positions for a certain period of time until formally removed by the new owner. Once a poison pill is in place, accumulating stock and the consequent change of management are precluded. However, the poison pill does not impede a firm's voting (or proxy) mechanism.<sup>37</sup> The bidder can therefore ask the shareholders to vote the bidder's proponents onto the board, and if successful, these directors can move to redeem the poison pill and allow the acquisition.<sup>38</sup>

Poison pill designers tried to develop a means to overcome this voting mechanism as well, but these pills were rejected by the courts. This was the case of the "dead-hand" poison pill that restricted the power to redeem the poison pill to members of the board at the time of the poison pill's adoption. This mechanism, therefore, would have eliminated a bidder's option to cir-

<sup>33</sup> See, e.g., *Moore Corp. v. Wallace Computer Servs.*, 907 F. Supp. 1545 (D. Del. 1995) (allowing managers to maintain a poison pill even after shareholders voted against the management and replaced one-third of the directors with bidder proponents).

<sup>34</sup> See *Paramount Commc'ns, Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994) (requiring management to accommodate additional offers once it decides to put the target on sale); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (same).

<sup>35</sup> The tender offer mechanism was invented in the 1950s and has become the main tool for acquiring shares in control transactions. In contrast to a simple aggregation of single purchases in the open market, each with a different price, in a tender offer the bidder sets a time period for the public shareholders to tender their shares, the price at which the bidder is interested in buying the company's shares, and the amount it is willing to pay. See DOUGLAS V. AUSTIN & JAY A. FISHMAN, *CORPORATIONS IN CONFLICT—THE TENDER OFFER* 7–23 (1970) (describing the tender offer tool and its evolution).

<sup>36</sup> See John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable are U.S. Public Corporations?*, 24 J. CORP. L. 837, 850 (1999).

<sup>37</sup> Gilson argues that the main consequences of Delaware's sanctioning of the poison pill are the redirection of takeover activity to the voting route. See Ronald J. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001) (arguing that Delaware law prompted bidders to use the voting mechanism of the target firm, while foreclosing the ability to purchase stock directly from the target's shareholders). And, indeed, the Delaware Supreme Court was always sensitive to managerial interference in the voting process. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests.").

<sup>38</sup> In fact, the existence of this avenue to remove the takeover shields was one of the reasons to uphold them in the first place. See *Unitrin v. Amer. Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995).

cumvent the poison pill mechanism by appealing to the shareholder vote. With a view to such a consequence—essentially granting incumbent boards an unlimited power to preclude bids—Delaware courts disallow this type of invincible poison pill.<sup>39</sup>

To take advantage of the vote mechanism to circumvent the poison pill, the bidder must create a credible commitment to purchase the target's stock after capturing the board. This commitment is necessary to assure the shareholders that after prevailing in the vote, the bidder will pay them the premiums that convinced them to help the bidder remove the existing management. Such a commitment is a contingent tender offer held in conjunction with a proxy fight for control of the board, which proceeds as follows.<sup>40</sup> First, the bidder makes an offer to the shareholder who must decide whether to tender their shares or not. However, to avoid triggering the poison pill, the tender offer does not consummate at this stage. Rather, if shareholders tender some minimal number of shares, then shareholders are asked to vote for the board. If the bidder succeeds in the vote for the board, its newly elected proponents redeem the poison pill, leading to the consummation of the contingent tender offer. Finally, the target's stock changes hands for the specified price, and the takeover is accomplished.<sup>41</sup>

Thus, poison pills do not exclude the possibility of a hostile takeover, but they do require the bidder to use the target's proxy mechanism, which entails delays.<sup>42</sup> Delay is extremely costly for the bidder for at least three important reasons. First, the bidder must rely on the existing market condi-

<sup>39</sup> This view was adopted by the Delaware Supreme Court in *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998). See generally Stephen M. Bainbridge, *Precommitment Strategies in Corporate Law: The Case of Dead Hand and No Hand Pills*, 29 J. CORP. L. 1 (2003) (discussing and criticizing the court decision).

<sup>40</sup> See J. Harold Mulherin & Annette B. Poulsen, *Proxy Contests and Corporate Change: Implications for Shareholder Wealth*, 47 J. FIN. ECON. 279, 286 (1998) (describing simultaneous offers to replace the management of the company and to buy the company's shares).

<sup>41</sup> This joint vote and tender offer also assists shareholders in overcoming strategic tendering, which could hurt the entire shareholder group. Thus, it precludes coercive bids that are designed to pressure and absorb shareholder value. See Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985) (describing the problem of coercive bids); Bebchuk, *supra* note 13 (same). In addition, uninformed shareholders may find it difficult to decide whether to vote for or against their own managerial team. The offered price in the contingent tender offer as compared to the pre-bid price of the firm's stock may help the shareholders to reach a decision. See Lucian Bebchuk & Oliver Hart, *Takeover Bids vs. Proxy Fights in Contests for Corporate Control* (NBER Working Paper No. W8633, 2001), available at [http://Papers.ssrn.com/sol3/Papers.cfm?abstract\\_id=293246](http://Papers.ssrn.com/sol3/Papers.cfm?abstract_id=293246) (highlighting the advantages of the joint mechanism vis-à-vis pure proxy contests or pure tender offers).

<sup>42</sup> In addition, proxy solicitation involves expenses, but in most takeover battles, this cost is negligible. See Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Toward Proxy Contests*, 78 CAL. L. REV. 1071–1136 (1990) (discussing collective action problems in incurring proxy expenses); Catherine M. Daily et al., *Institutional Investor Activism: Follow the Leaders?* (SSRN Working Paper Series No. 10299, 1997), available at [http://Papers.ssrn.com/sol3/Papers.cfm?abstract\\_id=10299](http://Papers.ssrn.com/sol3/Papers.cfm?abstract_id=10299) (discussing the cost of proxy solicitation).

tions when contemplating the acquisition and bid price. The longer it takes to consummate the transaction, the higher the chances that market conditions will shift to the bidder's detriment.<sup>43</sup> Second, the takeover battle consumes precious managerial attention as it drags on and prevents the bidder's management from returning to normal business life. Finally, and perhaps most importantly, delay fosters competition, and the bidder certainly does not want to lose its prey to a third-party bidder.<sup>44</sup>

It was therefore to be expected that a target's boards would be eager to foster delay and thereby increase the effectiveness of the poison pill.<sup>45</sup> If managers can postpone board of director turnover, then it will take longer to remove the poison pill, achieving the desired delay and increasing the cost to the bidder, as well as possibly rendering the takeover non-viable. This endeavor, however, requires the availability of special measures in the form of antitakeover charter amendments. In the absence of such measures, a poison pill by itself does not create much delay to the conclusion of a takeover.<sup>46</sup> For example, the default arrangement under Delaware law allows the majority of the shareholders to replace the entire board of directors without any cause,<sup>47</sup> in a rapid process of written consent.<sup>48</sup> This process is slightly hindered by the federal securities regulation that requires filing and clearance of proxy statements.<sup>49</sup> However, this procedure also does not produce much delay, especially since, even in the absence of a poison pill, the Williams Act imposes a minimum period of twenty business days to tender shares.<sup>50</sup>

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<sup>43</sup> See Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 920 (2002) ("If the bidder makes a firm offer, however, the bidder will expose itself to risk—essentially the bidder will be providing the target shareholders with a year-long put option for their shares.").

<sup>44</sup> *Id.* at 938 (reporting that, in their sample of hostile bids, from 25% to 32% of the targets were eventually acquired by a white knight).

<sup>45</sup> Coates measures the potency of a takeover defense by the number of days in which the defense can delay a purchase of the company's stock. This delay is computed for every firm and thereby creates an innovative index, the "contestability index," for every measured company. The contestability index allows for a fine-tuned comparative analysis of different types of legal defenses. See Coates, *supra* note 6, at 1388–1410.

<sup>46</sup> The fact that a poison pill, in itself, does not create much delay could explain empirical findings that a poison pill does not have much of an impact. For the results of an empirical study, see Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3 (1995) (finding that a poison pill does not greatly hinder the likelihood of being taken over).

<sup>47</sup> See DEL. CODE ANN. tit. 8, § 141 (1999) (removal of directors).

<sup>48</sup> See DEL. CODE ANN. tit. 8, § 228 (1999) (written consent in lieu of a vote in shareholders meeting).

<sup>49</sup> For the delays imposed by the SEC involvement, see Coates, *supra* note 36, at 853 (stating that it takes at least forty-five days for the SEC to pre-clear the proxy statement, which includes the time required for the solicitation itself).

<sup>50</sup> See 17 C.F.R. § 240.14e-1(a)(2003) (setting forth a requirement of a minimum of twenty business days for the tendering period under the Williams Act).

This, however, is only the state of affairs under the default legal standard; well-crafted antitakeover charter provisions that opt out of the default standard can radically alter the picture. It was, therefore, hardly surprising that such antitakeover provisions became prevalent in the wake of the poison pill's arrival. Simply put, in the absence of such provisions, the poison pill is rather impotent, although it should be noted that these defensive provisions require shareholder consent for implementation.<sup>51</sup> Among the charter provisions that delay the replacement of an existing board (and, therefore, the removal of a poison pill),<sup>52</sup> the most prominent is the staggered board provision.<sup>53</sup> The default standard in every state requires that all directors stand for election annually.<sup>54</sup> Nevertheless, every state also allows boards to deviate from this standard by adding a staggered board provision to a company's incorporation documents.<sup>55</sup> With a staggered board, directors are divided into three classes, with each class up for election in different successive years.<sup>56</sup> This structure forces a bidder to win at least two proxy battles in order to capture the majority of the board and redeem the poison pill.<sup>57</sup> Thus, a staggered board imposes at least a year's delay in gaining control over the board.<sup>58</sup>

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<sup>51</sup> See Coates, *supra* note 24, at 323–25 (discussing midstream defenses adoption that requires shareholder approval).

<sup>52</sup> Other charter provisions include: provisions that revoke shareholders' right to voice their opinion by written consent (in lieu of voting in person or via proxy in a shareholders meeting); provisions that forbid special shareholder meetings (or make them harder to assemble); provisions that require a supermajority vote to remove directors from office; provisions that divest shareholders' powers to fill vacancies on the board; a blank-check-preferred stock provision that entitles the board to issue preferred stock without shareholders' approval; and provisions that require supermajority shareholder approval for by-law amendments that are not recommended by the board of directors. See Hannes, *supra* note 15 (discussing various antitakeover provisions).

<sup>53</sup> In the absence of a poison pill, a staggered board is a mild takeover defense, since the bidder may purchase the entire stock. Following such an acquisition, the removal of directors is imminent, even if it takes some time. Once a poison pill is in place, the board can take all the time it has until its removal to try and evade the bid. See ROBERT C. CLARK, *CORPORATE LAW* 576 (1986) (classifying the staggered board provision in the pre-poison pill era as a mild takeover defense).

<sup>54</sup> See, e.g., DEL. CODE ANN. tit. 8, § 211(b) (2000); MODEL BUS. CORP. ACT § 8.03(d) (1999).

<sup>55</sup> See Bebchuk, Coates & Subramanian, *supra* note 43, at 893.

<sup>56</sup> This description fits the usual three-tiered classified boards. It is unusual for state law to allow for more classes. *But cf.* N.Y. BUS. CORP. LAW § 704(a) (McKinney 2001) (allowing four classes for firms incorporated in New York).

<sup>57</sup> Staggered boards may delay takeover for even longer periods of time if managers have considerable influence over a small percentage of the firm's votes and the firm has cumulative voting. See Coates, *supra* note 6, at 1389–93 (explaining factors that foster delay).

<sup>58</sup> In addition to the delaying measures, prevention of hostile takeovers altogether may be achieved if the founders maintain a controlling stake subsequent to the IPO, including by separating ownership from control. Separation of ownership and control can be achieved by way of three alternative mechanisms: stock pyramids, cross-holdings, and dual class stock. Using one of these mechanisms, the controller can achieve a complete lock on control with any level of ownership. See Lucian Bebchuk et al., *Stock Pyramids, Cross-Ownership and Dual Class Equity: The Creation and Agency Costs of Separat-*

It is not surprising, then, that one study found that staggered boards increase a target's likelihood of remaining independent in a hostile bid by as much as 26%.<sup>59</sup> This significant increase in the likelihood of remaining independent was undoubtedly quite appealing to many managers. Thus, in the second half of the 1980s, just before the poison pill had gained its current full-fledged court support, managers in many firms succeeded in securing shareholder approval to stagger the boards. Danielson and Karpoff found that the number of antitakeover provisions, including staggered-board provisions, grew tenfold in seasoned firms during this period.<sup>60</sup> In a recent sampling of 2421 large public U.S. firms, 59% were found to have staggered boards.<sup>61</sup> Interestingly, 84% of the companies with staggered boards adopted the provision prior to 1990.<sup>62</sup>

Since the late 1980s, however, institutional investors have changed their voting practices and become unwilling to vote for antitakeover charter provisions.<sup>63</sup> This change occurred due to either the realization of the poison pill's power or the growth in institutional investors' activism and organization. In turn, management proposals to stagger boards dropped from ninety proposals in 1988 to just nine proposals in 1998.<sup>64</sup> The window of opportunity to adopt antitakeover provisions in seasoned firms was practically shut. Interestingly, the very same institutional investors who block management proposals to adopt staggered boards do not require that IPO-stage firms reject staggered boards. Hence, in the 1990s, the takeover defenses adopted by public U.S. companies were generally fixed, whereas IPO-stage companies continued to enjoy the flexibility to choose among different types and amounts of defenses.<sup>65</sup>

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*ing Control from Cash Flow Rights*, in CONCENTRATED CORPORATE OWNERSHIP 295–318 (Randall K. Morck ed., 2002) (discussing alternative methods for separating ownership from control).

<sup>59</sup> See Bebchuk, Coates & Subramanian, *supra* note 43, at 937 (“Figure 3 shows that the likelihood of remaining independent is 26% higher for ESB [effective staggered board] targets; Table 3 shows that the short-run cost of remaining independent is 36%.”); see also Brent W. Ambrose & William L. Megginson, *The Role of Asset Structure, Ownership Structure, and Takeover Defenses in Determining Acquisition Likelihood*, 27 J. FIN. & QUANTITATIVE ANALYSIS 575 (1992) (finding that staggered boards are associated with a decrease in the likelihood of a firm being acquired, whereas other takeover defenses have no statistically significant effect on acquisition likelihood).

<sup>60</sup> See Morris G. Danielson & Jonathan M. Karpoff, *On the Uses of Corporate Governance Provisions*, 4 J. CORP. FIN. 347, 354 tbl. 2 (1998) (collecting data on takeover provisions). See also Wayne H. Mikkelsen & M. Megan Partch, *Managers' Voting Rights and Corporate Control*, 25 J. FIN. ECON. 263, 267 (1989) (same).

<sup>61</sup> See Bebchuk, Coates & Subramanian, *supra* note 43, at 895.

<sup>62</sup> See Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 NW. U. L. REV. 489, 517 (2002).

<sup>63</sup> See Daines & Klausner, *supra* note 6, at 84 (“ATPs [antitakeover provisions] are . . . opposed by institutional investors. Institutional investors have sponsored shareholder proposals seeking the elimination of ATPs and adopted shareholder voting protocols under which they will automatically vote against the adoption of a charter amendment containing an ATP.”).

<sup>64</sup> See Bebchuk & Hamdani, *supra* note 62, at 517.

<sup>65</sup> Coates, *supra* note 6, at 1308 (stating the fixation of takeover defenses following the IPO).

### B. Traditional Arguments Vis-à-Vis New Empirical Findings

The proliferation of takeover defenses in the 1980s sparked an unprecedented debate over whether these defenses are beneficial or detrimental. This debate stems from the intense discussions in the economic and legal scholarship on hostile takeovers.<sup>66</sup> Simply put, those who regard takeovers as beneficial oppose takeover defenses, and those who are skeptical about the benefits of the takeover phenomenon value defenses. Traditional arguments about takeover defenses maintain either that defenses (or at least some level of defenses) are beneficial for all firms or that they are detrimental for all firms, with most scholars closer to the latter view.

Perhaps the most prominent scholars in the early period of this debate are Martin Lipton<sup>67</sup>—in favor of takeover defenses—and Frank Easterbrook and Daniel Fischel—opposing defenses. In a nutshell, Lipton argues that hostile bids are often coercive, harm shareholder interests, and are disruptive and costly for the targets.<sup>68</sup> Moreover, he posits that hostile bidders often exploit the market's mispricing of the target stock and that the threat of hostile takeovers reduces investment in long-term projects by management.<sup>69</sup> Hence, according to Lipton, takeover defenses are beneficial as they allow management to control the sale of the company:<sup>70</sup> it can use its discretion to thwart unfavorable deals or negotiate better terms for the shareholders.<sup>71</sup> Easterbrook and Fischel's view runs in the opposite direction. They assert that takeovers improve social welfare by producing premiums for target shareholders and relocating assets to those who value them

<sup>66</sup> For a summary at length, see Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 YALE J. ON REG. 119 (1992).

<sup>67</sup> Not only does Lipton support takeover defenses employed by target firms, he also requires the legislator to provide protection against hostile bids. See Martin Lipton & Steven Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205–14 (1991) (requiring protection by legislators).

<sup>68</sup> Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 120–24 (1979).

<sup>69</sup> *Id.* Among his arguments, Lipton also mentions socially undesirable layoffs, but in this Article, I concentrate on the shareholders' perspective.

<sup>70</sup> While these views were highly unpopular in academia for many years, they recently regained support. See Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) (opposing the most recent views that negate Lipton's traditional arguments); Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right* (UCLA Law & Econ. Research Paper Series, Research Paper No. 05-21, 2005), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=803836](http://papers.ssrn.com/paper.taf?abstract_id=803836) (backing the traditional view presented by Lipton).

<sup>71</sup> The negotiation power is a repeated theme in the literature. See Bebchuk, *supra* note 13, at 917–31; Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985); Elazar Berkovitz & Naveen Khanna, *How Target Shareholders Benefit from Value-Reducing Defensive Strategies in Takeovers*, 45 J. FIN. 137, 137 (1990); Harry DeAngelo & Edward M. Rice, *Antitakeover Charter Amendments and Shareholder Wealth*, 11 J. FIN. ECON. 329 (1983); Gilson, *supra* note 1, at 51; Jonathan R. Macey, *The Legality and Utility of the Shareholder Rights Bylaw*, 26 HOFSTRA L. REV. 835, 841–53 (1998); René M. Stulz, *Managerial Discretion and Optimal Financing Policies*, 26 J. FIN. ECON. 3 (1990).

most.<sup>72</sup> In addition, they argue that the threat of hostile takeovers reduces agency costs between managers and distant shareholders.<sup>73</sup> Armed with takeover defenses, managers are shielded from the beneficial takeover threat,<sup>74</sup> or at least may secure some personal gains when they do finally concede to a takeover.<sup>75</sup> Therefore, Easterbrook and Fischel maintain that the law should prohibit all takeover defenses and maneuvers.

Three recent empirical studies tracing firm behavior at the IPO stage have cast much doubt on both traditional views. The empirical data show that firms have divergent preferences for takeover defenses at the IPO stage, suggesting that defenses are neither entirely harmful nor beneficial. Moreover, these empirical works do not even back the more nuanced views that claim that defenses suit only certain firms.<sup>76</sup> It is of primary importance to give close scrutiny to these new empirical findings, which have puzzled corporate scholars and on which this Article intends to shed light.<sup>77</sup>

Daines and Klausner published the first empirical work on a sample of more than 300 IPO-stage firms that went public between 1994 and 1997.<sup>78</sup> In their sample, they intentionally included many IPO corporations backed by either venture capitalists or LBO experts. Daines and Klausner reasonably assumed that the company's managers would enjoy considerably less influence over the professional pre-IPO investors and that the professional investors would be unlikely to mistakenly adopt irrational antitakeover practices. Venture capitalists and LBO experts are sophisticated investors with great influence over the firms in which they invest—presumably leading to an optimal governance structure at the IPO stage.<sup>79</sup>

The highlight of Daines and Klausner's findings is that IPO firms vary greatly with respect to their antitakeover practices. Almost half of the firms sampled had adopted harsh takeover defenses (mostly staggered boards), and 18% had adopted milder takeover defenses in their charters.<sup>80</sup> The remaining firms had refrained from adopting defenses altogether. Most importantly, however, similar findings emerged in the sub-samples of firms

<sup>72</sup> Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1168–74 (1981).

<sup>73</sup> *Id.*

<sup>74</sup> Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 719 (2003) (discussing managers' perverse incentives).

<sup>75</sup> See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Value*, 118 HARV. L. REV. 835, 899 (2005) (claiming that even when the board agrees to the sale, it might seek some private payoff at shareholders' expense).

<sup>76</sup> See *infra* Part III.2.

<sup>77</sup> I discuss the empirical studies in their order of publication.

<sup>78</sup> Daines & Klausner, *supra* note 6, at 92.

<sup>79</sup> Robert Gertner & Steven N. Kaplan, *The Value Maximizing Board* (SSRN Working Paper Series No. 10563, 1996), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=10563](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=10563) (exploring the effects of efficient board structures on firm performance).

<sup>80</sup> Daines & Klausner, *supra* note 6, at 95–96, 110.

with highly sophisticated outside investors, such as venture capital funds or LBO experts.

Daines and Klausner further examined whether dissimilarities among the sampled firms led to the divergent behavior. They tested three major hypotheses, discussed at length below,<sup>81</sup> that the empirical evidence ultimately rejected or at least could not validate.<sup>82</sup> The authors concluded that it is practically impossible to attribute the variance in antitakeover protection to the dissimilarities among the issuing firms.

The second paper was published by Coates, examining two samples of IPO firms in order to measure the changes in antitakeover protection over time: a main group of data, including over 300 IPOs between 1991 and 1992, and a smaller control sample of IPO firms from 1998.<sup>83</sup> His basic findings follow those of Daines and Klausner: there is a high degree of variance in the antitakeover practices of firms that go public. Although adopting takeover defenses has become more popular, the 1998 sample indicates that many firms still choose not to adopt defenses at all. Thus Coates, like Daines and Klausner, empirically refutes alternative theories that might explain why defenses are better suited for some firms than others.

Finally, Field and Karpoff also conducted comprehensive research of takeover defenses at the IPO stage, investigating more than 1000 firms that went public between 1988 and 1992.<sup>84</sup> This is the earliest sample of IPO-stage firms tested empirically. Of the firms sampled, 53% had at least one takeover defense, while the rest refrained entirely from adopting defenses.<sup>85</sup>

Altogether, the empirical picture revealed by these recent high-profile studies gives reason to reconsider the voluminous literature of takeover the-

<sup>81</sup> See *infra* Part III.2.

<sup>82</sup> Specifically, they claimed that their findings refute the myopia theory and the bargaining-power theory, whereas they could neither refute nor support the private benefits hypothesis. We cannot be certain that the bargaining-power and myopia hypotheses were, indeed, refuted by the Daines and Klausner findings. First, the authors assumed that the more M&A activity in the industry, the less defenses were needed, because competition will drive the prices up regardless of defenses. However, one could make the opposite argument, that when potential competition is present, defenses are most valuable for driving up the price, because delaying the takeover will definitely allow competition to emerge. Second, the examination of the myopia hypothesis is also imperfect. The authors assume that high R&D levels in the industry will lead to adoption of defenses because of the fear of an opportunistic bid. However, it has been also argued in the literature that R&D levels may be excessive when asymmetric information exists. See Lucian Arye Bebchuk & Lars A. Stole, *Do Short-Term Objectives Lead to Under- or Over-Investment in Long-Term Projects?*, 48 J. FIN. 719 (1993). Thus, it is possible that the exposure of targets with excessive R&D to the market of corporate control can cure part of the waste, assuming that specialized bidders can identify excessive R&D levels. To sum up, while I do not fully accept Daines' and Klausner's interpretation, they did expose the fact that it is hard to key dissimilar antitakeover practices to dissimilarities among firms.

<sup>83</sup> Coates, *supra* note 6, at 1344, 1375.

<sup>84</sup> Field & Karpoff, *supra* note 6, at 1859.

<sup>85</sup> *Id.* at 1884.

ory. Not only was it a blow to traditional theories that argue either that defenses fit all firms or fit none, but it also undercut more moderate theories, which argue that variances among issuers explain divergent antitakeover practices. These nuanced heterogeneity theories, which concentrated on relevant dissimilarities amongst firms, were not supported by the empirical findings.

This development in the literature has had two ramifications. First, scholars crafted alternate heterogeneity theories. Second, the authors of the empirical papers raised some market-failure explanations for firms' diverging practices. In Section III, I argue that a comprehensive view of the market for takeover defenses could shed light on these recent empirical findings. Under this view, this Article regards all existing heterogeneity explanations as supply factors, and together with a novel demand-side factor, provides a richer view of firm behavior. In Section V, I compare this market view with the market-failure explanations proposed by the authors of the three empirical papers noted above.

### III. RECONSIDERING TAKEOVER DEFENSES

#### A. Reframing Traditional Arguments in Market Terms

The empirical findings indicating that IPO-stage firms sharply diverge in takeover practices challenged the traditional views that defenses are either beneficial or inimical to all firms,<sup>86</sup> and paved the way for the evolution of more nuanced theories of defenses. Before describing the latter theories, it is important to first reformulate the traditional accounts in market terms. This new explanation on the traditional views exposes them as stemming from a highly degenerated and unrealistic market for takeover defenses.

Recall the features of the market for takeover defenses as described in the Introduction. There are two types of products in this market: the first, a firm lacking takeover defenses, or an unshielded target, and the second, a firm with takeover defenses, or a shielded target. In reality, a variety of shields exists, each with different antitakeover potencies,<sup>87</sup> but for our purposes we need only concentrate on these two extreme forms. In addition, there are multiple producers in the market, each capable of producing a separate, single product for each firm they control. The act of producing a potential takeover target combines both adopting (or rejecting) takeover shields and going public. Production currently takes place at the time the firm goes public since “[o]nly at the IPO stage does a company continue to

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<sup>86</sup> For the classic approach of opponents of defenses, see Easterbrook & Fischel, *supra* note 72. See also Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. ECON. & ORG. 229 (1986). For the classic view of proponents of defenses, see Lipton, *supra* note 68.

<sup>87</sup> See Coates, *supra* note 6, at 1387 (listing various governance terms that affect takeover vulnerability).

have the ability to choose different types and amounts of defenses that will regulate hostile bids for the life of the company.”<sup>88</sup>

The aggregate supply of unshielded (and shielded) targets is the result of the joint decision of multiple producers. The cost of producing a shielded target, as discussed below, determines the supply curve; as the costs for implementing takeover defenses increases, the number of firms that adopt them diminishes. In addition to the negligible cost of legal counsel for installing defenses, these costs primarily consist of all the shortcomings associated with having defenses, such as managerial consumption of increased control benefits. Similarly, the cost of producing an unshielded target includes all the shortcomings of being unshielded, such as the lack of negotiating power. Moreover, since producing an unshielded target necessarily requires rejecting the shielded alternative, the costs of rejection include the foregoing of all the benefits of being shielded.<sup>89</sup> Finally, the market for takeover defenses includes potential acquirers of both shielded and unshielded products. Since takeover defenses make targets more elusive, and thus expensive, we should expect a divergence in demand for shielded and unshielded targets.

Equipped with this understanding of supply-and-demand for shielded and unshielded products, it is now possible to give a new account of the traditional views about takeover defenses in a market setting. Two markets can be described: the market for unshielded products (i.e., firms lacking defenses) and the market for shielded products (i.e., firms with defenses). However, these markets are intertwined, as the two products constitute the “flip sides of the same coin.” It therefore suffices to examine only the market for one of the products, as the equilibrium in the one market will reveal the outcome in the alternative market. In other words, if we determine the number of firms that would go public with defenses, we can easily ascertain the complementary number of firms that would reject defenses, and vice versa. Hence, throughout this Article, in an effort to simplify matters, I concentrate on the market for unshielded products.

Again, the classic takeover defense theories include arguments that describe the defenses as either beneficial or harmful for *all* firms. These classic theories were recently rephrased in terms of which group within the company should be granted the decision-making power regarding the fate of a takeover bid:

The classic debate on how a publicly traded company should decide whether to accept an acquisition offer has been dominated by two schools of thought. According to one group of scholars, it is the elected representatives of shareholders entrusted with the management of the company—the board of direc-

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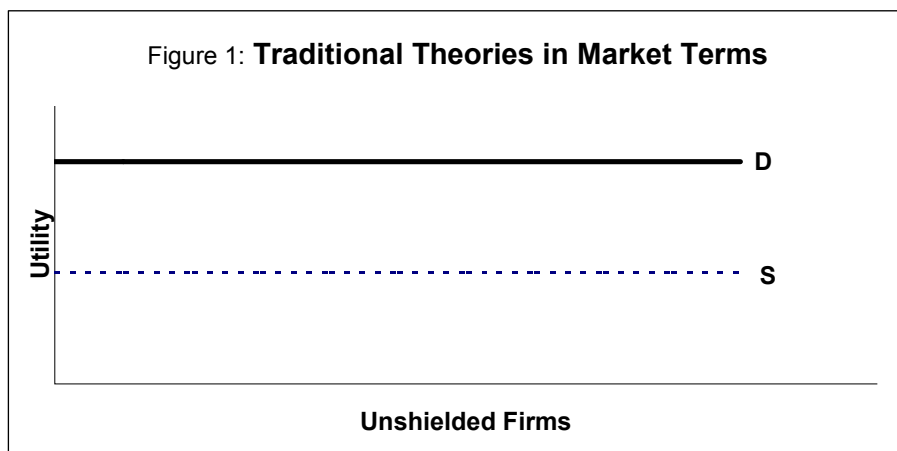
<sup>88</sup> Coates, *supra* note 6, at 1308. See also Lucian A. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 721–23 (2003).

<sup>89</sup> The foregone benefits of adopting takeover shields could, therefore, be termed the opportunity costs of producing an unshielded target.

tors—whose approval should always be necessary to sell a company . . . .

According to a second group of scholars, it is the shareholders as owners of the company who should, at any time, be able to sell the company, whether or not the board approves of the sale.<sup>90</sup>

Most scholars undoubtedly subscribe to the latter school of thought, advocating absolute choice for shareholders and, therefore, considering such defenses to be harmful.<sup>91</sup> Accordingly, the market for takeover defenses implied by this latter traditional view is depicted in Figure 1, below, in which the X-axis represents the number of unshielded “products” on the market.



The categorical nature of both traditional views, and, in this case, the anti-defenses view, is evident from Figure 1. Neither supply nor demand for unshielded products fluctuates with the number of products produced, reflecting the view that the costs and benefits of defenses are fixed. Note that the demand exceeds supply at all points, manifesting the view that the benefit of going public without defenses always outweighs any possible cost of creating defenses. In short, it is a market with one simple rule: produce as much as possible. As a result, all producers—that is, any firm considering going public—should opt to produce only unshielded firms. Any other decision would mean that the producer fails to produce a product for which the market is willing to pay much more than its cost of production.

The proponents of the anti-defenses, or traditional view, advocate their view not only as a normative argument, but also as a positive description of reality. Adoption of takeover defenses, goes the argument, would never oc-

<sup>90</sup> See Kahan & Rock, *Corporate Constitutionalism*, *supra* note 3, at 480–81.

<sup>91</sup> See Coates, *supra* note 6, at 1327 (“Exceptions exist, but academics have generally opposed defenses, and practitioner-commentators have generally supported them.”).

cur in IPOs and can only occur in mature firms—where managers adopt defenses contrary to the welfare of the firm’s shareholders. In the words of such proponents, “Firms go public in easy-to-acquire form: no poison pill securities, no supermajority rules or staggered boards. Defensive provisions are added later, a sequence that reveals much.”<sup>92</sup> While this description might have been accurate at the time of its writing (reflecting market features of the 1980s), it certainly cannot stand today. By the end of the 1990s, as discussed above, mature firms were not able to alter their anti-takeover exposure, whereas IPO firms were free to adopt or reject defenses.<sup>93</sup> That many IPO-stage firms realized this freedom by adopting defenses means the market structure implied by this traditional view and reflected in Figure 1 cannot stand.

Let us recall the opposite traditional view, regarding takeover defenses as beneficial to all firms since defenses equip management with the discretion to decide the fate of takeover bids. The main advocate of this view is Martin Lipton, who wrote:

Many corporations annually or periodically face decisions with respect to capital expenditures, new product introductions, adoption of new processes, termination or disposition of business or bankruptcy, that may have as significant an impact on the market value of the corporation as a takeover bid. As long as matters such as capital expenditures, discontinuances of businesses and bankruptcy are for the reasonable business judgment of the directors, there is no reason to put acceptance or rejection of a takeover bid on any different basis.<sup>94</sup>

However, the market structure implied by the pro-defenses traditional view is as stringent as under the other traditional view, and likewise fails to pass the test of reality. Following the market structure reflected in Figure 1, Lipton’s view is that the costs and benefits of defenses are, for all intents and purposes, fixed for all firms. In market terms, the difference between Lipton and the traditional opponents of defenses is that, in contrast to the market portrayed in Figure 1, Lipton assumes that supply for unshielded targets always exceeds demand. That assumption means the cost of going public without shields (i.e., the foregone benefits of being shielded) always outweighs the willingness of the market to pay for an unshielded target; therefore no producer should decide to produce such a worthless product. Simply put, when the cost exceeds the market price, it is illogical to produce such a product. The empirical studies that found divergences in firm antitakeover practices consequently negate the market structure implied by this second traditional theory as well.

In light of these findings, researchers have been forced to update their views on the structure of the market for corporate takeover defenses. Old

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<sup>92</sup> FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 204–05 (1991).

<sup>93</sup> See, e.g., Bebchuk, *supra* note 88, at 723, 727–28; Coates, *supra* note 6, at 1308.

<sup>94</sup> Lipton, *supra* note 68, at 120.

theories that could account for the diversified practices of defenses were revitalized, and new theories were crafted. All these theories entailed a modified view of this market, implicitly claiming that producers vary in production costs of shielded and unshielded products. These theories should be regarded as supply-side explanations from a market perspective, as discussed in subpart B below.

### B. *Multiple Supply-Side Explanations*

Supply-side theories offer different explanations for why it is better for some firms (or some controllers) to adopt defenses, while others would fare better in the absence of defenses. These explanations draw a more contoured picture of reality as they flesh out the understanding that firms differ in relevant characteristics. This variation in characteristics bears an accompanying divergence in firms' costs of going public without defenses (i.e., of producing an unshielded target). Below, I present four such supply-side theories, all of which highlight firms' heterogeneity, and I reformulate them in market terms. Each of these explanations constitutes a unique set of supply-side considerations, though these theories do not exhaust all supply-side explanations. Any theory that explains why it is better for some firms to adopt or reject defenses due to their nature or business characteristics may be viewed similarly.<sup>95</sup> Following the presentation of the supply-side explanations, I will complete the depiction of the market for takeover defenses by presenting a novel demand-side consideration. In contrast to the supply-side arguments, which focus on the issuer side, the demand-side explanation concentrates on bidders' *willingness to pay* for an unshielded target and argues that it is linked to the proportion of the firms on the market that remain unshielded.

Finally, note that although supply-side and demand-side considerations should complement one another to formulate a more comprehensive understanding of IPO-stage defense-adoption trends, they also serve as independent explanations that are not necessarily interrelated. In the case of supply-side explanations, this means that issuer concerns alone could determine which firms will adopt defenses; with demand-side explanations, it means that bidder preferences alone can explain why firms differ in their defense practices—even when they share relevant characteristics.

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<sup>95</sup> This may be the case of “team production” explanations for takeover defenses. *See, e.g.*, Lynn A. Stout, *The Shareholders as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 679–81 (2003) (arguing that takeover defenses may promote team production within the firm); Stout, *supra* note 10 (arguing that antitakeover defenses encourage nonshareholder groups to make extracontractual investments in corporate team production); *accord* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 305 (1999). *But cf.* Lucian A. Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 1011–13 (2002) (claiming that there is no clear empirical support for the team production theory).

*1. Bargaining Power and Managerial Control over the Method of Sale.*—Perhaps the most famous supply-side theory builds on the

argument that takeover defenses may assist shareholders in bargaining for the sale of the company and that this benefit varies from firm to firm.<sup>96</sup> A recent sophisticated version of the argument, which emphasizes managerial discretion in crafting an optimal sale strategy, states:

[S]hareholders reasonably might opt for board entrenchment—implemented, for example, by means of a staggered board—in order to enable a board to employ selling strategies more effectively and, thus, to increase the premium shareholders receive when the company is sold. Such a decision is a kind of precommitment whereby shareholders, by binding themselves ex ante, may be able to improve their collective position ex post.<sup>97</sup>

This theory concentrates on the ex post influence of takeover defenses, that is, the payoff to shareholders once a takeover has begun. Shareholder gain from a takeover event is the increase in the price per share above the market price prior to the takeover, or the takeover premium.<sup>98</sup> Since the board has flexible capabilities and superior information about the firm, it can time the sale of the firm, dictate the manner of sale,<sup>99</sup> and negotiate with potential buyers much better than the scattered body of shareholders.<sup>100</sup> To be sure, managerial discretion also entails agency costs: The board may abuse defenses to its advantage by entrenching managers in their current positions, while disregarding the interests of shareholders.<sup>101</sup> It is therefore far from surprising that, as has been empirically proven, the takeover frequency of shielded targets is lower than that of their unshielded counterparts.<sup>102</sup>

<sup>96</sup> For some recent empirical findings, see Krishnan Maheswaran & Sean Pinder, *Australian Evidence on the Determinants and Impact of Takeover Resistance*, 45 ACCT. & FIN. 613 (2005) (finding that bid resistance increases target shareholder wealth in the post-announcement period).

<sup>97</sup> See Kahan & Rock, *Corporate Constitutionalism*, *supra* note 3, at 473 (emphasis added).

<sup>98</sup> See Michael Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21 (1988) (reporting vast premiums to target shareholders in takeover events).

<sup>99</sup> Even if the managers decide on an auction, they can improve the results for the shareholders by deciding on a minimum price that is higher than the market price. The shareholders themselves can hardly commit to such a higher threshold price. See John G. Riley & William F. Samuelson, *Optimal Auctions*, 71 AM. ECON. REV. 381 (1981) (providing a formal analysis of auction rules that shows the benefits of announcing a minimum acceptance price that is higher than the reservation price).

<sup>100</sup> Additionally, antitakeover mechanisms may enable managers to block coercively designed bids. The coercion results from a front-loaded bid, i.e., a bid that offers the tendering shareholders more than the value of untendered stock. If shareholders believe that enough shareholders will tender and that the bid will therefore succeed, they will rationally elect to tender their stock as well, even if it would have been better for all shareholders to cooperate rather than tender their stock. See Bebchuk, *supra* note 13, at 917–31; Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693 (1985).

<sup>101</sup> Two types of costs are involved: loss of some takeover opportunities and an increased consumption of private benefits by the managers who are partially protected from removal.

<sup>102</sup> See Bebchuk, Coates & Subramanian, *supra* note 43 (covering only firms that were actually engaged in hostile takeover battles); Field & Karpoff, *supra* note 6, at 1877 (measuring the frequency of all acquisitions and, therefore, not focusing only on actual cases of hostile takeover events).

Hence, a tradeoff exists between the benefits of managerial discretion and its costs, varying from firm to firm, and based on each firm's distinct characteristics.

The new articulation of this theory, cited above, follows older theories that emphasized the bargaining advantage of the board of directors.<sup>103</sup> However, there are two major differences. First, the new account emphasizes the board's advantage in deciding on the proper method of sale for the company,<sup>104</sup> rather than the older emphasis on the board's superior information about the firm. Second, and more importantly, the authors make it clear that, under their theory, only certain firms will adopt defenses:

*[T]he optimal allocation of decision-making power depends on several empirical factors that may vary from company to company. These factors include the balance between the significance of the board's informational advantages and the importance of selling strategies, on the one hand, with the various benefits from constraining agency costs on the other.*<sup>105</sup>

And although the bargaining power argument seems, at first glance, to be a pro-defense argument, the authors stress that it also explains why some firms should reject defenses. From this point of view, they interpret some recent empirical evidence as follows:

In 1990, Massachusetts legislatively imposed staggered boards on all Massachusetts public companies, even if the charters of these companies provided for annual elections of the whole board. Studies of this Massachusetts legislation have shown that the stock price of Massachusetts companies that did not

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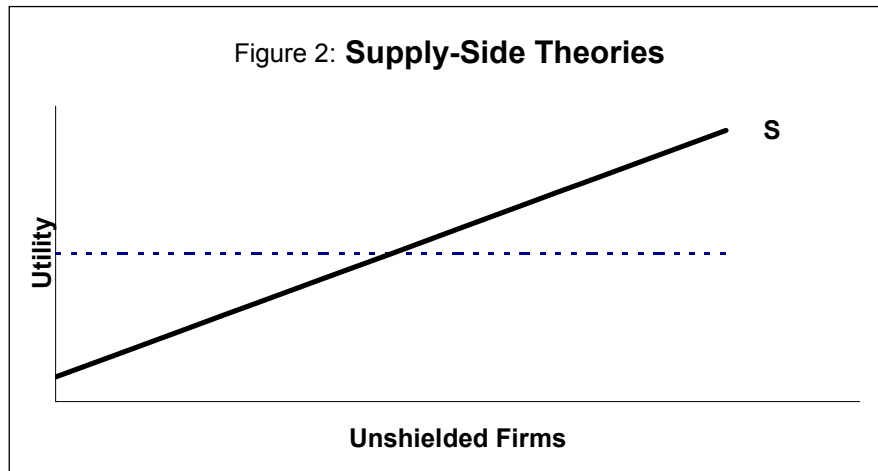
<sup>103</sup> The crux of all these arguments is that managers have better means and incentives to negotiate an improved deal than does the body of scattered shareholders. Granting takeover defenses to managers empowers them to conduct such negotiations. See, e.g., Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028–56 (1982) (arguing for target's managers' ability to seek competing bids and for allowing them the necessary delay to achieve this goal); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23–50 (1982); Elazar Berkovitch & Naveen Khanna, *How Target Shareholders Benefit from Value-Reducing Defensive Strategies in Takeovers*, 45 J. FIN. 137 (1990); DeAngelo & Rice, *supra* note 71 (modeling how managerial discretion can lead to higher premiums in a takeover event); Dale A. Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 124–31 (1986) (emphasizing managers' superior ability to assess the value of the company); David S. Scharfstein, *The Disciplinary Role of Takeovers*, 55 REV. ECON. STUD. 185 (1988); René M. Stulz, *Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control*, 20 J. FIN. ECON. 25, 28–34 (1988) (modeling manager ability to overcome dispersed shareholders' collective action problems); Stulz, *supra* note 71 (same). On the empirical side, see Comment & Schwert, *supra* note 46, who found that the presence of a poison pill increases the takeover premium. However, since most firms without poison pills can easily and rapidly adopt one, the significance of this finding is dubious.

<sup>104</sup> The method of sale should be read in a broad sense. See Kahan & Rock, *Corporate Constitutionalism*, *supra* note 3, at 477 (“A selling strategy can, among other things, entail choosing the time to sell, soliciting offers from other bidders or threatening to do so, haggling over price, disclosing information to bidders, rejecting an offer, making ‘take-it-or-leave-it’ counter-offers, or misrepresenting one’s willingness to sell.”).

<sup>105</sup> *Id.* at 488 (emphasis added).

already have staggered boards declined. *The result of these studies is consistent with our argument that shareholder choice represents a plausible governance structure and that staggered boards are not universally desirable. Forcing staggered boards onto companies that did not opt to include staggered board provisions in their charter should thus be expected to reduce company value.*<sup>106</sup>

It is now possible to formulate this theory as a supply-side explanation for the divergence in antitakeover practices among IPO firms, with the assistance of Figure 2, below, which follows the same lines as the earlier framework.



In Figure 2, the X-axis is the number of firms that do not adopt defenses, and the Y-axis represents the costs arising from the decision of a given firm to remain unshielded. Recall that we are considering the market for unshielded targets and that producing an unshielded target requires foregoing any benefits of the shielded alternative. The curve is a supply curve for producing unshielded targets, as it represents the marginal costs of going public without defenses for any number of unshielded firms in the market. The supply curve is upward sloping since firms diverge in their taste for defenses. Some firms, the ones for which managerial discretion is most important, have high costs for going public unshielded, since defenses serve as a commitment to empower managers. Other firms, with a lower need for managerial discretion (or perhaps higher costs for granting such discretion), do not incur such high costs for going public unshielded. From left to right, the first firms are those that have the least need for managerial bargaining power and, thereafter, in ascending order, lie the firms that benefit more from a commitment for managerial discretion.

<sup>106</sup> *Id.* at 506 (emphasis added).

In order to identify the cutoff between firms that adopt defenses and those that reject them, we must also consider the price that the market is willing to pay for a firm that goes public unshielded. For now let us assume that the benefit of going public without defenses is represented by the dotted horizontal curve, which may, therefore, be termed the demand curve. Consequently, all firms to the right of the intersection of the two curves will go public with takeover defenses. For these firms, the costs of producing an unshielded target, represented by the supply curve, are higher than the benefits derived from being unshielded. Conversely, all firms to the left of the intersection will opt to produce unshielded products—since their costs of producing an unshielded target are lower than the benefits derived from that product.

But note that, in this framework, demand remains stagnant and does not fluctuate with the number of unshielded firms in the market, leading to the issue of empirical verification of the argument discussed above. Researchers have speculated that the firms that operate in market sectors with low merger and acquisition (“M&A”) activity, such as perhaps the utilities sector, are the ones most likely to need takeover defenses for negotiation purposes.<sup>107</sup> Where M&A activity is high, goes the argument, competition among bidders will drive the takeover premium up, even in the absence of takeover defenses. In contrast, where few potential bidders exist, the chances for competition are slim, and it is important to adopt defenses to extract a high offer from an available bidder.<sup>108</sup> This hypothesis, however, was rejected by the data, as researchers found that:

[T]he coefficient on the bidder competition variable is significant, but the sign is positive rather than negative, meaning that the more competitive the market for corporate control in a firm’s industry, the *stronger* the antitakeover protection a firm is likely to have. *This is the opposite of what the bargaining power hypothesis predicts.*<sup>109</sup>

This finding left the bargaining-power supply-side theory with no direct empirical verification.

2. *Protecting Managerial Ex Ante Incentives.*—A second supply-side theory is an ex ante perspective on managerial incentives. Under this theory, in some firms, exposure to the threat of a hostile takeover significantly distorts managerial incentives to run the firm’s business properly. This

<sup>107</sup> Daines & Klausner, *supra* note 6, at 101–02.

<sup>108</sup> This interpretation of the bargaining power theory is tenuous. It assumes that the more M&A activity present in the industry, the less defenses are needed, because competition will drive the prices up notwithstanding defenses. However, one could make the opposite argument, that when potential competition is present, defenses are most valuable for driving up the price because delaying a takeover will definitely allow competition to emerge. Put differently, defenses may provide leverage even in an environment with high levels of M&A activity. For additional criticism, see Kahan & Rock, *Corporate Constitutionalism*, *supra* note 3, at 503.

<sup>109</sup> Daines & Klausner, *supra* note 6, at 102 (second emphasis added).

view seems to contradict the traditional *ex ante* approach that rests on the notion that hostile takeovers generally benefit shareholders by disciplining managers, i.e., the possibility of a takeover will threaten managers and deter them from shirking their duties.<sup>110</sup> Otherwise, the market value of their firm would decline, creating the opportunity for a “raider” to buy the company at a low cost and reap the benefits of improving the firm after the acquisition. Accordingly, any takeover defense that might impede a takeover attempt is harmful. Thus, the more shielded a firm, the greater the risk of misconduct on the part of the firm’s management.<sup>111</sup>

A more nuanced view, however, considers managerial exposure to takeovers to be detrimental to the shareholders, at least in certain market sectors. In market sectors in which managerial decisions are highly complex or involve a good deal of unverifiable inside information, the market may underestimate management efforts. In such a myopic market, unleashed market discipline may be counterproductive.<sup>112</sup> Managers who have not committed any wrongdoing may be replaced in a hostile takeover maneuver simply because the market undervalues the firm, which would create the opportunity for a shrewd raider to take over the enterprise.<sup>113</sup> Consequently, managers may forsake long-term or hard-to-evaluate projects that are beneficial to the shareholders, in favor of projects that are inferior but easier to assess. For instance, with an eye to the threat of a takeover, managers may under-invest or over-invest to satisfy investors seeking short-term returns.<sup>114</sup> Takeover defenses could prevent such scenarios and the distortion of managerial incentives by partially neutralizing the threat of takeover.<sup>115</sup> When managers are relatively takeover-proof, goes the argu-

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<sup>110</sup> In their seminal work, Jensen and Meckling define the three components of agency costs: monitoring (costs of principal scrutiny); bonding (costs of agent commitments); and residual loss (the remaining loss from agent misbehavior). Jensen & Meckling, *supra* note 10, at 308, 323–57.

<sup>111</sup> Many more restraining market forces and internal mechanisms help reduce managerial agency costs. However, they also create exposure to takeover threats. See, e.g., Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 847 (1993).

<sup>112</sup> Stein was the first to link the takeover market behavior with the inefficient market hypotheses. See Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988) (explaining how myopic markets require managerial protection); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989) (same). Many additional papers followed on the topic. See, e.g., Thomas J. Chemmanur & Yawen Jiao, *Dual-Class IPOs, Share Recapitalizations, and Unifications: A Theoretical Analysis* (ECGI—Fin. Working Paper No. 129, 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=925236](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=925236) (providing a model of antitakeover provisions and market inability to observe the value of long-term projects).

<sup>113</sup> Similar to Stein’s principal point, Shleifer and Vishny argue that the value of firms that invest in long-term hard-to-evaluate projects is likely to be discounted relative to their peers that invest in short-term projects. Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148 (1990).

<sup>114</sup> The observation that market inefficiencies can cause both under- and over-investment belongs to Bebchuk & Stole. See Bebchuk & Stole, *supra* note 82.

<sup>115</sup> While it is difficult to find direct evidence for myopic mispricing, it was recently shown that high levels of transient ownership are associated with an overweighing of near-term expected earnings.

ment, they can freely pursue the best possible business strategies without fear of being misevaluated by the market.

This nuanced approach to how takeover defenses affect managerial behavior—holding that firms diverge in how takeover exposure affects managerial incentives—can also be framed as a supply-side theory of takeover defenses. Some firms incur lower costs when producing an unshielded target, when takeover exposure fails to distort their managers' incentives. Other firms, however, have higher costs, since foregoing takeover defenses would lead their managers to pursue undesirable business strategies.

The graph in Figure 2 depicts this theory as well. On the left-hand side are the firms that benefit or do not suffer much from takeover exposure in terms of manager incentives. These firms would be the first to opt for the non-shielded option. In contrast, the firms on the right-hand side of the graph need defenses to protect their managers from misjudgment by the market; therefore, producing an unshielded target is overly costly. As a group, all firms produce the upward-sloping supply curve, which reflects the increasing costs of adopting defenses from left to right. The firm for which the costs and benefits of going public without defenses are equal lies at the point at which supply crosses demand (i.e., the dotted curve representing the price that the market is willing to pay for an unshielded product). All firms to the right of this intersection would refrain from adopting defenses, as the costs of production (represented by the supply curve) fall short of the benefits (represented by the dotted demand curve). All the firms to the left of the intersection would reject defenses since the costs of producing an unshielded company exceed the demand for such companies.

Though tempting in theory, this supply-side explanation has no direct empirical support. Researchers speculate that certain characteristics of a given firm may expose it to an increased threat of market myopia, and hence, defenses are especially valuable to such firms.<sup>116</sup> Specifically, they point to a firm's level of research and development ("R&D") expenditure: high R&D levels exacerbate market myopia vis-à-vis the particular firm, since it is hard to estimate the long-term value of the relevant projects.<sup>117</sup>

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This finding supports the concerns of many corporate managers about the adverse effects of an ownership base dominated by short-term focused institutional investors. See Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?*, 18 CONTEMP. ACCT. RES. 207 (2001).

<sup>116</sup> See Daines & Klausner, *supra* note 6, at 99–100.

<sup>117</sup> A recent study supported this speculation. The study examined a sample of 8313 firms between 1951 and 2001, where firms unexpectedly increased their R&D expenditures by a significant amount. Sample firms were found to be undervalued following their R&D increases, as manifested in the significantly positive long-term stock returns that the sample firms experienced. The study also found evidence that the sample firms had significantly positive long-term abnormal operating performance following their R&D increases. Altogether, these findings suggest that R&D increases are beneficial investments and that the market is slow to recognize the extent of this benefit, consistent with the investor under-reaction hypothesis. See generally Allan C. Eberhart, William F. Maxwell & Akhtar R. Siddique, *An Examination of Long-Term Abnormal Stock Returns and Operating Performance Following R&D Increases*, 59 J. FIN. 623 (2005).

Consequently, goes the argument, firms with high R&D levels such as those in the high-tech or bio-tech sectors, are more likely to adopt defenses.<sup>118</sup> The data, however, contradict this hypothesis, as researchers found that “[t]he coefficient on the R&D variable in column A is equally surprising. That coefficient is significant and negative—the opposite of what the rational myopia hypothesis predicts.”<sup>119</sup> This finding left this theory too without any empirical verification.

3. *Firm Ability to Adopt Unregulable Defenses.*—The third supply-side theory is a novel argument regarding unregulable defenses.<sup>120</sup> Arlen and Talley argue that, instead of using legally-based takeover defenses such as staggered boards and poison pills, firms may opt for transactional and unregulable defenses.<sup>121</sup> These transactional or “embedded” defenses include change-of-control provisions in debt instruments, joint venture agreements, leases, license contracts, and employment arrangements.<sup>122</sup> Because these arrangements mimic transactions that are frequently value-increasing, they are not susceptible to legal regulation of any stripe.<sup>123</sup> Embedded defenses could be quite effective in blocking acquisitions, but they could also be more detrimental than legally-based defenses as they diminish value. Legally-based defenses such as the poison pill can be easily abolished or avoided by management itself, whereas embedded defenses entail the consent of a third party and therefore, may alter the business profile of the firm.<sup>124</sup> To avoid this scenario, firms that can easily use embedded defenses should be allowed to opt for the less harmful, legally based alternatives.

At first glance, this argument seems to suggest that targets (both shielded and unshielded) do not vary much in terms of vulnerability to hostile takeovers, since embedded defenses are always available. Hence, this argument seems to contradict the premise of this article that tries to explain why some prefer to be less shielded than others. However, a closer reading of the new theory reveals that its argument is perfectly reconcilable with the

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<sup>118</sup> See Daines & Klausner, *supra* note 6, at 99–100.

<sup>119</sup> *Id.* at 102.

<sup>120</sup> See generally Arlen & Talley, *supra* note 12.

<sup>121</sup> *Id.* at 579–82. For a salient example of embedded defenses, see David Millstone & Guhan Subramanian, Oracle v. PeopleSoft: *A Case Study*, 11 HARV. NEGOT. L. REV. (forthcoming Spring 2007), available at [http://papers.ssrn.com/paper.taf?abstract\\_id=816006](http://papers.ssrn.com/paper.taf?abstract_id=816006) (describing PeopleSoft’s unprecedented Customer Assurance Program, which promised PeopleSoft customers between two to five times their money back if Oracle acquired PeopleSoft).

<sup>122</sup> See Arlen & Talley, *supra* note 12, at 582–83 (exemplifying different arrangements that can serve as embedded defenses).

<sup>123</sup> *Id.* at 581 (explaining how the business judgment rule makes embedded defenses impervious to legal critique).

<sup>124</sup> *Id.* at 583 (discussing “unregulable substitute defenses that reduce firm value, not only by deterring takeovers (friendly or hostile), but also by inefficiently altering the operating profile of the firm outside of the takeover context”).

theory presented in this Article, as it is actually an additional supply-side theory. As such, it emphasizes that different firms enjoy different benefits from adopting legally based takeover defenses and incur different costs for remaining unshielded.

Arlen and Talley do not argue that the firms we see *today* without harsh takeover defenses are actually as protected as their shielded peers, since they could always adopt substitute transactional defenses. Rather, they argue that in a hypothetical world with a prohibition on legally-based defenses, the firms that we see today with strong legally-based defenses would adopt substitute embedded defenses. The reason those firms have legally-based defenses *today* stems from their shareholders' belief that, in the absence of such defenses, management would resort to an even worse means of entrenchment. Granting defenses preempts this worst-case scenario.

This, however, is evidently not the fate of all firms, for otherwise all firms would adopt legally based defenses when takeover defenses are permitted. Hence, Arlen and Talley explicitly acknowledge firm heterogeneity, which turns their theory into a supply-side explanation. Simply put, some firms compete in environments in which the management can more easily use embedded defenses, such as the software industry,<sup>125</sup> while others cannot. The argument made by Arlen and Talley could be read as claiming that shareholders at the IPO stage can differentiate between these two types of firms and grant harsh takeover defenses only to the former type, as they, *a priori*, prefer managers to use legally-based shields rather than their more destructive embedded counterparts. As stated by the authors:

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.*<sup>126</sup>

This theory is important for two reasons. First, as discussed above, it presents an additional supply-side consideration, resting on the fact that all firms are not able to use the embedded defenses to the same extent. Sec-

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<sup>125</sup> See Millstone & Subramanian, *supra* note 121, at 8 (describing a salient example of an embedded takeover defense in the software industry).

<sup>126</sup> Jennifer Arlen & Eric L. Talley, *Unregulable Defenses and the Perils of Shareholder Choice* 6 (USC Law, Olin Research Paper 03-7, 2003) (emphasis added), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=398600](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=398600). In the published version of the paper, the authors make the same claim, although in a slightly less-pronounced manner. See Arlen & Talley, *supra* note 12, at 585 (“We are skeptical, therefore, 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 . . .”).

ond, although Arlen and Talley believe certain defenses are unregulable, they nonetheless believe that shareholders can assess which firms are most likely to use unregulable defenses and preempt this costly possibility by granting them takeover defenses at the IPO stage. Similarly, shareholders can observe which firms cannot use harmful embedded substitutes and, accordingly, refrain from arming them with legal takeover defenses. As discussed below, the ability to assess the takeover vulnerability of peer firms is an important factor in the demand-side theory to be discussed in subpart C, below. Simply put, firms lacking harsh defenses have shareholders who initially believed that their management could not easily abuse embedded defenses. Hence, the firms that go public without legally-based takeover defenses are less shielded even when the possibility of covertly adopting embedded defenses is taken into account.

To conclude, Arlen and Talley's theory is a provocative supply-side argument. The cost of producing an unshielded target, from their point of view, is the possibility that the management of the unshielded target will resort to an embedded defense, which is unregulated and especially harmful to shareholders. This cost fluctuates from firm to firm, as not all business environments facilitate adopting embedded defenses. Framed in this manner, this argument can also be understood through Figure 2, which explains how it yields a market in which only a fraction of the firms adopt defenses.

On the right-hand side of Figure 2, we find the firms with management that could easily adopt embedded defenses. From the point of view of their shareholders, there is a huge cost to "producing" an unshielded target, as management would surely resort to the embedded option. This is why the supply curve is at its highest level at that point. Moving to the left-hand side of the graph, firms become more constrained in their ability to adopt embedded defenses, making it less risky to go public without takeover defenses. At the far end of the line we find the firms whose business characteristics entirely prevent them from adopting embedded defenses; these firms incur no cost in going public without defenses, at least when the only cost considered is the adoption of embedded defenses. Taken together, all producers bring about an upward-sloping supply curve, representing the escalating costs of going public without defenses. All firms to the left of the intersection between the supply and demand curves would go public without defenses, since production costs are lower than the benefits of going public unshielded; the opposite is true for the firms to the right of the intersection. The firm sitting at the point of intersection is indifferent between the two options.

#### *4. Firms with Different Levels of Private Benefits of Control.—*

Before progressing to the demand-side considerations, I consider another supply-side theory that slightly deviates from the pattern outlined above. This fourth theory also can be explained on the backdrop of the framework presented in Figure 2, but it first requires a modification of the

implicit assumptions that have served us thus far. Until now, I have implicitly adopted the classic notion regarding the IPO process, namely, that this process has certain features that ensure the inclusion of only optimal corporate governance terms, from the point of view of the public shareholders, in the charters of firms that go public.<sup>127</sup> This premise was fundamental to the three previously discussed supply-side theories, which argue that some firms adopt defenses at the IPO stage to benefit the public shareholders.<sup>128</sup> The reasoning underlying this classic view of the IPO process is that pre-IPO shareholders can maximize the value they receive in the IPO only if they satisfy the will of the prospective public shareholders under the watchful eyes of the underwriters. A sub-optimal governance term would reduce the firm market value in the IPO, which, in turn, would lower the returns for the pre-IPO owners.<sup>129</sup> The most enthusiastic proponents of this explanation summarize the operation of the market forces as follows: “[S]elf-interested entrepreneurs and managers, just like other investors are driven to find the devices most likely to maximize net profit. If they do not, they pay for their mistakes because they receive lower prices for corporate paper.”<sup>130</sup> Consequently, pre-IPO owners will always adhere to the advice of professionals (such as investment bankers or lawyers) regarding which governance terms best serve the public shareholders.

This reasoning, however, does not hold for firms with significant considerations of so-called “private benefits of control.” Aside from generating income for the benefit of all shareholders, companies also produce benefits that only the firm’s controller enjoys. These benefits take many forms, and are often wasteful and harmful to the corporation and its public shareholders; insider trading in corporate securities, consumption of perks, investment in “pet projects,” or unjustified expansion and diversification are all inimical practices that generate private benefits.<sup>131</sup> In countries with lax le-

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<sup>127</sup> See Jensen & Meckling, *supra* note 10 (presenting the notion of the IPO-certification process); see also EASTERBROOK & FISCHER, *supra* note 92, at 6 (describing at length the market operation that leads to the adoption of the best business practices).

<sup>128</sup> In the first case, defenses are adopted for bargaining power purposes; in the second case, they are adopted to preserve managerial ex-ante incentives; and in the third case, they are adopted to preempt the possibility of adoption of embedded defenses. But in all cases, their adoption (or rejection) is meant to benefit the public shareholders.

<sup>129</sup> And in our framework, the defense decisions of IPO-stage firms are supposed to be optimal in view of the fact that the securities market carefully prices public offerings and that entrepreneurs in such situations are guided by market professionals to adopt the structures that the market favors. The defense decisions of seasoned firms, in contrast, are not affected by such exonerating mechanisms, but as was previously explained, market forces currently render the defenses status stagnant after the IPO stage.

<sup>130</sup> EASTERBROOK & FISCHER, *supra* note 92, at 6.

<sup>131</sup> See, e.g., Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986); Michael C. Jensen, *The Free Cash Flow Theory of Takeovers: A Financial Perspective on Mergers and Acquisitions and the Economy*, 31 FED. RES. PROC. 102 (1987), available at <http://papers.ssrn.com/ABSTRACT=350422>.

gal regimes,<sup>132</sup> these types of harmful activities are salient, and researchers found indications that they impede the development of capital markets.<sup>133</sup> Other forms of private benefits of control may be the mere transfer of value from the public shareholders to the controllers, which does not entail any direct waste, such as excessive levels of executive compensation.<sup>134</sup> In addition, the enterprise's controller amasses certain private benefits without any adverse effect to the firm's value. Such benefits are mostly non-pecuniary and attach to the prestige of the position, including self-satisfaction from being the controller of the enterprise and, accordingly, the social respect and esteem deriving from the position,<sup>135</sup> and the important factors of political power and reputation. These types of private benefits are not bound by the legal regime in which the corporation exists. The weight of these control benefits cannot be underestimated if we accept that managers are driven not only by monetary compensation and perks, but also by prestige, satisfaction, and authority.

These private benefits naturally fluctuate from firm to firm, even within a given country. The relevant factors are how glamorous the firm is, on the one hand, and how open the firm is to abuse by the controller, on the

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<sup>132</sup> For an international comparison of the levels of private benefits of control in different countries, see Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. FIN. 537 (2004). In this study, control benefits were measured indirectly by looking at the premiums (i.e., the price paid beyond the market price) when the incumbent controller sold its holding to a new controller. The idea is that such premiums represent the benefits that the minority and public shareholders cannot enjoy.

<sup>133</sup> See, e.g., Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997) (empirically linking lax legal regimes and private control benefits with weak and concentrated capital markets); Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999) (same); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Law and Finance*, 106 J. POL. ECON. 1113 (1998) (same); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert W. Vishny, *Legal Determinants of External Finance*, 52 J. FIN. 1131 (1997) (same); Simon Johnson, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Tunneling*, 90 AM. ECON. REV. 22 (2000) (same); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000) (same).

<sup>134</sup> However, much waste may be involved in the process of managerial pay due to distorted managerial incentives. See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE PAY* (2004) (describing flaws in the design of managers' pay and their consequences); Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 761–63 (2002) (same); Lucian A. Bebchuk & Jesse M. Fried, *Executive Compensation as an Agency Problem*, 17 J. ECON. PERSP. 71 (2003) (same); Michael C. Jensen, *Agency Costs of Overvalued Equity* (Harv. Working Paper No. 04-26; ECGI-FIN. Working Paper No. 39, 2004), available at <http://ssrn.com/abstract=480421> (emphasizing managers' perverse incentives in the event of a market bubble).

<sup>135</sup> See Daines & Klausner, *supra* note 6, at 106–07; see also Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 119 HARV. L. REV. 1641 (2006) (distinguishing between efficient and inefficient controlling shareholders and between pecuniary and nonpecuniary private benefits of control).

other.<sup>136</sup> Beyond some threshold of private benefits of control, it has been shown that pre-IPO owners install takeover defenses in the corporate charter even when those defenses will harm the value of the corporate shares.<sup>137</sup> The pre-IPO owners may be willing to sustain the decrease in share value because defenses help them preserve their private control benefits. In the absence of defenses, they might receive a higher price per share in the IPO, but a hostile bidder may easily wrest the control benefits from their hands when taking over the enterprise.<sup>138</sup> Therefore, the more private control benefits the firm generates, the higher the costs to the pre-IPO owners of going public unshielded.

This theory is also a supply-side explanation for the antitakeover practices of IPO-stage firms. Going back to Figure 2, the firms with high costs of going public without defenses are those that generate high private benefits of control; they appear in declining order from right to left, forming the supply curve. Any firm to the right of the intersection between the supply and demand curves has levels of control benefits that are so high that its costs of going public without defenses are higher than the gains from going public without defenses. Consequently, all firms to the right of the intersection will adopt defenses when they go public. The opposite is true with regard to the firms lying to the left of the intersection point, which have mild levels of private control benefits.

Note, however, that one major difference exists between this supply-side explanation and the previous ones. The previous three supply-side explanations all suggest that both adopting and non-adopting firms opt for the tactic that maximizes the market value of the firm. The current explanation is different: it implies that both adopting and non-adopting firms select the

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<sup>136</sup> For instance, vast cash flows may provide ample opportunities for managers to divert resources to their own benefit in a wasteful manner. See Jensen, *supra* note 98 (describing the waste in mature firms that do not need the cash flows they generate for any fruitful purpose).

<sup>137</sup> The reason for this is, in essence, that a hostile control transaction does not generally compensate the incumbent controller for the loss of private benefits. See Lucian A. Bebchuk, *A Rent-Protection Theory of Corporate Ownership and Control* (Harvard Law & Econ., Discussion Paper No. 260, 1999) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=168990](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=168990). In addition, other versions of this argument exist, and are surveyed by Coates, *supra* note 6, at 1330–32.

<sup>138</sup> To demonstrate, imagine a firm that is worth 100 to the shareholders without defenses and additionally provides its managers with non-monetary private benefits of 20 that cannot be shared with the public shareholders. However, without defenses, the chances of a takeover that would oust the entrepreneur are 50%, and therefore the entrepreneur values the option of taking the firm public without defenses at 110 (i.e.,  $100 + (50\% \times 20)$ ). Alternatively, with defenses, the private benefits would remain the same, but the firm's inherent value would decline to 95, because managers may reject value-enhancing mergers. For purposes of simplicity, let us further assume that the probability of a takeover with defenses is 0. Consequently, the entrepreneur would value the company with defenses at 115 (i.e.,  $95 + 20$ ) and would prefer to take the company public with takeover shields ( $115 > 110$ ). Note that the value of the firm with defenses in this case would be lower than the comparable value without defenses, both in the eyes of the public shareholders ( $95 < 100$ ) and from the perspective of social welfare ( $(95 + 20) < (100 + 20)$ ). Nonetheless, the entrepreneur would prefer to install defenses to protect her private consumption of control benefits, which would be endangered by the prospects of a hostile takeover.

tactic that maximizes the benefits to the pre-IPO owners, even if that tactic does not maximize the market value of the firm. Takeover shields may be costly to adopt, but entrepreneurs may adopt them to protect the private benefits of control unreflected in the firm's market value. And if the harm that defenses cause to the public shareholders is reflected in the market price at the time the firm goes public, then public shareholders do not lose anything by buying the stock of shielded companies.<sup>139</sup> Indeed, public shareholders pay less for firms that adopt defenses, and the cost of adopting defenses is borne by the pre-IPO owners who could otherwise receive a better price for the venture. In turn, pre-IPO owners prefer to bear such costs only in firms with ample private-benefits potential, as explained above. It should be noted, however, that this theory, just like the preceding supply-side explanations, lacks any direct empirical substantiation. Indicators for private benefits of control are hard to gauge, and researchers concluded that: "at least with respect to this source of private benefits, we cannot conclude that [antitakeover provisions'] use is associated with the presence of high private benefits."<sup>140</sup>

### C. *A Novel Demand-Side Argument and the Unified Theory*

The four supply-side theories presented above complement one another to explain why some firms adopt takeover defenses at the IPO stage while others reject such measures.<sup>141</sup> A firm is likely to adopt defenses in light of four considerations: the importance of providing management with the power to control the sale of the firm; the difficulty in evaluating the firm's long-term projects; the ease with which management can adopt embedded unregulated defenses; and the extent to which the firm provides private benefits to its controller. The lack of direct empirical verification for any of these four explanations is disturbing,<sup>142</sup> but it does not mean that they are necessarily flawed. Some effects, such as those related to private benefits, are almost impossible to trace, and perhaps the empirical examination of other effects was not designed properly.<sup>143</sup>

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<sup>139</sup> See Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409 (2005) (providing evidence that staggered boards bring about reduced firm value).

<sup>140</sup> Daines & Klausner, *supra* note 6, at 108.

<sup>141</sup> See *infra* Part IV; see also *infra* note 219.

<sup>142</sup> Recall that certain versions of two of the supply-side theories were rejected by empirical examination, while another could be neither verified nor refuted. See, e.g., Daines & Klausner, *supra* note 6, at 102 (refuting the bargaining power and the market myopia hypotheses); *id.*, at 108 (explaining how the examination is unable to either refute or verify the private benefits hypothesis).

<sup>143</sup> Some evidence of the private benefits of control theory was found in another context, when researchers analyzed the determinants of concentrated ownership. See Shijun Cheng, Venky Nagar, Madhav V. Rajan, *Identifying Control Motives in Managerial Ownership: Evidence from Antitakeover Legislation*, 18 REV. FIN. STUD. 637 (2004) (finding that state-mandated takeover protection is keyed to a reduction in the level of stock held by the managers, which is an alternative means to protect managerial private benefits); Asjeet S. Lamba & Geoffrey P. Stapledon, *The Determinants of Corporate Ownership Structure: Australian Evidence* (Univ. of Melbourne Pub. Law Research Paper No. 20, 2001),

In response to the lack of empirical support for the supply-side explanations, some researchers have suggested that adoption and rejection trends in IPO firms may result from certain market failures. One paper suggests that firms vary in legal counsel competence.<sup>144</sup> A second paper suggests that some pre-IPO managers are potent enough to trick their pre-IPO counterparts into adopting wasteful defenses.<sup>145</sup> Finally, a third paper notes a widely-held, though infrequently-cited, view that the IPO pricing mechanism is imperfect, which may lead to the adoption of detrimental defenses.<sup>146</sup> All of these market failure explanations deviate from the present Article's antitakeover market framework.<sup>147</sup> Interestingly, once demand-side considerations are taken into account, it seems that the conclusions of the different studies that tried to link defense-adoption trends to market failures in the IPO process could be overreaching.<sup>148</sup> As we shall see below, demand-side considerations are linked to bidders' propensity to pay, in contrast to the supply-side consideration that focuses on producers' (i.e., targets') characteristics and costs.

*1. Constructing a Downward Sloping Demand Curve.*—The demand-side considerations highlighted by this Article derive from a notion of diversion of takeover activity. Unlike other markets, it is well acknowledged in the market for corporate control that “[t]he threat of competing bids might be insufficient to secure a competitive price because the competition in the market for corporate acquisitions is far from perfect.”<sup>149</sup> The essence of the takeover diversion argument is that, in the absence of ample M&A opportunities, targets compete among themselves for the prospects of a takeover, while bidders compare among different targets in search of the best alternative. Consequently, all things being equal, an unshielded target is more attractive to a bidder if its peers are shielded and therefore harder and more expensive to acquire.

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available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=279015](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=279015) (finding that firms with higher levels of managerial private benefits were more likely to have concentrated ownership); Elisabeth Müller, *Benefits of Control, Capital Structure and Company Growth*, 39 APPLIED ECON. (forthcoming 2007) available at [http://papers.ssrn.com/paper.taf?abstract\\_id=776364](http://papers.ssrn.com/paper.taf?abstract_id=776364) (finding that companies in which existing owners would lose control if they were to expand grow more slowly; potential loss of control is measured as the difference in the probability of winning a vote for the largest owner before and after a hypothetical equity increase).

<sup>144</sup> See Coates, *supra* note 6.

<sup>145</sup> See Field & Karpoff, *supra* note 6.

<sup>146</sup> However, the authors do not support this view, and show that it is incompatible with their empirical data. See Daines & Klausner, *supra* note 6, at 113.

<sup>147</sup> I will return to these non-market explanations later on, but in the current section I suggest supplementing the existing supply-side theories with novel demand-side considerations.

<sup>148</sup> In other words, while other studies suggest sacrificing the classic understandings regarding the IPO process, I suggest reevaluating some firmly-held understandings regarding the takeover phenomenon.

<sup>149</sup> See, e.g., Bebchuk, *supra* note 13, at 930.

M&A opportunities are often limited due to the increasing trend towards intra-industry mergers and consolidation.<sup>150</sup> Most acquisitions are synergy-driven and therefore only specific targets complement the special needs of specific buyers.<sup>151</sup> In these circumstances, therefore, the pool of potential bidders is relatively narrow, as has been acknowledged by a number of empirical studies gauging M&A trends. As Subramanian recently reported:

Although the pattern does not hold for every industry, *the general trend is toward more intra-industry acquisitions*: in the 1990s, more than three-quarters of all acquisitions were intra-industry, compared to just over half in the 1980s. *These statistics are consistent with conventional wisdom characterizing the 1990s takeover wave as more strategic and less disciplinary than the 1980s wave.*<sup>152</sup>

Thus, each bidder must compare among relevant targets and each target must consider the acts of its peers due to the limited number of suitable bidders and amount of takeover opportunities.<sup>153</sup> Bidders should weigh all relevant characteristics of the relevant targets, and since takeover defenses generate costly delays, they must also consider the relative antitakeover potency of the different targets. In a candid interview to the business press, William Steere, Pfizer CEO, discussed the process that led the company to launch its bid to acquire Warner Lambert, considered to be the largest hostile takeover in U.S. business history. Steere's decision to acquire Warner Lambert was based on a careful analysis of the suitability of other takeover alternatives and the acquisition costs of those alternatives. The costs entailed by the need to overcome takeover shields are not mentioned explicitly

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<sup>150</sup> See Mehmet E. Akbulut & John G. Matsusaka, *The Waning of Corporate Diversification* (May 2005) (unpublished manuscript on file with SSRN at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=754064](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=754064)) (doing an empirical investigation of bidder returns over the last fifty-five years, the authors show how in the 1990s, diversification fell from favor, while intra-industry mergers were rewarded by the market; intra-industry M&A activity is associated with synergies, whereas diversification may serve other motives).

<sup>151</sup> See Kahan & Rock, *Corporate Constitutionalism*, *supra* note 3, at 503 ("Industry takeover volume, in turn, is likely to be correlated with the probability of a synergy-producing takeover, where the division of gains between the bidder and the target shareholders is likely to be an important issue.").

<sup>152</sup> Guhan Subramanian, *The Drivers of Market Efficiency in Revlon Transactions*, 28 J. CORP. L. 691, 712 (2003) (emphasis added). In addition, mergers are often triggered by industry-specific external shocks, resulting in a clustering of acquisition activity within an industry, as acknowledged by many studies. See, e.g., Michael Gort, *An Economic Disturbance Theory of Mergers*, 83 Q.J. ECON. 624 (1996); Mark L. Mitchell & Harold J. Mulherin, *The Impact of Industry Shocks on Takeover and Restructuring Activity*, 41 J. FIN. ECON. 193 (1996).

<sup>153</sup> This fact was revealed by an empirical study that found that termination of a planned merger creates vast stock gains for industry rivals, suggesting that industry rivals are takeover alternatives and may be purchased once the merger fails. See Aigbe Akhigbe et al., *The Source of Gains to Targets and Their Industry Rivals: Evidence Based on Terminated Merger Proposals*, 29 FIN. MGMT. 101 (2000).

by Steere, but Warner Lambert was cited by the business press as having minimal takeover protection and, hence, being relatively easy to acquire.<sup>154</sup>

In picking their target, bidders weigh the relative virtues of the potential targets and the relative expected costs or difficulty of their acquisition.<sup>155</sup> Since takeover defenses increase the costs of acquisition, bidders must take into account the relative degree of takeover protection of the potential targets. This means that adoption of shields by a company not only reduces its chances of acquisition, but also increases the chances that one of its unshielded peers will be acquired instead. The academic literature has already identified several externalities that a firm's decision to adopt takeover defenses entails, including negative externalities for employees, tax authorities, consumers, and bidders.<sup>156</sup> However, the influence of one potential target's adoption of defenses on its fellow potential targets is an externality that has not been discussed so far. Rather, the academic literature has consistently ignored the fact that takeover defenses divert some takeover activity, at least within a given industry sector, from shielded to unshielded corporations.

One can indirectly observe the takeover diversion aspect of takeover defenses through the recent empirical findings about takeover activity diversion in general.<sup>157</sup> While many studies have measured intra-industry merger effects,<sup>158</sup> one recent study is unique in its analysis of the intra-industry effects of merger terminations. After examining 192 terminated mergers between 1987 and 1996, including 57 hostile takeover attempts, the authors show that industry peers collect abnormal stock returns once a pre-

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<sup>154</sup> See Robert Langreth, *Behind Pfizer's Takeover Battle: An Urgent Need*, WALL ST. J., Feb. 8, 2000, at B-1.

<sup>155</sup> The claim that industry peers are takeover substitutes does not mean that all firms within an industry are possible alternatives. Each firm has a reference group with which it competes. The adoption of defenses becomes more influential over time with the dispersion of ownership, and at that point, the late entrant into the market may be mature enough to compete for takeover opportunities with some portion of the market (which I believe may be roughly estimated by the underwriters at the IPO stage).

<sup>156</sup> The contemporary literature has identified various other externalities. See, e.g., Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33 (Alan Auerbach ed., 1988) (externalities on the employees of takeover targets); Lucian Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) (externalities on consumers, tax authorities, etc.); Sanford Grossman & Oliver Hart, *One Share, One Vote, and the Market for Corporate Control*, 20 J. FIN. ECON. 175 (1988) (negative externalities on bidders); Lucian A. Bebchuk & Luigi Zingales, *Corporate Ownership Structures: Private Versus Social Optimality* (NBER Working Paper Series, Paper No. 5584, 1996) (externalities on corporate bidders).

<sup>157</sup> See Akhigbe et al., *supra* note 14.

<sup>158</sup> See, e.g., Sayan Chatterjee, *Types of Synergy and Economic Value: The Impact of Acquisitions on Merging and Rival Firms*, 7 STRATEGIC MGMT. J. 119 (1986); B. Eckbo, *Horizontal Mergers, Collusion and Stockholder Wealth*, 11 J. FIN. ECON. 241 (1983); Moon H. Song & Ralph A. Walkling, *Abnormal Returns to Rivals of Acquisition Targets: A Test of the 'Acquisition Probability Hypothesis'*, 55 J. FIN. ECON. 143 (2000).

viously announced merger in their industry falls apart.<sup>159</sup> The authors' interpretation of this finding is that industry peers are takeover substitutes. The boost in the share prices of peer firms following a failed merger announcement reflects the market expectation that these firms might benefit from the failed takeover attempt.

The authors conducted a few additional tests to verify their hypothesis since other explanations—namely those that tie merger activity to the product market—are also possible.<sup>160</sup> To begin with, the authors found that the size of the peer firms relative to the target is inversely related to the gains to those peer firms from the merger termination.<sup>161</sup> Since ample evidence exists that firm size is an impediment to takeover bids,<sup>162</sup> this test supports the takeover diversion explanation. Second, the authors found that peer firms in regulated industries, such as banking, utilities, and transportation, experience less favorable abnormal returns when the merger termination is announced.<sup>163</sup> Since regulatory approval may partially impede takeover activity, this test also backs the takeover diversion explanation. Finally, the authors showed that an index of product market concentration (the Herfindahl Index) has no statistically significant influence on a rival's returns,<sup>164</sup> which indicates that product-market explanations, such as antitrust-based explanations cannot shed any light on the study's principal findings.

Taken together, the above findings, which prove that peer firms are substitute candidates and that takeover activity can be diverted from firm to firm, also indirectly support the argument that takeover shields divert takeover activity. If defenses are potent enough to reduce the M&A potential of a shielded target, as other studies clearly show,<sup>165</sup> they should create a similar reaction to that provoked by a merger termination. And this diverted

<sup>159</sup> See Akhigbe et al., *supra* note 14, at 117 (“[M]erger termination results in significant negative returns for targets and target rivals experience significant positive returns.”).

<sup>160</sup> For instance, one could imagine that the merger threatened the market power (in the market for products) of all rivals of the merging entities, and that once the merger failed, this threat was removed, boosting the stock prices of the competitors.

<sup>161</sup> See Akhigbe et al., *supra* note 14, at 119 (“Thus, the larger the average size of rivals relative to the target, the lower the probability that they will become acquisition targets and, hence, the lower the CARs.”).

<sup>162</sup> See, e.g., Krishna Palepu, *Predicting Takeover Targets: A Methodological and Empirical Analysis*, 8 J. ACCT. & ECON. 3 (1986); Moon H. Song & Ralph A. Walkling, *The Impact of Managerial Ownership on Acquisition Attempts and Target Shareholder Wealth*, 28 J. FIN. & QUANTITATIVE ANALYSIS 439 (1993).

<sup>163</sup> Akhigbe et al., *supra* note 14, at 116 (“This finding is consistent with the assertion that the need for regulatory approval of acquisitions might reduce the likelihood of regulated firms becoming takeover targets.”).

<sup>164</sup> *Id.* (noting that there is “no relation between extent of market concentration and returns to rivals”).

<sup>165</sup> This statement is true for both hostile and friendly M&A activity. See Bebchuk, Coates & Subramanian, *supra* note 43 (empirical findings on hostile transactions); Field & Karpoff, *supra* note 6, at 1877 (empirical findings on all transactions).

takeover activity, which constitutes a benefit for peer firms, raises demand-side considerations as it involves bidder choice to pay for shielded and unshielded targets.

It is now possible to translate the takeover diversion argument into a demand-side theory of takeover defenses that supplements the supply-side theories in order to construct a market for takeover defenses.<sup>166</sup> The familiar framework developed earlier appears again in Figure 3, below, which now includes demand-side considerations.

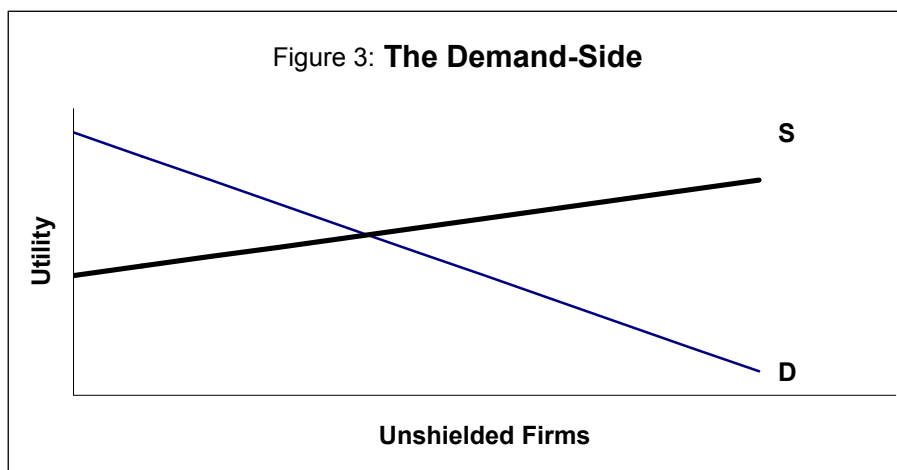


Figure 3 above draws a full picture of the market for takeover defenses. Like its predecessors, it shows an upward sloping supply curve, which is the result of the combination of all supply-side theories discussed earlier. Differences among issuers in terms of private benefits, propensity to adopt unregulated defenses, or any other relevant factor appear as different costs of foregoing defenses. The firms on the left-hand side of the graph have extremely low costs for going public without defenses; issuers are aligned, from left to right, in ascending order of the costs of forgoing defenses.

But for the first time, one can explicitly take into account the bidder's perspective, which translates into the price that the market is willing to pay for the product. This factor is reflected in the downward sloping demand curve in Figure 3. The downward slope, common to most product markets,<sup>167</sup> means that the market price drops as more products are introduced into the market. On the flipside, the fewer the products that are available on

<sup>166</sup> Absent a supply-side theory, the mere belief in diversion of takeover activity does not mandate the conclusion that only a portion of firms adopt defenses. Theoretically, defenses may be harmful for the shareholders of the adopting firm even when very few firms remain unshielded and diversion of takeover activity peaks. However, the opposite scenario is also possible.

<sup>167</sup> See PINDYCK & RUBINFELD, *supra* note 2, at 21–23 (depicting and discussing downward sloping demand).

the market, the higher will be the price for each product. This is the precise influence of takeover diversion on the market for takeover defenses.<sup>168</sup> A bidder—that is, the consumer of the unshielded products in our market—will be willing to pay more for unshielded targets when few such products are available. When many firms are shielded, their unshielded counterparts receive much attention diverted from the shielded types, leading to higher takeover frequency.<sup>169</sup> Higher takeover frequency translates into greater takeover premiums for the shareholders of the target. And, all things being equal, as the market becomes saturated with defenses, this phenomenon intensifies. Conversely, when fewer firms adopt defenses, more unshielded types are produced, which have to share the lower diverted levels of takeover activity. This leads to fewer takeovers and smaller takeover premiums for the shareholders of the unshielded target, making the unshielded tactic less attractive.

Now it is possible to understand the full picture of the market for takeover defenses, and how it reaches an equilibrium. Put differently, we can now understand how demand and supply forces ascertain the fraction of the market that adopts defenses and the fraction of the market that rejects them. To do so, we need to compare the costs of going public unshielded with the benefits of such a tactic. All firms for which the costs of going public unshielded are lower than the price that the market is willing to pay for an unshielded target will go public without defenses, and vice versa. In Figure 3, this is true for all firms to the left of the intersection between supply and demand, reflected by the fact that the demand curve tops the supply curve. And all firms to the right of the intersection will adopt defenses, as going public without defenses is too costly for them when the costs are compared with the benefits. The point of intersection represents the point of equilibrium. At that point, the marginal firm, for which the costs equal the benefits as supply crosses demand, is indifferent as to defense adoption versus rejection. Put together, this setup contains all factors relevant to a firm's decision to adopt or reject shields, and these factors work in concert to reach the outcome we see in reality.

In the absence of demand-side considerations, each issuer has to concentrate on its own characteristics and decide whether it would do better to go public with or without defenses. This is the essence of the supply-side explanations, which refer to demand as though it is fixed. The above-mentioned demand-side explanation holds that attention to the issuer's characteristics is only part of the story. Observing the state of the relevant

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<sup>168</sup> In product markets, this phenomenon stems from the fact that consumers have different evaluations for the same products. Hence, in order to sell more products, producers must tap consumers with lower valuations.

<sup>169</sup> In Appendix 1, *infra*, I present a simple model of two targets and two bidders, in which takeover diversion sometimes leads to competition over the unshielded firm, thereby increasing the premiums the target could expect.

industry is also necessary, since demand for an unshielded target rises when more firms adopt shields. Demand-side considerations do not have to be apparent to the market. The data (or hunches) used in the normal decision-making process regarding defenses will be affected by the unseen forces of demand. Hence, it is perfectly reasonable for underwriters to more strongly advocate defenses in industries that are not saturated with defenses, while opposing or discouraging them in industries replete with defenses. However, this may happen even if underwriters are unaware of the reason that led one industry (that which is saturated with defenses) to be a more favorable environment for unshielded firms.

In this framework, the demand-side argument and the different supply-side explanations complement one another. However, since the empirical literature was unable to verify any of the supply-side influences, it is also important to note that the demand-side argument has much explanatory force even in the absence of the supply considerations. Put differently, even if firms' heterogeneity does not play a role in adopting or rejecting defenses, demand may still lead to only a fraction of the firms deciding to adopt defenses. The reason for this is that takeover diversion erodes any benefits from going public with defenses, notwithstanding firms' internal motivations. All things equal, the adoption of defenses by peers increases the attractiveness of rejecting shields. Hence, even among similar firms, the benefits of defenses equal the benefits of being unshielded in some fraction of the market. This latter scenario is more intriguing than the one in which targets are heterogeneous, since it is unclear which firms would opt for defenses and which firms would reject them, and the process by which the market reaches the right balance is obscure. This matter warrants a separate explanation of this evolutionary nature, which appears at the end of the discussion of the demand-side considerations.<sup>170</sup>

2. *Demand-Side and Executive Pay.*—The downward sloping demand curve discussed above rests on the notion of takeover diversion. However, the assumption that takeover defenses deter and divert takeover activity requires a closer look at the issue of managerial remuneration, since in theory remuneration can be designed to mute the influence of takeover defenses. Before discussing the relevant issues regarding managerial compensation, one must first acknowledge that there is sound empirical evidence that takeover defenses serve as effective guards against takeovers, notwithstanding the scenarios analyzed below. In a recent study, Bebchuk, Coates, and Subramanian found that harsh takeover defenses—particularly staggered boards—significantly reduce the likelihood that a target will be acquired once a hostile bid is launched. In their sample, nine months after a hostile bid, 60% of targets with staggered boards remained independent,

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<sup>170</sup> See *infra* Part IV.

compared with only 34% of targets without a staggered board.<sup>171</sup> In addition, while Bebchuk, Coates, and Subramanian measured the effect of takeover defenses on hostile takeovers, Field and Karpoff measured their impact on overall M&A activity, that is, both negotiated and unsolicited transactions. In the latter sample, the overall probability of a takeover event for both types of transactions was 16.8% for firms without takeover defenses and 11.4% for firms armed with at least one defense, a salient difference of 5.4%.<sup>172</sup> Thus, the impact of takeover defenses cannot be denied.

Nevertheless, two issues related to executive pay must be analyzed here. First, if managers' compensation is heavily tied to the performance of the firm's stock, managers may cede to a hostile bidder even if they have potent takeover defenses.<sup>173</sup> The premium offered in the takeover could compensate them for any benefits lost in the transaction.<sup>174</sup> In turn, takeover defenses will not impede bids, and no takeover diversion will take place. Second, and related, if a bidder is able to make side-payments to the management of the target, those managers may waive the battle and opt for the side-payments in the form of consulting fees, golden parachute arrangements or otherwise.<sup>175</sup> Once again, takeover defenses would not forestall bids, and no takeover diversion would take place. In both scenarios, the managers are analogous to security guards at a mansion. Effective guards deter criminal activity directed at the mansion they are protecting, but also divert such activity to neighboring mansions. A guard with an interest in the criminal activity—whether through receiving a portion of the stolen goods or a direct bribe—welcomes it, which undercuts deterrence and diversion alike. There is a vast difference, however, between the two management scenarios. In the first scenario, the bidder must raise the price paid to all shareholders of the target in order to convince the managers to cede control, since the managers' gains accrue through their fractional holdings of the firm's stock (or stock options, etc.). In the second scenario, a side-payment could have the same effect on the managers, but without requiring the bidder to extend generous offers to all shareholders. This difference re-

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<sup>171</sup> See Bebchuk, Coates & Subramanian, *supra* note 43, at 930. Similar findings were obtained thirty months after the hostile bid had been launched. Forty-seven percent of the targets with staggered boards remained independent versus 23% of the targets without staggered boards. *Id.* at 933.

<sup>172</sup> See Field & Karpoff, *supra* note 6, at 1877.

<sup>173</sup> Incentive pay is a common measure in the United States and is persistently on the rise. The reasons for this trend lie beyond the boundaries of takeover considerations. See, e.g., Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, 68 Harv. Bus. Rev. 138 (1990) (stressing the importance of this measure to align shareholder/manager interests). *But cf.* LUCIAN A. BEBCHUK & JESSE M. FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004) (explaining how managers turned incentive pay from a solution into a problem); Lucian A. Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751, 764–74 (2002).

<sup>174</sup> See Stulz, *supra* note 71 (a formal model of the managerial decision problem in such setting).

<sup>175</sup> For a model that includes a feature that allows the bidder to make a side-payment that goes directly to the incumbent managers, see Arlen & Talley, *supra* note 12, at 642.

quires separate analysis, although, as discussed below, both executive incentive pay and a bidder's ability to make side-payments do not rule out takeover diversion.

First, consider why managers' incentive pay does not entirely erode the impact of defenses. The answer is that incentive pay can be designed so as to render defenses almost obsolete, but shareholders have no interest in doing so. The first reason is, simply, that motivating managers to accept all bids might be extremely expensive. The higher the fraction of the firm held by managers, the greater their benefits from an acquisition. Consider, for instance, a bidder that is willing to pay one billion dollars above the target's market price, and assume that the manager derives overall benefits of ten million dollars from her stint at the firm in terms of salary or otherwise. In order to convince the manager to accept such bid, shareholders must pre-design the manager's incentive pay in a manner that would ensure her at least 1% of the firm's stock (1% of one billion = ten million).<sup>176</sup> At any lower fraction, the manager would prefer to maintain her position at the firm and to try to fend off the bid. But a stock or option grant might be too expensive a measure for the shareholders to take, especially since takeover opportunities might be rare and cannot justify any expense. And note that the cost to the shareholders increases if they want their manager to accommodate bidders with a lower valuation of the firm.

The second reason why shareholders have no interest in calibrating incentive pay so as to neutralize defenses is more intriguing: shareholders use the combination of executive pay and defenses for strategic reasons. In a recent paper, Kahan and Rock explain how incentive pay can fine-tune shareholders usage of takeover defenses to extract high takeover bids. In accordance with the numerical example set out above, when shareholders set incentive pay, they actually set a minimum price for a takeover that the managers would not oppose. In setting the threshold, goes the Kahan and Rock argument, shareholders must balance between their desire to induce high-value bidders to pay high premiums and the loss of bids from bidders who cannot meet the threshold.<sup>177</sup> Moreover, explain Kahan and Rock, this is true also for any other measure that shareholders may take to restrain management resistance to takeovers:

[C]ompanies can (and do) adopt devices that reduce the degree and effective-

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<sup>176</sup> The above numbers regarding managerial fractional holdings are quite realistic. In the U.S., manager fractional ownership is typically extremely low relative to the situation in most other countries. See, e.g., Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999).

<sup>177</sup> In an earlier paper, the authors showed that the use of incentive pay (such as option grants) and other mechanisms *can* mute the effect of antitakeover mechanisms. See Kahan & Rock, *How I Learned to Stop Worrying*, *supra* note 20. However, in the more recent article, they clarify that shareholders have no interest in muting the effects of defenses, but, rather, use them to their advantage as a credible commitment to accepting only high-premium offers. Put differently, shareholders have no reason to worry about defenses since defenses can be manipulated and not because defenses are silenced.

ness of managerial resistance as the premium rises—for example, by granting managers stock options (which become more valuable as the premium increases) or by having outside directors placed on the board who are not fully beholden to management (who may overrule managers reluctant to accept a high-premium offer). *As a result, conflict of interest may induce a board to reject low premium bids, but not bids where the premium is sufficiently high. This, however, may be exactly the selling strategy shareholders would want to pursue.*<sup>178</sup>

Altogether, it is therefore not surprising that shareholders choose not to mute manager resistance to the point that takeover defenses are rendered non-functional. In fact, this may be the reason for the adoption of defenses in the first place.<sup>179</sup>

Next, consider bidders' motivation to privately "bribe" managers into accepting their bids. Empirical findings that takeover defenses deter all types of M&A transactions<sup>180</sup> suggest that, even in friendly transactions, the ability to make such side-payments is limited. Otherwise, takeover defenses would have no substantial deterrence potency and shareholders could not use them for strategic reasons. There are at least five limitations on bidders' ability to convince managers to accept a bid through side-payments, although it cannot be denied that some side-payments do take place.<sup>181</sup> For one, federal securities regulation prohibits bidders from buying management's stock at a different price from that offered to the public in a tender offer. Second, case law prohibits managers from "selling" their positions in the company.<sup>182</sup> Third, severance pay in the event of a hostile bid, also known as "golden parachute" arrangements,<sup>183</sup> are limited by pen-

<sup>178</sup> See Kahan & Rock, *Corporate Constitutionalism*, *supra* note 3, at 487 (emphasis added).

<sup>179</sup> This view, however, is not shared by all scholars. See Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621 (2003) (arguing that there is no evidence that defenses are actually used for bargaining purposes).

<sup>180</sup> See Field & Karpoff, *supra* note 6, at 1877.

<sup>181</sup> See, for example, the famous case of *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977) (managers' resistance dropped after they obtained employment agreements).

<sup>182</sup> *Manson v. Curtis*, 223 N.Y. 313 (1918).

<sup>183</sup> Since these arrangements are designed by the targets and not by the bidders, it should also be noted that shareholders have no interest in arrangements that would nullify defenses. For instance, assume that the manager values her position at the firm at twenty million dollars and that shareholders want to attract a bid of one billion dollars (above the target's market price). In the absence of a golden parachute, the shareholders would have to grant the manager options for two percent of the company stock to guarantee her approval (two percent of one billion = twenty million). However, the shareholders may combine stock options with a golden parachute arrangement. For instance, a golden parachute of ten million dollars would allow them to reduce the option grant to one percent of the firm stock (ten million + one percent of one billion = twenty million). They would not want to make the golden parachute so lucrative as to cause the manager to accept any bid, which, in the example above, would happen if the golden parachute were set at twenty million or more. The advantage to using a golden parachute and not only stock option grants is that a golden parachute is an expense that materializes only if a takeover occurs, whereas a stock option is an expense regardless of whether the takeover occurs, as recognized by the recently amended accounting standards. See FINANCIAL ACCOUNTING FOUNDATION,

alty tax laws.<sup>184</sup> Fourth, while it is possible to compensate the managers of a target with lucrative consulting agreements and other such tactics,<sup>185</sup> this manner of compensation does not constitute adequate compensation for the loss of private benefits. Much, if not most, of the private benefits that accompany a managerial stint are of a psychological nature (including social status, self-esteem, the feeling of being in charge of the enterprise, and even the accompanying political influence),<sup>186</sup> which cannot be easily detached from the CEO or other managerial title. Hence, it would take much to convince many managers to forego their positions, especially those who are not approaching retirement age<sup>187</sup> and those who are already wealthy enough. Finally, at least some managers will consider it unethical to cut a good deal for themselves rather than insisting on high premiums for all shareholders. Altogether, therefore, there are good reasons why side-payments from the bidder do not neutralize the power of defenses to reject and divert bids, nor do they invalidate demand-side considerations.<sup>188</sup>

#### IV. THE MECHANISMS OF THE MARKET FOR TAKEOVER DEFENSES

Since it is possible that market participants are unaware of all the delicacies of the market for takeover defenses, and especially the demand-side forces, it is important to discuss the market mechanisms that maintain the equilibrium in this unique market. Until now, the Article emphasized the case in which supply-side considerations and demand-side forces work in

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<sup>184</sup> In fact, the excise tax is so extreme that literally no firm ever exceeds the limits imposed by these laws. See Donald E. Rocard, Jack S. Levin & Martin D. Ginsburg, *Revisiting Golden Parachutes*, 102 TAX NOTES 237 (2004).

<sup>185</sup> Note, however, that for reasons connected to their personalities and business views, many managers simply cannot stay on board after an acquisition (even if it is structured as a friendly one) to play second fiddle.

<sup>186</sup> This description fits the United States, where the legal environment is considered strict and, therefore, restrictive of the most lethal opportunities for managerial consumption of private benefits such as massive self-dealing. See, e.g., Andrey Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737 (1997); Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Governance*, 58 J. FIN. ECON. 3 (2000).

<sup>187</sup> It is a widely-acknowledged fact that managers approaching retirement age are more eager to sell their firms. See, for instance, the famous insinuation made by the court in *Smith v. Van Gorkom*, 488 A.2d 858, 866 (Del. 1985) ("It is noteworthy in this connection that he was then approaching 65 years of age and mandatory retirement.").

<sup>188</sup> More generally, when some side-payments are possible, shareholders can calibrate incentive pay so that only high-value bids will be accommodated by management. If  $P_s$  denotes premiums paid to the entire shareholder body (including the manager),  $P_m$  denotes the direct side-payment to the manager,  $PB$  denotes the private benefits that the manager enjoys from her stint at the firm, and  $\alpha$  denotes the manager's fractional holding after the incentive compensation, then only bids that meet the following conditions will be acceptable to the manager:

$$P_s \geq \frac{PB - P_m}{\alpha}$$

concert. Under those circumstances, the theory presented in this Article is no more demanding of market participants than any supply-side theory. Recall that supply-side explanations assert that firms differ and therefore each firm (or, perhaps more realistically, each firm's investment banker) decides whether takeover defenses are suitable or not.

This decision by the issuer or its underwriter, under any supply-side theory, must take into account the costs and benefits of adopting takeover defenses, as well as the anticipated takeover frequency and premiums paid for unshielded and shielded firms. Adding the demand-side theory to the mix does nothing to change this evaluation process. However, takeover diversion from shielded to unshielded firms increases the benefits of going public unshielded. Investment bankers or issuers do not have to acknowledge the sources of such phenomena in order to make the right choice. When market participants develop a professional hunch or actually measure the benefits of going public without defenses, the unnoticeable influence of demand forces is already present. Demand forces tilt the benchmark so that being unshielded offers more benefits than would be the case in the absence of demand-side effects.

There is, however, a more complicated scenario. As discussed, demand-side forces may shed light on issuers' diverse antitakeover practices, even if supply-side explanations are not particularly compelling. In such a scenario, all firms in a certain market sector have similar preferences regarding defenses at the stage of going public. This scenario is important to consider since the empirical literature could find no correlation between a firm's relevant characteristics and defense adoption or rejection trends.<sup>189</sup> Interestingly, the absence of supply-side forces does not undermine the demand-side theory. Takeover diversion still erodes the benefits of going public with defenses and intensifies when more firms adopt defenses. It is therefore possible that at some point, when only a fraction of the market has shields, the benefits of going public with shields will be equal to the benefits of going public without shields.

However, recall that in the absence of supply forces, all firms share similar characteristics at the stage when they go public. This means that with the right fraction of defenses in the market, *all* firms (and not only the marginal firm at the point of intersection between supply and demand) are indifferent to adopting or rejecting defenses at the IPO stage.<sup>190</sup> If this pecu-

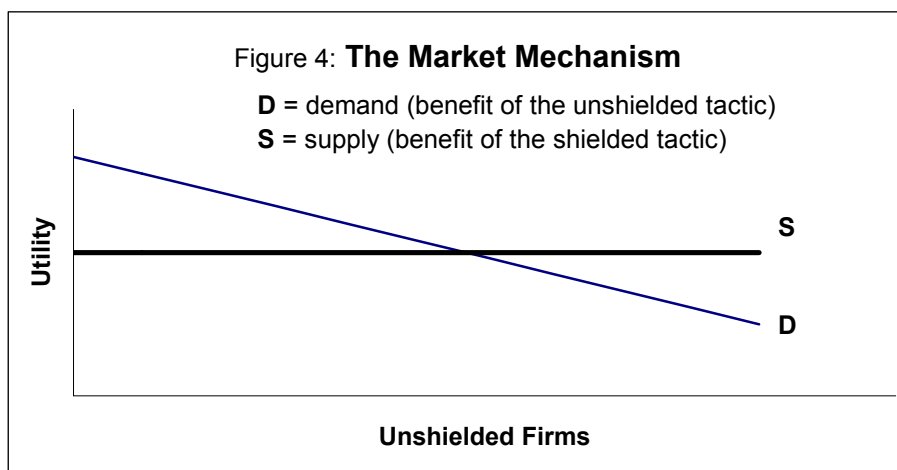
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<sup>189</sup> Moreover, as mentioned above, recent empirical findings indicate that this scenario is highly realistic. See Bates et al., *supra* note 23, at 3 ("Average target shareholder wealth effects are statistically equivalent for firms with and without classified boards across each of the modeled bid outcomes. Additional analysis in a multivariate setting, controlling for bid and target firm characteristics, yields similar results.").

<sup>190</sup> If this is the case, then it is no wonder that the vast body of empirical research has never been able to provide a clear answer as to whether takeover defenses are harmful or beneficial to shareholders. See, e.g., Anup Agrawal & Gershon N. Mandelker, *Large Shareholders and the Monitoring of Managers: The Case of Antitakeover Charter Amendments*, 25 J. FIN. & QUANTITATIVE ANALYSIS 143 (1990);

liar eventuality does occur, how firms decide whether to adopt or reject defenses so that the market reaches the right balance becomes enigmatic, especially if market participants are unaware of the demand-side forces.<sup>191</sup>

Interestingly, a simple evolutionary process leads the market to the stable state where only some of the firms adopt defenses at the IPO stage, even if at that stage all firms are quite similar in terms of their preferences. In Figure 4, below, the familiar downward sloping demand curve is present, the product of takeover diversion. Recall that the demand for unshielded firms reflects the benefits for going public unshielded. This benefit diminishes with an increase in unshielded firms, since fewer shielded firms divert takeover activity and more unshielded counterparts share the diverted benefits. Commensurate with our current assumptions, the supply curve in Figure 4 is entirely flat, reflecting that the costs of going public without shields are similar for all firms. Recall also that the costs of producing an unshielded target are actually the foregone benefits of being shielded. The supply curve for unshielded firms therefore also represents the benefits derived by each firm in adopting defenses.



DeAngelo & Rice, *supra* note 71; Gregg Jarrell & Annette Poulsen, *Shark Repellants and Stock Prices: The Effects of Antitakeover Amendments Since 1980*, 19 J. FIN. ECON. 127 (1987); Scott Linn & John McConnell, *An Empirical Investigation of the Impact of Antitakeover Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361 (1983); Victoria McWilliams & Nilanjan Sen, *Board Monitoring and Antitakeover Amendments*, 32 J. FIN. & QUANTITATIVE ANALYSIS 491–505 (1997).

<sup>191</sup> Perhaps the following analogy would be helpful. When car manufacturers decide on the location of the gas tank intake, they should take into account that approximately 50% of the fueling spots in gas stations fit left-side intakes and 50% fit right-side intakes. If manufacturers fail to pay attention to this fact, much discomfort may result to some of the drivers (those who purchased a car with an intake of the type with which the market is saturated), as they will have to wait for their turn in long lines or maneuver around the pumps causing delays to all drivers. However, as long as the market is more or less at an equilibrium, all drivers (and manufacturers) are indifferent to having (or producing) a left-side or right-side intake. Assuming this indifference, it would be interesting to identify the mechanism that keeps the market at equilibrium.

As in the previous figures, the intersection of the supply and demand curves marks the point at which the diversion of takeover activity has eroded the benefits of defenses such that only part of the market should adopt defenses in equilibrium.<sup>192</sup> To illustrate how this can happen when all firms share the same preferences, let us first assume that when a given IPO-stage firm enters the market, all incumbent targets have takeover shields. The spot on the graph reflecting this state of the market is  $X = 0$ , since the x-axis charts the number of unshielded firms in the market. In this state, it is wise for a firm going public not to adopt shields. The reason is that at  $X = 0$ , the demand curve, representing the benefits of being unshielded, tops the supply curve, which represents the benefits of being shielded. The issuer or its professional advisors (investment bankers, etc.) may make this decision without considering the argument of takeover diversion and demand-side forces. All that is necessary for making this decision is a familiarity with the market and the potential M&A activity for each unshielded and shielded type of firm. Investment bankers, for example, cater to both IPO stage firms—as their underwriters—and for seasoned firms—as advisors in their M&A activity. They are well equipped to sense or calculate takeover premiums and frequencies as well as overall firm-performance measures for both shielded and unshielded firms. Thus, articulated takeover data processing conducted by research departments, or professional hunches or both allow professionals to estimate if takeover defenses are beneficial or harmful at a certain point of time without being aware of the demand-side forces and takeover diversion.

Now let us assume that another firm is about to go public and has to decide whether or not to adopt shields after the former IPO stage firm decided to go public without shields. By now, the picture is slightly different because the market is no longer at  $X = 0$ . Nevertheless, the second firm will also reject defenses, since being unshielded still provides more benefits than going public with shields. This is manifested in Figure 4 by the fact that demand still tops supply. But as more firms going public receive the same advice and reject shields, the market gradually moves to the right on the X-axis, with the number of unshielded firms increasing. Firms going public will reject adopting defenses until the point at which demand intersects with supply. At the point of intersection, takeover adoption or rejection makes no difference, and market professionals cannot and should not develop any hunches with regard to the desirability of defense adoption. Moreover, as long as the market maintains this state, takeover defenses should not be adopted or rejected in any sort of systematic manner, so as to both serve the benefit of the individual target and preserve the market equilibrium.

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<sup>192</sup> If supply and demand do not intersect, defenses are either entirely harmful or entirely beneficial for all firms. This result is commensurate with the arguments of the classic literature. See *supra* Part III.A.

Furthermore, any shift back to the left side of the X-axis in Figure 4 would activate the market mechanisms discussed above. In the same gradual process described above, the market would slide back on the demand curve to the point of intersection between supply and demand. This process, as can be expected, would be mirrored for any shift to a point to the right of the intersection. To illustrate this, let us consider the case of a firm that goes public when all other available targets are unshielded. The firm's advisors would estimate that it is better to be shielded when all others are unshielded. This state is reflected in Figure 4 as supply tops demand. Once again, there is no requirement that market experts identify that the relative advantage of being shielded stems from, among other things, the fact that all firms are unshielded. Following the first firm, other firms will go public with shields, moving the market to the left of the X-axis, where fewer of the firms are unshielded, until the point of intersection. Instead of sliding down the demand curve, as described in the previous example, here the market climbs up to the equilibrium. The point of intersection is stable in the sense that market mechanisms will correct any deviation through one of the two processes discussed above.

This explanation may also elucidate another mystery surrounding the antitakeover practices of IPO-stage firms. As Coates reports, throughout the 1990s, defense adoption among IPO-stage firms grew dramatically. Coates argues that this tendency may have been the result of a beneficial learning process among lawyers handling IPOs.<sup>193</sup> But the evolutionary process described above proposes quite a different explanation, much more critical of current legal counsel.

The literature argues that underwriters serve as gatekeepers against the incorporation of improper governance terms in the charters of public firms.<sup>194</sup> If issuers insist on such terms, the underwriters penalize them by reducing their valuation, which, in turn, prevents the issuers from making the wrong choices. However, if firms are similar in their takeover defense preferences, as Coates suggests,<sup>195</sup> and if the market is at the point of supply-and-demand intersection—where all firms are indifferent between defense adoption and rejection—then underwriters' valuations of issuers would not fluctuate with any defense-adoption or rejection decisions.<sup>196</sup>

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<sup>193</sup> Coates, *supra* note 6, at 1379, 1383 (suggesting that high profile events in the 1990s made Silicon Valley law firms adopt the antitakeover practices of their New York peers).

<sup>194</sup> Jensen & Meckling, *supra* note 10.

<sup>195</sup> Coates, *supra* note 6, at 1385 (interpreting the empirical findings about firm similarity to suggest that defenses are optimal for all firms).

<sup>196</sup> This conclusion is not valid if the advantages of defenses are based on the private-benefits-of-control theory. Recall that under this supply-side theory, in equilibrium the pre-IPO owners are indifferent between adopting and rejecting defenses, but the valuation of firms adopting defenses will be lower than the valuation of firms rejecting them. The reason for this is that under this supply theory, the benefits accrued due to defenses are not reflected in the market value of the firm, since they accrue privately to the managerial team and not to the public shareholders. Note that the private-benefits theory

The issuers' legal counsel may interpret this underwriter indifference to the defenses question as a sign that defenses are always benign factors in a firm's valuation,<sup>197</sup> while in fact this is true only when the market is at or close to the equilibrium. Hence, counsel may always advise their clients to adopt defenses at the IPO stage. The managers of the issuers would favor such advice because adopting defenses does not harm the valuation of the firm and only benefits the managers in helping them hold onto their precious positions.

This systematic legal advice, however, tilts the market from the equilibrium. The market becomes saturated with shielded targets that divert takeover activity to unshielded peers, making defense rejection a more favorable strategy. At first, the harm to the adopting firms is unnoticeable, since the process is gradual and especially harmful only when the market is extremely off-balance. Eventually, however, when the costs of going public without defenses are much higher than the benefits (reflected by a sharp diversion between supply and demand), the harm becomes salient. Finally, market participants will identify that foregoing defenses is the more favorable strategy and will launch the process that will push the market back to the point of equilibrium by systematically opposing defenses.

It is noteworthy that the process above refers to defenses as though their adoption is possible only before an IPO. However, the discussion does not deal with all possible types of antitakeover measures, but, rather, only with antitakeover charter provisions. The key difference between these and any other takeover measure and maneuver is that antitakeover charter provisions require shareholder consent. Boards can adopt unilateral antitakeover measures that do not require shareholder consent at any stage beginning with, first and foremost, poison pills.<sup>198</sup> The ease with which firms can adopt a poison pill is such that one scholar argued that any target without a poison pill actually has a "shadow pill" since it can easily adopt one at any time.<sup>199</sup> Thus, it is almost impossible to speak about differences in the actual antitakeover protection of different firms when unilateral takeover defenses are at stake.

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can explain the institutional shareholders' disapproval of defense adoption in seasoned firms. While defenses are priced at the IPO stage and some issuers nevertheless choose to adopt them, their adoption hurts the value of the firm later on for the public shareholders, who do not receive compensation for this harm. For a discussion that most clearly presents the question of institutional investor preferences regarding defenses, see Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003).

<sup>197</sup> In Merton Miller's jargon, it means that takeover defenses are innocuous or "neutral mutations" in the design of corporate securities. Merton Miller, *Debt and Taxes*, 32 J. FIN. 261, 273 (1977).

<sup>198</sup> Theoretically, shareholders can install at the IPO stage a charter provision that forbids adopting a poison pill, but practically no firm has such an explicit provision, and only few firms have an implicit restriction. Daines & Klausner, *supra* note 6, at 85 ("Furthermore, we find that no firms adopt charter terms committing themselves to avoid subsequent adoption of ATPs . . .").

<sup>199</sup> Coates, *supra* note 24.

Nevertheless, unilateral takeover defenses are only the first layer of defenses. Antitakeover charter provisions, and, primarily, charter provisions that create staggered boards, clearly add significant antitakeover potency to the target.<sup>200</sup> These effective charter provisions may be included in the charter before going public or added down the road as a charter amendment requiring the consent of both the board and the shareholders.<sup>201</sup> However, in practice, since the early 1990s, decisions regarding antitakeover charter provisions that are made at the IPO stage have hardly ever been modified at a later stage.<sup>202</sup> As noted by Coates,

[T]he moment prior to going public is the one time at which U.S. companies have been able with certainty to reduce their legal takeover vulnerability . . . . Only at the IPO stage does a company continue to have the ability to choose different types and amounts of defenses that will regulate hostile bids for the life of the company.<sup>203</sup>

This is true with respect to both shield removal (which is quite understandable since managers have veto power over charter amendments) and decisions to adopt shields.<sup>204</sup>

The inability of firms to deviate from the status quo that is set at their IPO is part of a more general phenomenon of corporate stagnation, which I have analyzed elsewhere.<sup>205</sup> Corporate stagnation means that corporate governance structures and provisions are sticky in the sense that mature firms have very restricted ability to remove existing arrangements or add new ones. One side of this equation—the inability to remove existing arrangements—is quite understandable in the context of antitakeover charter provisions. Since any amendment to the corporate charter requires the consent of managers and shareholders alike, managers will be reluctant to part with a provision that protects their positions and related benefits. Therefore, it is not surprising that managers rarely cave in to shareholders' advisory resolutions to declassify the board, which have been gaining considerable support among shareholders since the beginning of the 1990s.<sup>206</sup>

A firm's inability to add new takeover defenses after the IPO stage (that therefore require shareholder consent) is more complicated. The em-

<sup>200</sup> Bebchuk, Coates & Subramanian, *supra* note 43.

<sup>201</sup> See DEL. CODE ANN. tit 8, § 242(b) (1991); REV. MODEL BUS. CORP. ACT § 10.03(a)-(c) (1985).

<sup>202</sup> Coates, *supra* note 6, at 1308. Coates then continues to review the rarity of new defenses being adopted post-IPO.

<sup>203</sup> Coates, *supra* note 6, at 1308.

<sup>204</sup> See, e.g., Bebchuk, *supra* note 88, at 723.

<sup>205</sup> See Hannes, *supra* note 15. Other papers discuss the hardships involved in reversing existing arrangements. See Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1410-13 (1989) (discussing the impact of managers' control over charter amendments).

<sup>206</sup> See Coates, *supra* note 36, at 861.

pirical evidence discussed above indicates that shareholders are unwilling to renegotiate a decision to reject shields made at the IPO stage. There are four possible reasons for the fact that shareholders prefer to make their decisions at the IPO stage and not thereafter. First, a decision following the IPO stage entails costly solicitation and raises problems of joint action among shareholders.<sup>207</sup> Second, and related, a decision at the IPO stage is made for the public investors under the scrutiny of underwriters, and it is therefore usually considered an informed decision (although underwriters have to consider future market conditions).<sup>208</sup> At the midstream stage, a decision to add defenses requires a charter amendment, which entails activating the flawed voting mechanism.<sup>209</sup> Such a decision made by the scattered shareholders body is less likely to be informed and beneficial than a decision overseen by the underwriter. Third, if a firm adopts defenses to preserve the private benefits of control<sup>210</sup> and the decision has an adverse effect on firm value, shareholders would want such a decision to be made at the IPO stage *before* they make their investment, not afterwards. After making the investment shareholders would not be compensated for the adverse change, while prior to making the investment the share price would include a discount that reflects the harm. Finally, while the decision at the IPO stage is made before the firm is exposed to the market for corporate control, it is possible that the midstream managers who are most aggressive in their demand to add defenses may be the ones who most fear takeovers due to poor performance. Shareholders might, therefore, reasonably adopt a policy that prevents them from being influenced by managers' biased explanations down the road.

Taken together, the above arguments shed light on the current behavior of institutional investors.<sup>211</sup> These investors adopt voting protocols that restrict the ability of managers to add antitakeover charter provisions down-

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<sup>207</sup> See CLARK, *supra* note 53, at 790–96 (discussion of shareholders' collective action problems); EASTERBROOK & FISCHER, *supra* note 92, at 66–67 (same).

<sup>208</sup> *Id.* at 32–34 (discussing “latecomer” terms).

<sup>209</sup> See Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989); Bebchuk, *supra* note 205, at 1412.

<sup>210</sup> Bebchuk, *supra* note 137.

<sup>211</sup> Institutional investors are the most potent force among the scattered public shareholder body. See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise and Limits of Shareholder Voice*, 39 UCLA L. REV. 811 (1992) (presenting institutional investors' ability to monitor managers); Gordon L. Clark & Tessa M. Hebb, *Pension Fund Corporate Engagement: The Fifth Stage of Capitalism*, 59 RELATIONS INDUSTRIELLES 192 (2004) (describing the promise of the activism of pension funds, the leading force among institutional investors). *But cf.* Stephen M. Bainbridge, *Shareholders Activism and Institutional Investors* (UCLA School of Law, Law-Econ Research Paper Series No. 05-20, 2005) available at [http://papers.ssrn.com/paper.taf?abstract\\_id=796227](http://papers.ssrn.com/paper.taf?abstract_id=796227) (arguing that institutional investor activism is rare and limited, and that activist investors pursue agendas not shared by and often in conflict with those of passive investors).

stream,<sup>212</sup> but, at the same time, take part in IPOs that adopt defenses without any disapproval.<sup>213</sup>

#### V. ALTERNATIVE EXPLANATIONS (NON-MARKET-BASED EXPLANATIONS)

Thus far, all existing theories presented in this Article regarding the adoption and rejection of takeover defenses dealt in market terms. And, except for the traditional theories, which imply a highly stringent nature of the market, all the theories were factors within the unified market explanation proposed by this Article. It is important, however, to mention three alternative explanations that were raised by the authors of the three empirical papers on IPO-stage antitakeover trends. These explanations are non-market explanations, and in this Section, I briefly describe them and contrast them with the market-for-takeover-defenses argument.

##### A. *Daines and Klausner's Study and the Suggestion that the Market Misprices Defenses*

Recall that Daines and Klausner collected data on the antitakeover trends of IPO-stage firms during the period between 1994 and 1997, with the intention of including IPOs backed by highly professional investors such as venture capitalists.<sup>214</sup> They found that IPO firms diverge greatly with respect to their antitakeover practices, but could not explain this divergence.

Daines and Klausner proposed the possibility, which they subsequently seem to refute, that the IPO process is flawed and incapable of pricing the harmful effects of antitakeover charter provisions. Evidently, this is a non-

<sup>212</sup> See Bebchuk & Hamdani, *supra* note 62, at 517 (discussing institutional investors' voting practices).

<sup>213</sup> See Lucian A. Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 126–28 (2001) (discussing institutional investors' opposition to adoption of takeover defenses by way of charter amendments); John C. Coates, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 860–62 (1999) (same); Michael Klausner, *Institutional Shareholders, Private Equity, and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003) (describing institutional investors' indifference to defenses adopted at the IPO stage and their opposition to midstream adoption by seasoned firms). It should be noted, though, that the above description fits firms with dispersed ownership status. For the period preceding dispersal of ownership, the question is how shareholders can trust the managerial team that owns much of the stock to sustain a decision not to adopt shields that was made at the IPO stage. Since the empirical evidence is quite unambiguous regarding the adherence of even pre-dispersion stage firms to decisions made at the IPO stage and the fact that they do not change their charters, there are two possible answers to this question. First, in many firms, even before ownership becomes dispersed, there are powerful non-managerial shareholders (such as venture capital funds) that do not allow managers to deviate from the IPO bargain. Second, even if the managerial team is powerful enough to change the corporate charter by itself, it may be apprehensive about the investor rage that would ensue should the rules of the game be changed so soon after the public offering.

<sup>214</sup> Daines & Klausner, *supra* note 6, at 92.

market explanation, which deviates from the prediction of the market-for-antitakeover-defenses explanation. Under this non-market theory, pre-IPO investors, especially managers, collectively abuse the public shareholders by selling securities with defective features at full price. This market failure explanation argues against the well-established understanding of the IPO market's accurately pricing corporate governance mechanisms.<sup>215</sup> Pre-IPO owners, according to Daines and Klausner, entrench themselves as managers by means of antitakeover charter provisions, while the market fails to penalize them by discounting the value of their firms for this inefficient behavior.

Daines and Klausner also note, however, that their empirical findings cast serious doubt on this interpretation. Although many firms adopt defenses, many others reject them; indeed, at least 50% of the firms in their sample did not adopt harsh defense measures. If defective governing structures were to yield advantages for managers without harming the firm's value, then all firms would use them. Daines and Klausner therefore argue against the suggestion they have raised, stating:

This interpretation, however, is also problematic . . . . [I]f ATPs [antitakeover provisions] are not fully priced, why don't more firms adopt strong ATPs? Assuming that management would generally favor ATPs, all things being equal, the fact that strong ATPs are not universally adopted implies that there is some *constraint* on their adoption . . . .<sup>216</sup>

And where Daines and Klausner conclude, the market for takeover defenses begins. Daines and Klausner search for some elusive constraint that prevents all firms from adopting defenses. The demand forces of the market for takeover defenses in fact impose the very constraint Daines and Klausner seek. The more firms that adopt antitakeover provisions, the more valuable it becomes to remain unshielded. Eventually, at some point, the market becomes too saturated to adopt additional defenses.

#### *B. Coates' Study and the Failure of the Market for Legal Advice*

As discussed above, Coates gathered two samples of IPO firms: the first sample went public between 1991 and 1992 and the second in 1998. To start with, Coates reiterates the Daines and Klausner findings by identifying high variance among the firms that go public in relation to those who adopt defenses. Coates, like Daines and Klausner, refutes some supply-side theories that might explain why defenses are better suited to some firms than to others.<sup>217</sup>

Coates then offers his explanation, which extends beyond the logic of the market for takeover defenses. Specifically, he argues that the divergent

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<sup>215</sup> See Jensen & Meckling, *supra* note 10.

<sup>216</sup> Daines & Klausner, *supra* note 6, at 113 (emphasis added).

<sup>217</sup> Coates, *supra* note 6, at 1335.

firm behavior stems from a failure in the market for legal advice.<sup>218</sup> Coates found that law firms are always either pro-defenses or anti-defenses, in disregard of the different characteristics of their clients. He therefore argues that the preferences of lawyers, rather than the requirements imposed by clients, determine whether a firm goes public with or without defenses. This means, according to Coates, that some law firms are simply wrong in the advice they give, and Coates makes it quite clear that he thinks that the optimal solution for all firms is to adopt takeover defenses.<sup>219</sup>

However, Coates' empirical findings regarding law firms' systematic preferences do not contradict the logic of the market for takeover defenses. Even if Coates is right and the different characteristics of firms do not dictate their takeover defenses decision, this may simply stem from weak supply forces and the fact that all firms derive similar benefits from adopting or rejecting defenses. Nevertheless, demand forces still prevent all firms from adopting defenses, since the advantages dwindle when many firms opt for adoption of defenses. At some point, with some fraction of the market adopting defenses, it no longer matters for any given firm whether or not it adopts defenses.<sup>220</sup> Moreover, Part IV of the Article posits a market mechanism that leads to and preserves this outcome. It is quite possible that some lawyers always advise their clients to adopt defenses, while others always give the opposite advice, and the market sits on the point of intersection between demand and supply.

Moreover, as long as this equilibrium persists, both proponents and opponents of defenses can, in good conscience, continue to give uniform advice to their clients, because it does not matter if a firm is shielded or not. Simply put, any legal advice will do when the market is in a state of equilibrium.<sup>221</sup> Interestingly, Coates mentions another empirical finding, that

<sup>218</sup> *Id.* at 1336.

<sup>219</sup> Coates has launched several attacks on the conventional academic connotation that takeover defenses are harmful and raise agency costs. *See, e.g.,* Coates, *supra* note 24. And as Coates mentions in his work, he was a partner in the firm that is credited with the invention of the poison pill. Coates, *supra* note 6, at 1301. However, Coates was also willing to update his own beliefs when his empirical findings identified high costs for defense adoption. *See* Bebchuk, Coates & Subramanian, *supra* note 43; *see also* Lucian A. Bebchuk, John C. Coates & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Further Findings and a Reply to Symposium Participants*, 55 *STAN. L. REV.* 885 (2002) (reinforcement of the previous study that includes a critical theoretical and empirical account of staggered boards).

<sup>220</sup> Note that this scenario is a bit different from the one where the supply curve is not flat and firms have different antitakeover preferences, in which case, only the marginal firm is indifferent to defenses adoption. When firms are similar in preferences, all firms are indifferent, but still only some of them adopt defenses.

<sup>221</sup> If legal advice drives the market to a severely distorted position, then the market professionals will have to expose the problem. For example, the research department of an investment bank can expose the abnormal returns of firms that chose one tactic and thus recommend that new firms systematically adopt or reject defenses depending on what was done by the earlier firms with these abnormal returns. Market forces can thus overcome the deviation, and a state of equilibrium will prevail.

many lawyers craft either illegal or ineffective defenses. In Coates' view, this is an indication of both the extent to which lawyers are frequently ill equipped to deal with defense issues and the fact that clients are easily persuaded to follow poor advice. Ironically, minimal attention to defense issues may be warranted, because it may be irrelevant whether or not a firm adopts defenses when the market is in a state of equilibrium and thus it is beneficial not to waste long billable hours deliberating the issue. As long as there are enough players in the market, such as underwriters, who will not tolerate substantial deviation from the market's equilibrium point, lawyers can afford to remain rather ignorant with regard to the advantages or disadvantages of defenses, and free ride the market for takeover defenses.

*C. Field and Karpoff's Study and the Assertion that Managers Abuse the Pre-IPO Investors Who Are Not Management*

As described earlier, Field and Karpoff's sample of takeover defenses at the IPO stage focused on the years 1988 and 1992.<sup>222</sup> They, too, found that firms diverge in their attitudes toward defenses.<sup>223</sup> Interestingly, Field and Karpoff argue that firm heterogeneity explains the divergent antitakeover behavior, but not the type of heterogeneity that is part of the supply-side forces in the market for takeover defenses. They found that IPO firms install more defenses if they have managers who are not well monitored by their non-managerial pre-IPO investors and when the managers lack incentives to operate well.<sup>224</sup> Put differently, Field and Karpoff posit that even though the market discounts the harmful use of defenses, pre-IPO managers nevertheless use defenses to their advantage.<sup>225</sup> This behavior, which takes place unless managers are carefully monitored, reduces the firm's value. In turn, it harms the pre-IPO investors who are not on the managing team and therefore suffer from a low valuation of the company without enjoying the benefits enjoyed by management from the adoption of defenses. These sub-optimal results, according to Field and Karpoff, stem from a market failure in monitoring the managers of firms prior to their going public and can therefore also be labeled a non-market explanation for takeover defenses divergences.

The two other empirical studies of takeover defenses raise some doubts regarding this understanding. First, Daines and Klausner found in their sample that the higher the level of management ownership, the more severe the defenses adopted, which completely contradicts the findings of Field

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<sup>222</sup> Field & Karpoff, *supra* note 6, at 1859.

<sup>223</sup> *Id.* at 1884.

<sup>224</sup> *Id.* at 1871 (stating that among IPO firms, the likelihood of a takeover defense is positively related to managers' compensation, board size, and whether the CEO is also board chairman, and negatively related to managers' shareholdings).

<sup>225</sup> *Id.*

and Karpoff.<sup>226</sup> Thus, according to Daines and Klausner, the *more aligned* the incentives of managers are with the interests of shareholders, the more likely those firms are to adopt defenses. Second, Daines and Klausner examined a large control sample of IPO firms with venture capital and professional LBO investors.<sup>227</sup> Those firms did not have fewer defenses than other firms, which refutes the argument that rigorous monitoring leads to fewer defenses.<sup>228</sup> Finally, Field and Karpoff argue that IPO-stage firms suffer from agency costs, which then lead to the adoption of defenses. They do, however, concede that these problems are not as severe as the problems experienced by more seasoned firms in which ownership is highly dispersed and monitoring of management therefore much harder. Accordingly, Field and Karpoff stress that, in their sample, the rate of IPO-stage firms that adopted defenses was much lower than the rate of mature firms that adopted defenses during the 1980s.<sup>229</sup> This finding, however, corresponds only with the early period of the Field and Karpoff sample; since then, the early 1990's defense-adoption rates for IPO-stage firms have surged and surpassed those of mature firms. This development is problematic and does not fit the Field and Karpoff argument.<sup>230</sup>

But, these concerns aside, it is interesting to note that the Field and Karpoff argument does not contradict the theory proposed in this Article. Due to distorted managerial incentives, some firms have higher preferences for defenses. In turn, the presence of many shielded targets enhances the value of the remaining unshielded firms, to the point where the decision-maker of the marginal firm is indifferent to adoption or rejection of defenses. Diversion of takeover activity thus leads to an equalization of the pros and cons regarding being shielded or unshielded for the marginal firm.

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<sup>226</sup> Daines & Klausner, *supra* note 6, at 109–10. Field and Karpoff's results, on the other hand, are not unanimously significant in all their regressions. See the results of their sensitivity tests in Field & Karpoff, *supra* note 6, at 1870.

<sup>227</sup> Daines & Klausner, *supra* note 6, at 93.

<sup>228</sup> Recall that Field and Karpoff followed the firms in their sample for five years after the IPO stage in order to measure the impact of defenses on takeover activity and premiums. Although five years may be too short a period from which to draw absolute conclusions, many of the firms (168, or 16.5% of the sample) were acquired during this period. Recall that they found that takeover probability during the five-year period was 16.8% for unshielded firms and 11.4% for firms with at least one defense. Field & Karpoff, *supra* note 6, at 1877. Field & Karpoff did not find, however, that defenses raise takeover premiums. This seemingly contradicts the supply-side argument regarding bargaining power. However, demand-side forces may complement any other supply-side theories, such as the private benefits of control. See *supra* Part III.B.4. In any event, the Field and Karpoff study suffers from at least one weakness considering that, unlike other empirical studies that focus on the gravity of defenses, they focused on the number of defenses, which is a cruder measure of the potency of defenses. Field & Karpoff, *supra* note 6, at 1859.

<sup>229</sup> See Field & Karpoff, *supra* note 6, at 1861 (comparison of frequencies of takeover defenses in IPO and seasoned firm samples).

<sup>230</sup> *Id.* at 1885 (“Since most firms raise equity capital from nonmanagerial institutions and individuals before the IPO stage, their equity agency problems are different from those of seasoned corporations only in degree, not in kind.”).

## VI. CONCLUSION

The market for takeover defenses is a metaphor that helps to consolidate existing explanations for takeover defenses and formulate new ones. When reframed in market terms, traditional arguments for and against defenses are revealed as stringent in nature. Other existing theories, which make much sense despite their lack of empirical verification, are unified under the umbrella of supply-side forces. If the decision to go public without defenses is considered a decision to produce an unshielded target, then these supply-side explanations involve the producers. Each of these existing theories concentrates on the different characteristics of issuers and shows why they may make some of the issuers better-suited to adopting defenses. Finally, the takeover-defenses market metaphor requires a supplementary argument, one that focuses on market willingness to pay—i.e., the forces of demand that have been neglected up until now in the literature.

On the demand-side, the more firms producing unshielded targets (and, therefore, the fewer firms adopting defenses), the lower the price the market will be willing to pay for the unshielded product. Not only do defenses prevent takeovers, they also divert takeover activity to unshielded targets. Put differently, there is a downward sloping demand curve for unshielded targets.

The combined forces of supply and demand may cause the market to reach an equilibrium in which only a fraction of the firms adopt defenses. This may shed some light on current empirical findings on divergent issuer choice in adopting defenses. The theory put forth in this Article also yields some empirical predictions. For instance, industries with extremely high levels of defenses may (although certainly not necessarily) be indicative of out-of-equilibrium cases, and changes in the defenses ratio in such industries should be discernible over time. More generally, the ratio of defenses in an industry should be mean-reverting: if the market deviates from the equilibrium, it should correct itself under severe circumstances. The theory therefore also predicts that the recent period when most IPO firms adopt defenses, as reported by Coates,<sup>231</sup> will precede a period in which most IPO firms will reject defenses. In any event, a more sophisticated empirical agenda is also warranted.<sup>232</sup>

The main normative implication of this Article lies in the fact that recognizing the demand forces exposes a new type of positive externality.<sup>233</sup>

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<sup>231</sup> See Coates, *supra* note 6, at 1376.

<sup>232</sup> The essence of this empirical agenda is to derive the slope of the demand curve from the shifts in the supply curve over time or across market sectors (a simultaneous-equation empirical inquiry). Sharon Hannes, *A Demand-Side Theory of Antitakeover Defenses*, 35 J. LEGAL STUD. 475 (2006) (suggesting a broader empirical agenda).

<sup>233</sup> Elsewhere, I suggest that a contradicting negative externality might also surface as a result of takeover diversion. In a quest to expand, bidders may target even firms that are run efficiently. Consequently, even a firm with perfect management performance but which is left unshielded and vulnerable to takeovers may be raided. And, if takeover diversion exists, this fear becomes more acute when peer

Firms that adopt defenses benefit their unshielded peers by creating takeover diversion and, in turn, higher takeover frequency and additional takeover premiums. The effect of this positive externality would be to cause IPO-stage issuers to adopt fewer takeover defenses than they would otherwise. It is unclear, however, if this is a positive effect from a social welfare point of view. The literature has so far identified few possible negative externalities to the decision to adopt shields, including, for instance, harsh effects on employees.<sup>234</sup> If these effects are substantial, then society may have an excess of takeover defenses, and the contradictory effect exposed by this Article is a push in the right direction.

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firms adopt defenses. As a result, the virtues of a takeover market for unshielded firms may diminish as the number of potential shielded targets increases. See Sharon Hannes, *The Hidden Virtue of Antitakeover Defenses*, 24 CARDOZO L. REV. 1903, 1906–08 (2003). See also Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597 (1989) (discussing overpayment by bidders). While, theoretically, this negative externality explanation is sound, I doubt if it is substantial. Unlike the positive externality that is described in this Article, which takes place mostly within one industry section, this effect may run across industries and therefore dissolve.

<sup>234</sup> Shleifer & Summers, *supra* note 156.

## APPENDIX

To focus its inquiry, this Appendix analyzes a stylized model and makes some simplifying assumptions to emphasize the demand side of takeover defenses, i.e., the price the market is willing to pay for unshielded targets. First, in order to abstract away from supply-side considerations that are based on the heterogeneity of firms, I assume that all firms are similar at the stage that they go public. Therefore, they all have to forego similar levels of benefits when going public without defenses. Second, I assume that the potential benefits of defenses are derived only from the ability of shielded firms to extract high takeover premiums from bidders (but any other benefit, such as the ability to protect the private benefits of control, would lead to similar conclusions). Finally and most important, a key feature of the model is that there are too few potential bidders in the industry to guarantee an auction for all targets. Diversion of takeover activity will lead to a rise in the stock price of unshielded targets only if one assumes, as I do, that the bidder-pool is limited so that an auction would not necessarily emerge without the diverted activity (or, alternatively, that the diverted opportunity is highly precious). I offer support for the plausibility of this key assumption in the discussion section.

Now consider a framework with two potential takeover targets,  $T_1$  and  $T_2$ , and two bidders,  $B_1$  and  $B_2$ .<sup>235</sup> I model the adoption of antitakeover mechanisms and their effects on subsequent bidding behavior as a two-period game. In the first period, the two target firms decide whether to adopt defenses. Bidders observe this decision and decide in the second period on a bid for the target companies.

In this simple model, a firm consists of a shareholder and a manager. The shareholder can take one of two actions: she can decide to delegate decision-making regarding a takeover bid to the manager by adopting harsh takeover shields (action  $S$ ) or she can choose to hold on to that power (action  $NS$ ). The manager holds a certain share  $\alpha$  in the firm's stock. To abstract away from standard agency problems, I assume that the manager has no disutility of effort. However, the manager incurs a cost  $c$  from losing her job if the firm is taken over by a bidder in the second period (further on, this fixed cost will be replaced by managerial private benefits that fluctuate with the level of exposure to the market for corporate control). Let us also assume for simplicity that the bidders cannot "bribe" the manager to accept an offer with a low premium, nor will they offer the manager to hold on to her position after the takeover. This implies that the manager will consent

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<sup>235</sup> The main results of this simple model of two bidders and two targets remain in a setting of  $n$  bidders and  $m$  targets as long as one sticks with the assumption that there are not enough bidders (or bidding opportunities) to promise an auction for all targets. For a model with a large finite number of bidders and targets, see Sharon Hannes & Markus M. Mobius, ONE SIZE DOES NOT FIT ALL: DIFFERENCES IN ANTITAKEOVER DEFENSES AMONGST SIMILAR FIRMS (2001) (unpublished manuscript, on file with author).

to a merger only if the premium  $p$  paid by a bidder to the stockholders of the company is sufficiently large. That is:<sup>236</sup>

$$(1) \quad p \alpha \geq c$$

The manager will reject some takeover bids in the second period, which, though profitable to the owner, are costly to the manager. However, the owner, in turn, credibly commits to reject low takeover bids in the second period by irreversibly delegating the decision-making power to the manager. Therefore, the owner might implement an antitakeover mechanism in the first period for strategic reasons.

There is ex ante uncertainty about the bidders' valuations of each of the two target firms. With probability  $q$ , target firm  $T_i$  has a valuation (beyond the stand-alone value of the firm) of  $w > v$  for Bidder  $B_i$  and a valuation  $v$  for Bidder  $B_j$  ( $j \neq i$ ).<sup>237</sup> With probability  $1 - q$ , target firm  $T_i$  has a valuation beyond the stand-alone value of the firm of  $v$  for both bidders. This setup captures the idea that bidders can derive private benefits (for instance, synergy effects) from taking over a target firm, due to a unique characteristic that each target may develop. Both  $w$  and  $v$  are private values for the bidders beyond the stand-alone value of the firm. This also means that a bidder can pay a premium of up to either  $v$  or  $w$ , as applicable. I also assume that each bidder can take over no more than one company.

The second period is subdivided into three sub-periods. In sub-period 2.1, the uncertainty about the bidders' valuations is resolved, and they become common knowledge. In sub-period 2.2, Bidder  $B_i$  makes bids  $b_{ij} \geq 0$  for each of the two target firms  $j$ .<sup>238</sup> In sub-period 2.3, the target firms decide whether to accept a takeover bid and payoffs are realized.

I look for sub-game perfect equilibria of this game and solve through backward induction. In the second period, we have to distinguish between three possible cases.

Case I: *Neither firm adopts defenses.* In this case, both bidders will submit zero bids, regardless of their valuations.<sup>239</sup> We should recall that the bid is defined as the amount exceeding the stand-alone value of the target, which means that the bidder in this case offers the shareholders only the

<sup>236</sup> Assume, for example, that the manager holds only 1% of the company's stock but derives \$10,000,000 from holding on to her position. If this manager has complete discretion whether or not to accept a bid, she will reject an offer that consists of a premium of less than one billion dollars. The manager would receive only 1% of the premium, while foregoing all the benefits attached to her position in the company.

<sup>237</sup> And if  $T_i$  has a valuation of  $w$  for  $B_i$ , while  $T_j$  has a valuation of  $w$  for  $B_j$ , then  $B_j \neq B_i$ .

<sup>238</sup> We do not have to allow bidders not to bid for a company, because they can always bid 0 for a target and bidding is assumed to be costless. Remember that  $b = 0$  means that bidders pay only the market value of the target, without sharing its synergy gains.

<sup>239</sup> In reality, these results stem from the fact that dispersed shareholders do not have the ability to negotiate with the bidders and therefore cannot entertain competition that could drive the price up.

market value of the shares, without any premium. To avoid competition that would drive prices up, assume that Bidder  $B_j$  waits until Bidder  $B_i$  bids for one target, and only then does  $B_j$  place its bid for the other target, and that Bidder  $B_i$  avoids bidding for a target that Bidder  $B_j$  prefers.<sup>240</sup> Hence, both targets will accept one bid each, for zero premiums. Note that the bidders appropriate the entire surplus.

Case II: *Both firms adopt defenses.* In this case, either target firm can be acquired by a bidder only if the bidder's valuation (beyond the stand-alone value of the firm) is greater than  $c/\alpha$ . I assume that  $c/\alpha < w$ . Otherwise, the antitakeover mechanism will prevent *all* takeovers, which cannot be in the interest of the owner. Since for each of the targets, there is a probability  $q$  of being given the valuation of  $w$  by one of the bidders (with said bidder giving a low valuation for the other target), each target will receive one bid  $b_{ij} = c/\alpha$  with a probability of  $q$ .

Case III: *Only one firm adopts defenses.* Without loss of generality, assume that  $T_1$  is protected. To make this case interesting, let us assume that  $c/\alpha > v$ . This implies that a bidder will attempt a takeover only if it makes a high valuation of the target firm. Otherwise, the bidder will prefer to bid for the second firm. In this case, both bidders will compete for target  $T_2$  with a bid of  $b_{i2} = v$ , and  $T_2$  will be sold to  $B_2$  for a premium of  $p = v$ .<sup>241</sup>

Since we have solved the equilibria of the second period sub-games (i.e., the three different cases), we can present the decision-making problem of the target firms as a two-by-two game in the first period. Recall that the shareholders of each target firm can take two possible actions: to either adopt takeover shields ( $S$ ) or retain control ( $NS$ ).

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<sup>240</sup> This means that: (a) Bidder  $B_i$  will place a bid for its preferred target (if such a target exists); (b) Bidder  $B_j$  will not bid for a target that Bidder  $B_i$  prefers (if such a target exists), but, rather, will bid for the other target; and (c) if both (a) and (b) bidding rules do not ascertain the identity of the target to bid for (i.e., no target developed any appealing characteristic for either bidder), then Bidder  $B_i$  will randomize between both targets. Remember that there is no conflict between (a) and (b) bidding rules because, under the game's definitions, a target cannot develop a characteristic that is appealing to both bidders.

<sup>241</sup> Any price below  $v$  does not achieve a Nash equilibrium, because both firms have an incentive to bid  $p+\epsilon$ . If  $B_2$  has a low valuation, the target can actually go to either bidder. If  $B_2$  has a high valuation, it will obtain the target for certain (but will not have to offer more than  $v$ , since the target does not have takeover defenses).

		<b>T<sub>1</sub></b>	
		NS	S
<b>T<sub>2</sub></b>	NS	0, 0	(1-q)v, qc/α
	S	qc/α, (1-q)v	qc/α, qc/α

if  $q < \frac{1}{1+c/\alpha v}$  then Nash is (S, NS) and (NS,S)

The game has the unique equilibrium (S, S) if  $q > 1/(1+c/\alpha v)$  and two Nash equilibria (S, NS) and (NS, S) if  $q < 1/(1+c/\alpha v)$ . The outcome of the simple model is that for intermediate values of  $q$ , defenses prevent some takeovers, but extract a high price from high-valuation bidders.<sup>242</sup> Shareholders' optimal strategy is then dependent on the probability  $q$  of finding a high-valuation bidder in the second period. If that probability is high, then both target firms will prefer takeover defenses, since the shareholders of the target can extract high rents from the potential bidder.

We will see firms adopting both strategies if the probability of finding a high-valuation bidder is not too high (in particular,  $q < 1/(1+c/\alpha v)$ ). In such an environment, some firms can benefit from not adopting takeover defenses because of the resultant competition among bidders.

This competition is the main lesson of the simple model, which demonstrates the fact that defenses not only prevent some takeover activity, but also divert some of it to unshielded firms. The simple model uses a limited framework of two targets and two bidders, but it can be extended to a large number of firms without a loss of generality, as long as there are not enough bidders to guarantee an auction for any single target.<sup>243</sup> Every firm that

<sup>242</sup> Put differently, shareholders will choose to implement antitakeover mechanisms if the manager has relatively few incentives to use them ( $c$  is low). If  $c$  is too high, the manager will prevent all takeovers. In this case, the firm will choose against using any takeover defenses.

<sup>243</sup> See HANNES & MOBIUS, *supra* note 235.

adopts defenses increases the chances that a relatively low-valuation bidder will not be able to take it over, and this, in turn, increases the probability of competition emerging for unshielded targets. Therefore, the more firms that adopt defenses, the higher the benefits to their unshielded peers.

