

## *Federalism and Takeover Law: The Race to Protect Managers from Takeovers*

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Twenty-five years ago, William Cary (1974) published his most lasting contribution to corporate law: his Yale Law Journal article entitled ‘Federalism and Corporate Law: Reflections upon Delaware’—one of the most well-known and widely cited articles in corporate law (Shapiro 1991: 1462). In the article, he argued that Delaware’s reliance on revenues generated from corporate charters had led it to favour corporate managers in crafting its corporate code. Cary believed that managers, often at the expense of shareholders, enjoyed unjustifiably lax constraints with regard to issues ranging from fiduciary obligations to a parent’s treatment of a corporate subsidiary. To stop this harmful ‘race to the bottom’, Cary proposed that Congress adopt ‘federal standards of corporate responsibility’ (1974: 701).

Cary’s sceptical view of state competition has not been widely accepted by corporate law scholars. Indeed, scholars since Cary have largely taken a favourable view of state competition for corporate charters. Ralph Winter (1977), in an influential critique of Cary’s position, argued that state competition for corporate charters leads to a ‘race to the top’ as a result of market constraints on managers’ behaviour. Frank Easterbrook and Daniel Fischel have endorsed and developed Winter’s contention that state competition benefits shareholders (Easterbrook 1984; Easterbrook and Fischel 1991; Easterbrook and Fischel 1983; Fischel 1982). Roberta Romano (1998; 1993a; 1987b) has similarly argued that state competition ensures that corporate law maximizes shareholder wealth. Indeed, Professor Romano labels the federalist structure of corporate law ‘the genius of American Corporate Law’ (1993b).

Several years ago, one of us pursued the route suggested by Cary and developed an analysis of the problems produced by state competition (Bebchuk 1992). That analysis suggested that, with respect to a set of important corporate issues, state

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competition is unlikely to serve shareholder wealth maximization.<sup>1</sup> Rather, the analysis suggested that states might have an incentive to provide rules that are preferred by managers and controllers—and that on these issues the rules preferred by managers and controllers may well be different from what is beneficial to shareholders.

Building on that analysis, we continue in this chapter to examine the contention, articulated by Cary, that there are serious problems with state competition. Our analysis suggests that state competition suffers from important structural problems, and that competition among states is therefore likely to produce troubling results with respect to some critical aspects of corporate law. Cary carefully examined several corporate law issues, such as proxy contests, de facto mergers, fairness in parent–subsidiary transactions, and directors’ duty of care, all hot issues in the 1960s. We will discuss the issues involved in the state competition debate through the lens of takeover regulation, perhaps the most important issue in corporate law in the last two decades.<sup>2</sup> We use takeover law as a case study of the shortcomings of state competition.

Our analysis is organized as follows. Part I will argue that there are strong theoretical reasons to believe that states will have incentives to produce a body of takeover law that excessively protects incumbent managers and restricts hostile takeovers. Because managers play a key role in incorporation decisions, states (especially ones with a large number of already incorporated companies, such as Delaware) will give substantial weight to satisfying managers’ preferences. To be sure, in some areas of corporate law, because managers’ and shareholders’ interests are sufficiently aligned due to various market forces, the rules that managers would like states to adopt are those that maximize shareholder value. But, we argue, in the area of takeovers, this is unlikely to be the case. Because of the value that managers might place on their independence, they may prefer rules that excessively restrict takeovers, notwithstanding that such rules might somewhat reduce share value and make it somewhat more difficult for them to acquire other companies when they wear the acquirer’s hat.

Part II analyses the development of state takeover law and argues that it is consistent with the above theoretical analysis. States have developed a substantial body of rules, including both anti-takeover statutes and judicial decisions permitting the use of defensive tactics, that make takeovers more difficult. We suggest that these

<sup>1</sup> Moreover, state competition for corporate charters might lead to inefficiencies when the interests of not only shareholders but also third parties are implicated by a legal rule (Bebchuk 1992: 1485–95). The present discussion will focus on shareholder wealth.

<sup>2</sup> A parallel debate has been taking place concerning competition among jurisdictions in the international sphere. Some commentators believe that this form of competition is generally beneficial, (Choi and Guzman 1998; 1997; Romano 1998). Others predict harmful effects resulting from such competition (M. Fox 1997). While this chapter focuses on competition among states, the analysis also has implications for international competition among jurisdictions. For reasons explained by Bebchuk (1992: 1507–8), international competition and state competition have similar structural problems. Thus the implication of our analysis is that international competition would not work well with regard to rules governing takeovers.

rules are quite likely to excessively protect managers. To start with, we show that the extent to which these rules restrict takeovers has little support in the policy literature on takeovers. States' relentless effort to come up with new anti-takeover statutes seems to be motivated more by a desire to make takeovers more difficult than by an attempt to address in a cost-effective way some valid policy concerns. And the latitude that states have given to defensive tactics has surpassed what even the strongest supporters of defensive tactics have advocated. Furthermore, states have provided managers with more anti-takeover protections than shareholders seemed to have been willing to give them. Finally, and perhaps most importantly, states have elected to proceed in a way that imposed anti-takeover protections without giving shareholders much choice or say.

Our analysis of Delaware takeover law highlights the fact that its rules governing defensive tactics seem to be characterized by unnecessary ambiguity and unpredictability, resulting in frequent litigation. While this aspect of Delaware law benefits the interests of the Delaware bar, which might be of importance to Delaware, it is difficult to see how shareholders are benefited by the excessive unpredictability and vagueness of its rules. Finally, our analysis of state takeover law ends in a comparison of it to the body of takeover law produced by the British City Code, which is the product of self-regulation by a body that might well have stronger incentives to care about shareholder interests than do states. In sharp contrast to state takeover law, the British City Code severely restricts defensive tactics by incumbents, restricts bidders only to an extent that seems to serve some valid policy concerns, and overall regulates takeovers through rules that are much clearer and more predictable in application.

Part III discusses the inability of state competition advocates to square their position with their own view that state takeover law, including that of Delaware, excessively protects incumbent managers and excessively discourages bidders. Indeed, some of the fiercest critics of impediments to takeovers, which are as much a product of state competition for corporate charters as any other aspect of corporate law, are also the leading state competition advocates. We conclude by expressing our belief that state competition advocates would be well advised to reconsider their position. Pro-state competition scholars' own criticisms of state takeover law, many of which we share, demand no less.

#### I. THE THEORY OF TAKEOVER LAW UNDER STATE COMPETITION

As one of us has argued, state competition might have virtues with respect to some corporate law questions, but performs badly with respect to others (Bebchuk 1992). According to that analysis, the issues with respect to which state competition will work poorly are: (1) issues that are 'significantly redistributive' (in that their effect on managers' or controlling shareholders' private interests is not insignificant relative to their effect on shareholder value); (2) issues that directly affect the strength

of market discipline; and (3) issues that implicate the interests of not only shareholders and managers but also third parties. In this chapter, we will focus our attention on one very important area of corporate law: the rules governing takeovers. The argument will be that states have an incentive to design takeover law that is more restrictive on bidders and more protective of managers than is in shareholders' interests.

### **The importance of managers**

A state's takeover law will apply to companies incorporated in that state which become takeover targets. These companies have, almost by definition, sufficient dispersion of shares such that managers have some measure of *de facto* control.

Let us begin by explaining why states, in particular Delaware, will care about managers' preferences. The reason for this is simple: managers play a pivotal role in determining whether a company reincorporates to another state.<sup>3</sup> If a state wishes to maximize the number of companies that are incorporated there—the starting assumption of the 'race to the top'/'race to the bottom' debate—the state will take an interest in both initial incorporation decisions and subsequent reincorporation decisions.

Consider Delaware, which has a very large number of companies already incorporated there. It is critically important to Delaware's continued success, and any state in a similar situation, that it retains companies already chartered there. The potential loss by Delaware of chartered companies through reincorporation, for any given period of time, is greater than the potential gain from initial incorporations. While the number of initial incorporations in any given year is likely to be fairly limited, the number of companies that Delaware could potentially lose through reincorporation—that is, the companies already chartered there—is significant. Moreover, Delaware will not only be interested in preventing its companies from reincorporating to another state, but inducing companies chartered elsewhere to move to Delaware.<sup>4</sup> For these reasons, it would not be surprising if Delaware's corporate law catered, to a significant extent, to the preferences of managers, whatever those preferences may be.

Indeed, the incentive of states which do not have a large number of chartered companies to provide shareholder wealth-maximizing rules, when these harm managerial interests, is not nearly as strong as one might think. First of all, by providing rules preferred by shareholders the state will place itself at a disadvantage in

<sup>3</sup> A company cannot reincorporate without the company's managers deciding to bring a reincorporation proposal to a shareholder vote (Clark 1986: § 10.2.4). Moreover, managers in companies with widely dispersed ownership of shares can have significant influence over the outcome of a shareholder vote through control of the voting process.

<sup>4</sup> Delaware has been very successful in the market for reincorporations. Roberta Romano (1985: 265–78) has found that 82 per cent of all reincorporating companies between 1960 and 1982 switched to Delaware. Similarly, Demetrio Kaouris (1995: 1011) found that out of 255 surveyed companies that changed their corporate domicile between 1982 and 1994, 89 per cent reincorporated to Delaware.

the market for reincorporations with respect to the companies that are currently chartered there and to those that might otherwise consider reincorporating to that state.

But would not a state that provided rules beneficial to shareholders attract more initial incorporations as a result? Not necessarily. It is questionable the extent to which companies initially incorporating in a state with shareholder wealth-maximizing rules, when those rules differ from the ones preferred by managers, would benefit from them in the form of a higher price for securities sold in an initial public offering. Buyers of securities in a company initially incorporated in such a state might anticipate that if the state ever did enjoy a significant number of chartered companies, it would then have a powerful incentive, much as Delaware does, to craft its law so as to satisfy managerial preferences. Even if the state were judged unlikely to make such a mid-stream change in its law, a similar shareholder wealth-decreasing result might nevertheless be anticipated due to the ability of managers to reincorporate the company, at a later point in time, in a state that does have rules to the liking of the managers.

But merely concluding that states, and in particular Delaware, care a great deal about managers' preferences does not by itself imply that managers' and shareholders' interests are likely to systematically diverge. This was perhaps the most underdeveloped aspect of Cary's position. Pro-state competition scholars are quick to argue that state competition for corporate charters works well because, due to market incentives, managers want to do what is in the interests of shareholders (Easterbrook and Fischel 1991; Romano 1993b; Winter 1977). Below we explain why these market incentives may often be insufficient to induce managers to prefer takeover rules that are more restrictive than what would be optimal for shareholders.

## **Managers' preferred takeover law**

### *Market incentives*

At first glance, one might reason as follows: since managers want to keep their jobs and independence, they will surely want to prevent any takeover that does not receive their approval. It is not possible to jump to this conclusion, however, because managers also care about share value, for several widely noted reasons. Moreover, to the extent that restrictive takeover law would reduce shareholder value, they might prefer a state that opts for a more permissive approach.

Among the potential reasons why managers might have a strong interest in maximizing share value, we address two of the main ones. First, unnecessarily low share value can lead to an increased likelihood of takeover. The greater the difference between a share's value and what it could be worth if managers were acting in shareholders' interests, the more profitable, *ceteris paribus*, a takeover will be, and hence the more likely it is that one will occur. Second, managers' compensation and wealth are often tied, at least to a certain extent, to a share's price through share

options and share holdings. Insofar as managers are shareholders themselves, they will have an incentive to make decisions that reflect the interests of shareholders.

As will be explained, however, these two market constraints are unlikely to be sufficient, in a number of cases, to cause managers to prefer a permissive takeover legal regime.

*The effect of restrictive takeover law on managers' interests*

As noted, pro-state competition theorists argue that the threat of a takeover will cause managers to seek the legal arrangement that would be beneficial to shareholders. The argument is roughly as follows. Suppose there are two legal arrangements and one produces higher shareholder value compared with the other. In that case, managers will prefer the regime which maximizes shareholder value, because that arrangement also reduces the probability of a takeover. Higher share value makes takeovers more costly and, as a result, less likely.

But let us further suppose that, of the two regimes, A is the optimal takeover regime from the perspective of shareholders while B is a somewhat more restrictive arrangement. Since A is the optimal arrangement, share value would be, by definition, lower under regime B. But that does not necessarily mean that the likelihood of a takeover would be increased by B. To be sure, with a lower share value, a takeover at the same price would be more profitable. But if B makes it sufficiently more difficult to do a takeover, then the likelihood of a hostile takeover would be smaller despite the lower share price.

It is important to note that making a hostile takeover more difficult overall can benefit managers in two ways. First, they might be able to use the protective arrangement to prevent a takeover altogether—a valuable option since they could then retain all the private benefits of control that come with independence (including not losing their jobs). Alternatively, they can use their increased ability to resist takeovers so as to benefit themselves in any takeover, perhaps by maximizing the side payments they receive from an acquirer in a negotiated acquisition.

However, one might raise the interest of managers in increasing share value because of their stock options and stock holdings. But the two effects mentioned above which are potentially quite important to managers, can easily dominate this interest. Consider managers who now have, say, 3 per cent of the company's stock and enjoy substantial private benefits of control.<sup>5</sup> If a legal arrangement would substantially reduce the likelihood of their losing these private benefits of control, then that might well be more important to them than avoiding some reduction in the value of their existing holdings.<sup>6</sup>

<sup>5</sup> The correlation between managerial pay and performance has been found to be weak (Jensen and Murphy 1990a; 1990b).

<sup>6</sup> Melvin Eisenberg (1989: 1510) concluded that managerial interests are strongest when managers' jobs are implicated, thereby creating an incentive for states to adopt rules that enable managers to keep their positions.

*Managers' interests in acquiring other companies*

Thus far, we have explained why managers of a Delaware company might prefer that, if their company were to become a target, they enjoy the protection of a legal regime that restricted takeovers more than is optimal from the perspective of shareholders. But it might be said that this does not imply that they would prefer Delaware to have rules that inefficiently restricted takeovers, for such rules would apply to them regardless of whether their company becomes a target. Such rules may also apply to companies that they will want to acquire in the future. One might posit that this creates a countervailing consideration (Romano 1993b: 59–60). Because managers can be on both sides of a takeover, so to speak, they will not favour a takeover law that is too restrictive.

But this symmetry does not exist. For several reasons, managers of a Delaware company will likely care more about how Delaware's takeover rules would affect them should their company become a target than they would about the impact of Delaware's takeover law should they wish to acquire other companies.

First of all, while Delaware law would surely affect them if they become an acquisition target, it may or may not affect them should they want to acquire another company. It will affect them if they want to buy another company that is incorporated in Delaware with dispersed ownership, but it will not affect them if they go after a company with a controlling shareholder, a company that is closely held, or a company with dispersed ownership that is incorporated elsewhere.<sup>7</sup>

Second, even assuming that Delaware takeover law would apply each time they go after a target, there is an asymmetry in the stakes to managers. It might very well be extremely important to them to retain their own positions and private benefits of control—here the personal stakes of managers could be quite substantial. In contrast, it is unlikely to be as important to them to weaken the power of the managers of a company with dispersed ownership which they might wish to acquire. Their personal interests are not implicated to anywhere near the same degree; at most they will have to choose different acquisition targets or pay a higher acquisition price (including any side payments to the target's managers). This asymmetry is evidenced by the fact that corporations are the primary lobby responsible for the passage of anti-takeover legislation (Carney 1998: 749–50; Romano 1987a: 121–227), even though this legislation will presumably impede their own future acquisitions of corporations falling within the legislation's ambit.

**Conclusion**

The bottom line of the preceding analysis is that states competing for corporate charters—and in particular Delaware, which is presumably striving to maintain its

<sup>7</sup> In other words, a manager's decision as to where to (re)incorporate has no effect on the takeover law governing potential acquisitions. Foregoing (re)incorporation in a state with anti-takeover defences does not increase the probability that a potential target will do the same.

dominant role in this market—have an incentive to provide a body of law that makes takeovers more difficult regardless of whether this is in the interests of shareholders. We now take a look at Delaware's takeover law and reflect on whether it is consistent with our theoretical conclusions.

## II. REFLECTIONS ON STATE TAKEOVER LAW

We start with a qualification: this Part does not constitute a full analysis and evaluation of the development of state takeover law in the last twenty-five years. This would be too large an undertaking—the literature on takeovers is voluminous. What we do is to offer a set of observations on the body of takeover law that Delaware and other states have produced. Our observations are consistent with the preceding theoretical analysis, which indicated that state competition is unlikely to produce a body of takeover law that is optimal from the viewpoint of shareholders.

### **The pro-management tilt of state takeover law**

#### *How states worked to make takeovers more difficult*

States have worked hard, and quite successfully, to make takeovers more difficult. State takeover law consists of a substantial body of rules—both statutory and judge-made—that significantly impedes hostile takeovers and shields incumbent managers. The fruits of these efforts are reflected in both rules governing bidders and those governing the use of defensive tactics. As we will explain, it is the rules concerning defensive tactics that have erected the most important impediments. But we will also analyse the rules restricting the activity of bidders, both for the sake of completeness and because they also reflect, though less dramatically, the tendency of states to substantially restrict takeovers.

#### Rules restricting bidders

One popular way among states of protecting managers from unwanted takeovers is restricting what bidders are able to do. While the Securities Exchange Act of 1934<sup>8</sup> and the Securities Act of 1933<sup>9</sup> regulate various aspects of tender offers, the most important source of restrictions on the activities of bidders have come, by and large, from state anti-takeover legislation. Over a twenty-five-year period, there have been several waves of state anti-takeover statutes, easily making the passage of anti-takeover legislation one of the top priorities of states in the corporate law area. Numerous states over the years have enacted anti-takeover statutes, imposing a bewildering array of requirements on bidders.

<sup>8</sup> The Williams Act amendments to the Securities Exchange Act of 1934 impose various disclosure and procedural requirements on cash tender offers.

<sup>9</sup> If a portion of the consideration for the target company is securities of the bidder, the Securities Act of 1933 will often be applicable.



The first state takeover statute was enacted by Virginia in 1968 (Takeover Bid Disclosure Act, Va. Code §§ 13.1-528, 13.1-541). Over the next thirteen years, thirty-six states followed Virginia's lead (Romano 1985: 234). These statutes often imposed disclosure requirements on bidders as well as—more burdensomely—requiring administrative approval for a bid to proceed. After the constitutionality of the first wave of statutes was seriously called into question (*Edgar v. MITE Corp.*, 457 U.S. 624 (1981)), states enacted a new set of anti-takeover statutes.

So-called second-generation anti-takeover statutes spread rapidly.<sup>10</sup> There were several types of second-generation anti-takeover statutes. 'Control share acquisition' statutes typically require a shareholder vote approving an 'acquisition of control' by a party. Other states adopted 'fair price' statutes which prohibit a 'second-step' merger<sup>11</sup> between the bidder and the target company unless a supermajority shareholder vote approves the merger or the bidder provides a 'fair price', as defined by the statute, for the remaining shares. In a somewhat similar vein, states also adopted 'redemption rights' statutes, which provide minority shareholders with the right to sell to the bidder shares for their 'fair value', again a price determined by statute. Some states, including Delaware, adopted a 'business combination' statute prohibiting bidders from engaging in certain business combinations with an acquired company for a specified period of time (Choper *et al.* 1995: 1054–7). Thirty-seven states adopted second-generation anti-takeover statutes within a mere eight years of the *MITE* decision (Carney 1998: 752–3). The hard work of states ultimately paid off. They had fashioned anti-takeover statutes that were likely to pass constitutional muster.<sup>12</sup>

However, the states were still not satisfied. Yet another type of anti-takeover statute, the so-called 'constituency statute', has become popular among states. The focus of these statutes, however, is somewhat different from the others. They are concerned with what target management can legally do in frustrating an unwanted bid, not on what bidders can do. It is to this central issue that we now turn.

### Rules governing defensive tactics

The most important impediment to takeovers today is the wide latitude given to managers to engage in defensive tactics, especially the ability to hide behind a poison pill.<sup>13</sup> Perhaps the most critical development creating this managerial power

<sup>10</sup> While we refer to five different types of statutes as second-generation statutes, it is worth pointing out for purposes of clarity that some commentators have divided these statutes into several different generations.

<sup>11</sup> A 'second-step' merger is a merger between a corporation and a shareholder holding a significant percentage of the corporation's stock.

<sup>12</sup> *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69 (1987), upheld Indiana's second-generation anti-takeover statute against a dormant Commerce Clause challenge.

<sup>13</sup> The Chief Economist for the Securities and Exchange Commission (1986: 1, 6–7) defined a poison pill as:

[A]ny financial device that when triggered by a particular action (e.g. merging a target's assets or acquiring more than some specified amount of the target's common stock), results in one or a combination of the following:

was the approval by the Delaware courts of poison pills put in place by management.<sup>14</sup> After it became clear that managers had the power to erect poison pill defences, the key question became (and continues to be): when would managers be forced to dismantle them in a takeover contest? Delaware law has gradually evolved so as to allow directors, consistent with their fiduciary obligations to shareholders, to ‘just say no’ to potential bidders *with* their poison pill defences in place.

Many states have adopted ‘constituency statutes’ that enable directors to consider the interests of non-shareholder constituencies, such as employees and local communities, in exercising their authority.<sup>15</sup> Arguably, this provides managers with an even greater ability to formulate a legally acceptable reason not to dismantle a poison pill or to refrain from whatever other defence manoeuvres they might wish to engage in. It is worth noting that even though Delaware does not have a ‘constituency statute’, its case law has long permitted managers, in evaluating and responding to a hostile takeover, to consider its ‘impact on “constituencies” other than shareholders (that is, creditors, customers, employees, and perhaps even the community generally’ (*Unocal*, 493 A.2d at 955; *Time v. Paramount*, 571 A.2d 1140, 1153 (Del. 1990)).

### The corporate fortress

Considering the cumulative effect of the restrictions states have placed on the activities of bidders as well as managers’ ability to erect and maintain anti-takeover defences, especially the poison pill, it is obvious to even the most casual observer that managers have substantial power to block takeovers. Companies are today surrounded by high walls that can be very costly for bidders to breach against a determined target management. As a result of these legal developments, the impact on the operation of the market for corporate control has been far-reaching.

As one would expect, states have varied somewhat in how far they have gone in this direction. As pro-state competition scholars have emphasized, Delaware, despite offering managers substantial protection against unwanted acquisitions, has not fortified the corporate castle as much as other states have. But for our purposes,

- a. the acquirer is forced to purchase securities from the shareholders of the target firm at prices equal to or exceeding their market value
- b. security holders of the target firm gain rights to exchange stock of the target firm for a combination of cash and securities from the target firm exceeding that of the surrendered stock (acquirer is generally excluded from this exchange)
- c. the security holders of the target firm gain rights to purchase securities from the target firm at prices below market value (acquirer is generally excluded)
- d. the acquirer must sell securities of the acquiring entity at prices below market value to security holders of the target firm
- e. the acquirer loses substantial voting power of his or her shares relative to other security holders of the target firm.

<sup>14</sup> The use of the poison pill to ward off a potential bidder was first approved by the Delaware Supreme Court in *Moran v. Household Int’l, Inc.*, 500 A.2d 1346 (Del. 1985), a case which we will discuss later in this chapter.

<sup>15</sup> Thirty-one states have adopted ‘constituency statutes’ since 1986 (Choper *et al.* 1995: 1057).

what is important is not the differences among states, which are, on the whole, small compared to the long road toward restricting takeovers that almost all states have travelled. What is important is the aggregate product of state competition and how that differs from the body of rules that would maximize shareholder wealth. Accordingly, we now offer some observations on why the impediments to takeovers that states have so vigorously created are excessive.

*The weak policy basis for state anti-takeover law*

Being academics, we start with the observation that the powerful anti-takeover position taken by Delaware does not appear to have a strong basis in the extensive literature examining the desirability of different types of takeover regulation from the perspective of shareholders. Before proceeding, we want to emphasize that this is just one observation and not the basis for our view that Delaware has gone too far. Of course, the best arrangement could, in fact, be one that receives little support in academic circles. Even if powerful anti-takeover protections are justified, we will argue below that they should have been afforded to managers in a manner much different than they were. But a natural place to begin the analysis is to see how Delaware's anti-takeover position has fared in policy debates.

Rules restricting bidders

In this section, we will examine the policy basis for the arrangements introduced by state anti-takeover statutes. As we have seen, while these statutes have made takeovers more difficult, their impeding effect is likely less than that of the rules governing defensive tactics. Our problem with takeover statutes, however, is not so much with the magnitude of the difficulties they pose for takeovers. Instead, as explained below, our problem is that these statutes seemed to have been created to a large extent for the purpose of making takeovers more difficult rather than to address legitimate policy concerns.

We start with the observation that states have consistently come up with very different types of anti-takeover statutes, focusing on various issues and using different techniques. When a particular type of statute was found to be constitutionally suspect or to provide little impediment to takeovers, states simply went back to the drawing board and adopted another type of statute. The first generation focused on the tender offer process, a similar focus to that of the Williams Act. When the constitutionality of these statutes was called into question in *MITE*, states simply went back to the drawing board having in mind that a statute regulating a company's internal affairs would likely be permissible under the decision's rationale. They then tried to use this opening to impede takeovers, without interfering in the takeover process directly, by altering the powers that an acquirer would have following a takeover. When various second-generation statutes—many of which, as explained below, have a plausible policy rationale—were upheld against constitutional challenges but did not seem to pose a substantial impediment to tender offers that shareholders would want to accept, states went back to work. They came up with a new

and different set of statutes. The one common denominator to all the anti-takeover statutes is that they all seek, in one way or another, to make takeovers more difficult.

As has already been mentioned, for some second-generation statutes one could at least find a legitimate policy rationale: the need to address the pressure-to-tender problem that shareholders sometimes confront when considering a tender offer. The pressure-to-tender problem results from shareholders' incentive to tender their shares to a bidder out of fear of ending up with low-value minority shares in the event that other shareholders tender and the offer succeeds. Shareholders will have this incentive even if they all reach the conclusion that their shares would be worth more if the tender offer did not succeed (Bebchuk 1985; 1987; Brudney and Chirelstein 1974: 336–7).

One type of second-generation statute that some states adopted, referred to earlier, is the 'control share acquisition' statute. This statute could conceivably be justified as addressing the pressure-to-tender problem as it required shareholders to vote on whether a bidder can acquire control of a company. Such a vote might prevent a coercive offer from proceeding and, thus, benefit shareholders.<sup>16</sup> This type of statute provides shareholders with direct input as to whether an acquisition should proceed. In sharp contrast, many of the more formidable defensive tactics, as we shall see, are so potent precisely because they prevent shareholders from ever deciding for themselves the merits of a tender offer.

Another type of second-generation statute that addressed the pressure to tender problem is the 'redemption rights' statute. This statute typically ensures that the post-tender offer value of minority shares will not fall below the offer price. This again would eliminate the pressure to tender. Tender offers that shareholders do not find attractive would not be able to succeed through a bidder exploiting a shareholder's pressure to tender for fear of being stuck with less valuable minority shares.

So it is fair to say that many second-generation anti-takeover statutes responded to a concern that the literature had identified as important. One might have thought that states would rest content with their 'control share acquisition' or 'redemption rights' statutes. To the extent that the pressure-to-tender problem was effectively addressed by these statutes, the only tender offers that would be able to succeed are the ones shareholders want. Moreover, while these second-generation statutes would arguably frustrate all offers that shareholders would not want to succeed, they probably would not substantially deter offers that shareholders would want to take (Gilson and Black 1995: 553–8). But states did not stop here. Tellingly, states continued to add more restrictions on bidders which do not seem designed to address specific concerns over the operation of the takeover process.

<sup>16</sup> In *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987), the US Supreme Court explains, 'By allowing [ ] shareholders to vote as a group, [Indiana's control share acquisition statute] protects them from the coercive aspects of some tender offers'.

Take, for example, the 'business combination' statutes. Delaware has one (Del. Gen. Corp. Law § 203), along with thirty other states (Choper *et al.* 1995). These statutes typically restrict a successful bidder's ability to engage in a wide range of transactions with an acquired company, such as mergers, liquidations, sales of assets, and stock issuances. These statutes might also prevent some takeovers which shareholders would want. They could conceivably reduce the potential efficiency gains resulting from the bidder acquiring control to the extent that those gains would require, say, effecting a merger between the bidder and the target.

Some observers argue that the costs imposed on bidders by Delaware's 'business combination' statute, and similar statutes, are not all that large and thus, by themselves, should not greatly curtail takeovers (Gilson and Black 1995: 558–73). But our point does not depend on how large the costs are. Assuming that just having fewer hostile takeovers is not an end in itself, these statutes are not an effective instrument for addressing any valid concern. The only justification that could be given for these statutes is that, by defending minority shares in the aftermath of a takeover, they prevent coercion and unequal treatment of shareholders. A 'control share acquisition' statute or a 'redemption rights' statute would clearly be superior in accomplishing these goals. A state could fulfil these goals in a complete way without preventing efficient takeovers. In contrast, 'business combination' statutes carry the potential cost of preventing some desirable acquisition offers.

Reviewing what states have done legislatively in restricting bidders causes one to suspect that states really care about making takeovers more difficult rather than merely eliminating particular distortions in the takeover process. This impression is powerfully reinforced by looking at state rules governing defensive tactics. We now turn to this subject.

#### Rules governing defensive tactics

The use of defensive tactics by managers raises an obvious conflict of interest problem. There is no question that allowing managerial discretion to use defensive tactics entails costs. This has led some commentators to support a ban on defensive tactics. While other commentators have supported the use of some tactics to address particular threats and distortions, they did not want managers, given the severe conflict of interest problem, to be granted an open-ended licence. But this is the direction in which state laws have moved.

The discussion in this section will focus on the most powerful impediment to takeovers—the ability of managers, at least in a wide range of circumstances, to 'just say no' to potential bidders while keeping in place a poison pill defence. There can be no question that the use of defensive tactics by managers presents a serious problem, because of the inherent conflict of interest faced by them in the takeover context. After all, managers' private interests, including their very jobs, are directly implicated. There is always the danger that managers will oppose a shareholder value-enhancing offer in order to maintain their corporation's independence. As the Delaware Supreme Court has repeatedly emphasized, there is

always the ‘omnipresent specter that a board may be acting primarily in its own interests, in a takeover’ (*Unocal Corp. v. Misa Petroleum Co.*, 493 A.2d 946, 954–55 (Del. 1985)).

There is a large body of literature that argues that managers should be completely prohibited from engaging in defensive tactics—a literature which includes contributions by leading advocates of state competition (Easterbrook and Fischel 1981; Gilson 1981; Romano 1992). Those who oppose defensive tactics do not ignore the possibility that abusive takeover tactics might result in a bad takeover outcome. For example, there is the concern, discussed earlier, that shareholders will be pressured to tender due to the fear of being left holding minority shares with a value lower than the bid price (Bebchuk 1985). But those who oppose defensive tactics can point to legal arrangements that would address such problems. The pressure to tender problem, for example, can often be resolved by having a shareholder vote on a tender offer. There is no need, on this view, to use the costly remedy of giving managers the power to use defensive tactics and, thus, to have some veto power over acquisitions.

While both of us share the above view, some commentators favour giving managers power to use defensive tactics in order to address abusive takeover tactics. For instance, Reinier Kraakman and Ronald Gilson, in trying to explain and rationalize Delaware’s early cases applying *Unocal’s* proportionality test, suggested that defensive tactics, including retaining the pill in the face of a hostile tender offer, should pass judicial review insofar as they address two particular threats: so-called structural and substantive coercion (Gilson and Kraakman 1989). They argued that a pill should be retained only if either: (1) the offer is structured in a coercive way, or (2) the managers can demonstrate (by, say, relying on an investment banker’s opinion) that the independent value of the target significantly exceeds the offer consideration. The point worth emphasizing is that even commentators who endorse the use of defensive tactics to address abusive takeovers do not wish managers to have an open-ended, unlimited power to ‘just say no’.

It is interesting to note that even Martin Lipton, inventor of the poison pill and champion of takeover defences, writing in the 1980s, did not go so far as to argue that managers should always have the ability to frustrate hostile tender offers. In a 1987 article, Lipton justified defensive tactics by pointing to a list of particular takeover abuses, each of which he discusses at length (Lipton 1987). He does not at any point argue that managers should be allowed to ‘just say no’ when the identified abuses are not present.

But the Delaware courts have left the reasoning of all these commentators, even those sympathetic to some types of defensive tactics, far behind, instead endorsing a much more expansive licence for managerial use of poison pills and ‘just say no’ (Grundfest 1993). This was done in stages. Initially, Delaware law seemed to be willing to allow tactics only in response to particular well-defined threats. But later on, without much in terms of providing explicit justification, Delaware went well beyond this.

The first seminal Delaware cases, decided in the mid-1980s, which dealt with managers' ability to use defensive tactics to defeat hostile tender offers, were *Unocal Corporation v. Mesa Petroleum Co.* (493 A.2d 946 (Del. 1985)) and *Moran v. Household International, Inc.* (500 A.2d 1346 (Del. 1985)). In both cases, the Delaware Supreme Court was careful to both examine the particular threat to shareholders that would have existed without managerial use of the defensive tactic in question and whether the defensive tactic that was used addressed that particular threat. Only then did the Court conclude that the use of the defensive tactic was appropriate. In *Unocal*, the Delaware Supreme Court reviewed a selective self-tender offer by a target corporation that was being offered as a way of defeating a hostile tender offer. In explaining why the target management had not violated their fiduciary duties to shareholders, the Court repeatedly emphasized the fact that the board reasonably believed that the hostile tender offer was a 'grossly inadequate two-tier coercive tender offer' and that the self-tender offer was 'reasonably related to the threats posed' (493 A.2d at 956, 958). In *Moran*, the Delaware Supreme Court approved the use of another defensive tactic by managers: the erection of a poison pill defence. The Court relied on the fact that the plan was mild and would therefore not deter bidders. Rather, the poison pill at issue merely provided reasonable protection against a coercive two-tier tender offer (500 A.2d at 357). Moreover, the Court pointed out that once a bidder did arrive on the scene, a decision not to dismantle the pill at that time would be reviewable by the Delaware judiciary.

After these decisions, the Chancery Court began to develop a jurisprudence limiting the use of defensive tactics so as to protect shareholders not only from coercive hostile tender offers but also from managerial abuse of these tactics. For example, in *AC Acquisitions Corporation v. Anderson, Clayton & Co.* (519 A.2d 103 (Del. Ch. 1986)), the Chancery Court concluded that the target board's selective self-tender offer was itself coercive and, therefore, not reasonable. The Chancery Court followed this up with its decision in *City Capital Associates v. Interco Inc.* (551 A.2d 787 (Del. Ch. 1988)). There, the court forced a target board to redeem its poison pill in the face of a non-coercive tender offer that the board believed was too low.<sup>17</sup> Indeed, in the course of its analysis, the court approvingly cited Gilson and Kraakman's interpretation of the *Unocal* standard (796 n. 8). Later that same year, the Delaware Chancery Court in another case forced a target board to redeem its poison pill in the face of a non-coercive tender offer (*Grand Metropolitan Public Limited Co. v. The Pillsbury Co.*, 1988–1989 Transfer Binder, Fed. Sec. L. Rep. (CCH) 94,104 (Del. Ch. 1988)). Unfortunately, this searching inquiry of manage-

<sup>17</sup> The Chancery Court forcefully explained that '[t]o acknowledge that directors may employ the recent innovation of "poison pills" to deprive shareholders of the ability effectively to choose to accept a noncoercive offer . . . would, it seems to me, be so inconsistent with widely shared notions of appropriate corporate governance as to threaten to diminish the legitimacy and authority of our corporation law' (*City Capital Assoc. v. Interco*, 551 A.2d at 799–800).

rial use of defensive tactics, and whether shareholders were being well served by them, was not to last.

Perhaps the key turning point in creating a much more expansive licence for managerial use of defensive tactics was the Delaware Supreme Court's decision several years later in *Paramount v. Time* (571 A.2d 1140 (Del. 1990)) wherein the Court went out of its way to explicitly disavow the approach of the Chancery Court in *Interco*. The Delaware Supreme Court stressed that the all-cash, all-shares tender offer for Time by Paramount threatened the target management's business plan (here, merging with Warner)—a threat it found to be legally cognizable. In contrast to what one might have thought from *Unocal* and *Moran*, and the Chancery Court cases building on their analysis, the *Time* Court made very clear that the use of defensive tactics is not limited to situations where the tender offer is coercive—which Paramount's offer clearly was not—or when management has particular, defensible reasons to believe the offer is inadequate. The potential discretion this line of reasoning provides to managers is sweeping.

Until this decision, Delaware was arguably in line with those commentators, such as Professors Kraakman and Gilson, who endorsed defensive tactics in response to particular, well-defined threats. Beginning with *Paramount v. Time*, Delaware courts have, however, increasingly tolerated, although this is not much acknowledged, the open-ended use by managers of defensive tactics far more drastic than the one at issue in *Moran*, without requiring, in any meaningful way, a demonstration of structural or substantive coercion.<sup>18</sup>

This important leap was made by the Delaware courts without much justification. This development also had little support in the literature, at that time or since. Now it is always possible that Delaware law, notwithstanding the lack of articulated policy justifications, is in fact the legal regime that is beneficial to shareholders and reflects what shareholders want. In the end, what is important is not what some academics believe, but what actually serves the interests of shareholders.

And this brings us to our next two critical observations: that Delaware, as well as other states, has adopted stronger anti-takeover protections than those shareholders at the time were willing to voluntarily provide; and that states have imposed these arrangements on shareholders in a way that left them with little choice or say.

#### *States granted to managers what shareholders were not willing to give*

It is worthwhile to stress that impediments to takeovers, to the extent that they are favoured by shareholders, can be adopted through charter provisions. In the late 1970s and early 1980s, managers did indeed push for various anti-takeover charter

<sup>18</sup> In *Unitrin, Inc. v. American Corp.*, 651 A.2d 1361 (Del. 1995), for instance, the Delaware Supreme Court upheld a target corporation's repurchase of its stock, which was designed to defeat a hostile tender offer. The Court pointed out that the bidder could always conduct a proxy contest. This analysis seemed to give short shrift to the interests of shareholders in having the ability to agree to the terms of the competing tender offer and the difficulty of conducting a successful proxy contest.



amendments (Gilson 1982). But it became increasingly clear that informed shareholders were willing to vote only for ‘mild’ anti-takeover arrangements—ones aimed at addressing the pressure-to-tender problem but not going much beyond this (826–7).

Already in the 1980s, Roberta Romano described how managers were successful in gaining anti-takeover protections from states more severe than those they could receive from shareholders (1987a: 129–30, 147–8). If this was true then, it has become even more so since. The protections from takeovers which managers have been afforded by states have only grown stronger.

*States imposed anti-takeover rules on shareholders*

States could have taken the approach of making it easier for companies to have takeover protections should shareholders approve. This approach would likely have pleased state competition advocates, who often place great emphasis on the importance of permitting shareholders to choose the legal regime that governs the corporation in which they invest. States, however, have almost universally shunned this approach.

In the takeover context, shareholders did not appear interested or willing to restrict takeovers much beyond arrangements needed for eliminating the pressure to tender. Despite this, Delaware, along with other states, imposed its anti-takeover arrangements on shareholders *ex post* in a way that left them little choice.

The imposition of legislative anti-takeover protections

Consider the anti-takeover statute adopted by Delaware (8 Del. Code § 203).<sup>19</sup> Tellingly, Delaware did not follow its earlier approach concerning limitations on directors’ liability. In the aftermath of *Smith v. Von Gorkom* (488 A.2d. 858 (Del. 1985)), Delaware changed its corporate code so as to allow companies to adopt charter provisions that limit directors’ liability.<sup>20</sup> In contrast, shareholders were not given the option of adopting the anti-takeover protections contained in Delaware’s ‘business combination’ statute by approving a charter provision to that effect. Instead, the Delaware statute afforded managers these protections unless the corporation opted *out* of it by charter amendment. Why did Delaware adopt opt-in limitations on liability but opt-out limitations on takeovers?

The difference between opt-in and opt-out is of critical significance. This is because a charter amendment must be brought to a shareholder vote. As a result, shareholders cannot opt out of the Delaware statute unless the directors want this to happen.<sup>21</sup> And since managers generally prefer to have anti-takeover protection,

<sup>19</sup> Delaware’s anti-takeover statute, with certain exemptions, bars an acquirer from conducting a second-step merger with the target for a period of three years after the target’s acquisition.

<sup>20</sup> 8 Del. Code § 102(b)(7) permits the certificate of incorporation to contain ‘a provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of . . . [duty of care]’.

<sup>21</sup> Del. Code § 242(b) sets out that shareholders cannot propose charter amendments on their own.

there is no reason for them to opt out. In short, the Delaware takeover statute has followed an enabling approach for the *managers*, not the shareholders—it is the managers who can have an anti-takeover arrangement if they want it (which they generally do).<sup>22</sup>

Most states have adopted a similar approach in deciding not to condition legislative anti-takeover protections on shareholder consent.<sup>23</sup> Indeed, some states do not even allow for opting out of their takeover statute (such as Wisconsin's anti-takeover statute, which Judge Easterbrook confronted in *Amanda Acquisition Corporation v. Universal Foods Corporation*, 877 F.2d 496 (7th Cir.)). But practically, the difference between permitting opting out and not permitting it is usually not all that significant. As long as managers control the opting-out process, we are often going to have the anti-takeover arrangement preferred by managers regardless of shareholders' interests.

### The imposition of poison pills

The introduction of more and more potent poison pills, and their approval by Delaware courts and the courts of other states, has changed the landscape of takeovers. Poison pills have altered fundamentally the allocation of power between managers and shareholders.

What poison pills did was to use the formal power that managers have to issue securities. This power was originally given to facilitate the raising of capital.<sup>24</sup> The creators of the poison pill, however, used this power to design securities not with a view to raising capital but rather with the sole purpose of preventing acquisitions managers' wish to block it.

There is no question that the introduction of poison pills in the 1980s could not have been anticipated in the 1970s, 1960s, or 1950s. It took huge managerial demand for anti-takeover protection, coupled with the creative legal ingenuity of Martin Lipton and his colleagues, for poison pills to be invented and implemented on a widespread basis. Shareholders buying shares in Delaware companies earlier on simply could not have anticipated poison pills and the reallocation of power that they would cause.

And a drastic reallocation it is indeed. As long as they are not redeemed by managers, poison pills typically prevent shareholders from having access to an offer. For

<sup>22</sup> Professor Romano's suggestion that the opting-out structure of Delaware's takeover law saves on the transaction costs that would be incurred by forcing corporations to opt in (Romano 1987b: 729) is a fairly insignificant consideration in the light of the harm resulting from the increased ability of managers to thwart value-maximizing takeovers at the expense of shareholders.

<sup>23</sup> Carney (1998: 752) describes as the very purpose of state anti-takeover statutes the provision of 'takeover defenses without the necessity of [a shareholder] vote'.

<sup>24</sup> 8 Del. Code § 157 states that:

Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

this reason, they have had a dramatic effect on the takeover picture and the division of power between shareholders and managers.

Our point here is not that this reallocation is necessarily bad. Let us grant for a moment that it might be beneficial to shareholders. The important point is that this was a major reallocation, which had not been anticipated earlier. If states wanted to ensure that this was in shareholders' interests and not just in managers' interests, they would have required this reallocation of power to first enjoy shareholder consent.

Shareholder consent could have been required in any number of ways. Courts developing the doctrines governing the use of the poison pill could have required, given the inherent conflict of interest, that pills be ratified by the shareholders either right away or within a certain period of time. Or a court could have required managers to redeem a pill when shareholders express a clear preference for them to do so—say, by tendering *en masse* to a non-coercive bid. Or, at the minimum, courts could, in such circumstances, have required the managers to carry a heavier burden of demonstrating in a meaningful way the benefits of maintaining the pill. Similarly, state corporate statutes could have been amended to condition the use of poison pills on the adoption of a charter provision allowing managers to do so.

But this is not what Delaware and other states have done. Delaware has imposed on the shareholders of Delaware corporations an arrangement whereby managers enjoy a much greater level of protection from takeovers than they had before without requiring shareholders' consent or giving them some practical way of getting out of an undesired arrangement.

This is all consistent with the mid-stream problem discussed in Part I. Delaware cares a great deal not only about new incorporations but also about maintaining the large stock of companies it currently has. Managers play a crucial role in how successful Delaware is in maintaining its current position. The need to satisfy the preferences of managers of existing chartered corporations has proved to be an important force in the development of Delaware's law.

### **The pro-uncertainty tilt of Delaware anti-takeover law**

Besides predicting that states will tend to adopt corporate rules whose substantive content benefits shareholders, the pro-state competition position also entails that these rules would likely be formulated in a way that similarly maximizes shareholder wealth. Roberta Romano, one of the strongest supporters of state competition, suggested in her earlier writings that one of the advantages of Delaware law is its certainty and predictability (1985: 273–9, 280–1; 1987b: 720–5). It is important to realize that this dimension is not the same as where the law stands substantively. For example, a body of law can restrict takeovers greatly in either a predictable or fuzzy way. And similarly, if the law is permissive, this can again be done in a predictable or fuzzy way. That is, one dimension is roughly where the line is drawn, and the other dimension is how clearly that line is drawn.

Other things being equal, predictability is desirable. It reduces uncertainty and the amount of litigation. It is for these reasons that Romano viewed it as a virtue and suggested that Delaware law's certainty and predictability has enabled it to remain dominant in the competition for corporate charters despite widespread copying of Delaware law by other states (1985: 226). The problem, however, is that Delaware law does not enjoy this virtue of predictability and certainty. Delaware courts have consistently filled Delaware jurisprudence with principles that are open-ended and unclear (Coates 1999; Kamar 1998: 1913–23). The principles throughout Delaware law contain terms which call for a case-specific assessment by the court. Moreover, there is always some room for the Chancery Court's equitable intervention. Any plaintiff's lawyer knows that it would be difficult to attack successfully a freezeout or to get a derivative suit to pass the test formulated in *Aronson v. Lewis* (473 A.2d. 805 (Del. 1984)). But the outcome is never certain.

There are reasons to believe that this is no accident. Delaware might purposely be maintaining a legal regime that encourages litigation (Branson 1990; Macey and Miller 1987; Kamar 1998). Delaware's corporate lawyers, an important interest group in Delaware, benefit from more, rather than less, litigation. Thus, regardless of where Delaware law stands substantively, Delaware has an incentive and, consequently, the tendency to draw the line in a way that is more fuzzy and litigation-inducing than would be good for shareholders.

The pro-uncertainty tilt of Delaware's takeover law is as apparent as it is in other areas. Delaware could have given managers a great deal of power to 'just say no' while circumscribing very clearly the boundaries of what managers can and cannot do. But no—Delaware has chosen to do it in a way that leaves a fair amount of uncertainty as to where exactly the line is drawn.<sup>25</sup> Characteristically of Delaware, the court's requirement of a very case-specific investigation always keeps the door open, at least a little, to judicial intervention.<sup>26</sup> It is no coincidence how frequently takeovers result in litigation.

### Comparison to the British City Code

We would like to end our observations on state takeover law by comparing it to the regulatory arrangement created by Britain's City Code on Takeovers and Mergers (Begg 1991). British regulation of takeovers is interesting because it is basically in the hands of the Panel on Takeovers and Mergers, a non-governmental body which administers and revises the City Code. The City Code and its implementation is an example of a system of regulation that is not imposed from the outside by a detached governmental body but rather by a group that has strong

<sup>25</sup> In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), and *Revlon, Inc. v. McAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), the Court emphasized the need to conduct a very case-specific investigation to determine whether a manager acted improperly in rebuffing a takeover attempt.

<sup>26</sup> In *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995), the court described the Unocal test as a 'flexible paradigm that jurists can apply to the myriad of "fact scenarios" that confront corporate boards'.

connections to interested parties. The chair of the panel is chosen by the Bank of England, with other members representing such groups as the insurance industry, pension funds, investment banks, clearing houses, British industry, and the London Stock Exchange (DeMott 1983: 954).

The British City Code contains a body of arrangements that is very different from US state takeover law when measured along the two dimensions focused on earlier—the extent to which regulatory arrangements protect managers, and the extent to which they generate confusion and litigation due to a lack of clarity.

On the first dimension, the City Code differs sharply from US state takeover law on managerial defensive tactics. In particular, the Code contains a sweeping prohibition on defensive tactics unless shareholder consent is obtained. General Principle seven of the City Code states:

At no time after a bona fide offer has been communicated to the board of the offeree company, or after the board of the offeree company has reason to believe that a bona fide offer might be imminent, may *any action* be taken by the board of the offeree company in relation to the affairs of the company, without the approval of the shareholders in general meeting, which could effectively result in any bona fide offer being frustrated or in the shareholders being denied an opportunity to decide on its merits. (Begg 1991: A7.4) (emphasis added)

This general prohibition is reflected in Rule 21 of the City Code, which specifically prohibits a target board from engaging in a list of certain defensive tactics without shareholder approval<sup>27</sup>—a list which the Panel has made clear is not exhaustive.<sup>28</sup>

It is not the case that the City Code ignores the problems that takeovers might pose. To prevent the possible pressure to tender problem, the Code provides that, if an offer is successful, non-tendering shareholders will get a second opportunity to tender (Begg 1991: A7.14–A7.15), much like state ‘redemption rights’ statutes. But given that it is possible to enable shareholders to make an undistorted choice by having such an arrangement, the Code does not leave any room for defensive tactics.

Turning to the certainty/uncertainty dimension, the British regulatory arrangement seems to provide more certainty and less room for litigation than those under US state law. The clear prohibition on the use of defensive tactics contained in the

<sup>27</sup> Under Rule 21, a target board may not unilaterally:

- ... .
- B. issue any authorized but unissued shares;
  - C. issue or grant options in respect of any unissued shares;
  - D. create or issue, or permit the creation or issue of, any securities carrying rights of conversion into or subscription for shares;
  - E. sell, dispose of or acquire, or agree to sell, dispose of or acquire, assets of a material amount;
  - F. enter into contracts otherwise than in the ordinary course of business. (Begg 1991: A7.22)

<sup>28</sup> In Consolidated Gold Fields PLC (Takeover Panel, 9 May 1989: 14) it was concluded that the commencement of litigation against the bidder by a target board was ‘frustrating action’ in violation of General Principle 7.

City Code is one such example. It is not a 'flexible' balancing test tailor-made for endless litigation.<sup>29</sup> Indeed, a major concern of the Panel on Takeovers and Mergers, as well as others involved in London's financial markets, is that the European Union might pass takeover regulation that will enable targets to engage in strategic takeover litigation so common in the United States and so rare in Great Britain (*Financial Times* 1997).

The reasons why the Code went in such a different direction might lie in the different incentives its designers had from those who crafted US state takeover law. Presumably those responsible for the City Code gave less weight to managerial interests because of the close connection at least some of them had with the interests of shareholders. Moreover, corporate managers operating in a federal system such as the United States have significantly more influence, as they can reward states that cater to their interests and punish those that do not through their incorporation and reincorporation decisions.

The British regulatory system is an example of a national system of regulation that both addresses possible defects in the takeover process and ensures that shareholders, not management, have the ultimate say on whether a takeover proceeds. It accomplishes this without the degree of uncertainty and pervasive takeover litigation that characterizes US state takeover regulation. The British experience suggests that the federalist structure of corporate law might not be as powerful a force for desirable corporate rules as some pro-state competition advocates contend.

### III. TAKEOVER LAW AND THE SUPPORTERS OF STATE COMPETITION

So far we have argued that state takeover law is consistent with the theory of state competition, outlined in Part I, which views such competition as problematic. We now make our point in another way—by showing how supporters of state competition are unable to square their position on state competition with their views on the type of takeover regulation that maximizes shareholder value.

As will become clear, the leading advocates of state competition are also vigorous supporters of a robust market for corporate control. As a result, there is a deep tension in their views. We begin by analysing the reasoning of four prominent proponents of state competition and how they try to reconcile their respective positions on state competition and takeovers. Then we will argue that their attempts at reconciling these two positions are unconvincing. We suggest that a more productive path would be for them to reconsider their position on state competition in the light of their own arguments concerning the substantial benefits takeovers can create for shareholders.

<sup>29</sup> Another example is the Code's rigid timetable for the completion of a tender offer. A takeover bid must be completed in no more than 102 days.

### **The dilemma facing supporters of state competition**

The most prominent supporters of state competition—Ralph Winter, Frank Easterbrook, Daniel Fischel, and Roberta Romano—also simultaneously advocate a legal regime that facilitates, rather than frustrates, takeovers. The hostility of state law to takeovers therefore poses a serious problem. What would explain the poor record of states in the takeover area without undermining their general position on state competition? Assessing how successful they are in reconciling their facially inconsistent positions will go a long way towards determining how convincing their views are on the desirability of state competition. Accordingly, we will examine these pro-state competition scholars' arguments.

#### *Ralph Winter*

Ralph Winter (1977: 256) formulated the classic response to Cary's contention that state competition results in a 'race for the bottom' that harms shareholders. He built his critique on the observation that a corporation chartered in a state with an inefficient corporate code will have a lower rate of return on investment as a result (1989: 1526). Companies with sub-par rates of return will have greater difficulty raising capital (1977: 257), have less success in the product market, and be more likely to be the target of a takeover (264–6). The consequences of inferior returns created by inefficient corporate rules reduce managers' private benefits of control, including their job security. Managers accordingly have a strong incentive to ensure that the legal regime governing the operations of their corporation results in shareholders receiving the greatest possible return on their investment. In other words, in Winter's view, managers will maximize shareholder value out of self-interest.

At the same time, however, Winter expressed his general belief that a regime that facilitated takeovers maximized corporate profits (288). Profit maximization is obviously what shareholders, as residual claimants, typically want. Not surprisingly, he was critical of state anti-takeover statutes and, indeed, attributed part of the high cost of takeovers to the comparatively regulatory light-handed federal law (Williams Act, 15 U.S.C. §§ 78m(d)–(e), 78 n(d)–(f)) regulating tender offers. There was much for Winter to object to. Some 'first-generation' state anti-takeover statutes went so far as to prevent acquisitions of companies which had their principal place of business in the state unless a state official approved it.

In explaining how existing state anti-takeover law, which he disapproved of based on its effect on shareholder wealth, was consistent with his defence of state competition, Winter made several points—points that, as we shall see, have often been repeated by others. He stressed that Delaware's anti-takeover statute, by far the most important state statute on the subject, was relatively innocuous (289). More importantly, Winter claimed that whether federal regulation was appropriate in the takeover context was an issue 'quite different' from the arguments raised by Cary (270). Since existing state anti-takeover statutes typically had extraterrito-

rial application—they applied to companies even if they were not chartered in the state—these laws, accordingly, implicated a ‘chartering issue in only a peripheral sense’ (289). Indeed, Winter believed that the extraterritorial features of anti-takeover statutes substantiated his basic contention that states competing for corporate charters have strong incentives to provide efficient corporate rules.

This last explanation, based on state anti-takeover statutes’ extraterritorial application, is obviously inadequate to explain the reaction of states to the Supreme Court’s decision in *MITE* (457 U.S. 627 1981), which called into serious question the constitutionality of these statutes. After this decision, the vast majority of states, including Delaware, quickly passed new anti-takeover legislation that was confined to companies chartered in the state. State anti-takeover law, as a result, can no longer be cabined from the rest of state corporate law in the way that Winter suggested. On the other hand, his other two arguments—that state anti-takeover law somehow raised different issues than other aspects of corporate law, and the reliance on Delaware’s regulatory light touch—are ones that remain popular to this day with pro-state competition scholars.

*Frank Easterbrook and Daniel Fischel*

Frank Easterbrook and Daniel Fischel are also strong, even passionate, believers in state competition for corporate charters. Thus, in their academic work, they presume that doctrines produced by state competition are efficient (1983: 398). However, like Winter, they are vigorous supporters of takeovers and, as a result, strongly oppose the use of any and all defensive tactics by target management (1981), because regulation that allows managers to impede takeovers is unjustified and socially wasteful.

The inconsistency in their position is even more obvious than was the case with Winter. Easterbrook and Fischel have consistently argued, over a period of some fifteen years in numerous articles, that state competition generally produces efficient corporate rules (Easterbrook 1984; Easterbrook and Fischel 1983; 1991; Fischel 1982). Yet on this important issue state competition produces the opposite of what they strongly believe are desirable legal arrangements. To their credit, they candidly acknowledge the problem state anti-takeover legislation creates for their position, describing it as ‘embarrassing’ (Easterbrook and Fischel 1991: 221). The dilemma they face is painfully reflected in *Amanda Acquisition Corporation v. Universal Foods Corporation* (877 F.2d 496 (7th Cir. 1989)) where Judge Easterbrook, while considering the constitutionality of a state anti-takeover statute, forthrightly acknowledged the tension between his belief in both state competition and the folly of anti-takeover regulation.

However, Easterbrook and Fischel, at the end of the day, are only willing to concede that state anti-takeover regulation reveals that state competition is not perfect. State competition, they argue, creates efficient rules over a period of time. We must be patient and recognize that the ‘long run takes time to arrive’ (507). They identify the shortcoming in state competition, at least in the short run, with respect



to takeover legislation as this: states that adopt anti-takeover laws are not penalized as much as perhaps they should be by competition from other states as investors will realize that any state can pass anti-takeover legislation mid-stream (Easterbrook and Fischel 1991: 222). State anti-takeover law, we are assured, is a 'special', though important, case (212).

Like Winter before them, Easterbrook and Fischel point to Delaware's anti-takeover statute. They stress that it is relatively mild compared to those of other states (222–3). This is used to substantiate the assertion that state competition, even in the takeover context, creates powerful incentives for states to enact efficient regulation.

#### *Roberta Romano*

Roberta Romano is another leading supporter of state competition. While avoiding taking a stand on the issue in her initial writings, she now characterizes state competition for corporate charters as the 'genius of American Corporate Law' (1993b: 1). Her belief in state competition is as strong as anyone's. Indeed, she has recently argued that securities law should be recast, based on the American corporate law model, so as to allow competition between chartering jurisdictions (1998).

Also, like Winter, Easterbrook, and Fischel, Romano views legal arrangements enabling managers to erect anti-takeover defences as inefficient. She acknowledges the 'dismal track records of most states in takeover regulation' (1992: 859). Is Romano any more successful in resolving the conflict?

In the course of defending the consistency of her position, Romano emphasizes that Delaware has been slow to adopt anti-takeover legislation, even though it typically has been a leader in most major corporate law reforms. Moreover, its anti-takeover statute is not as draconian as in other states, such as Pennsylvania's disgorgement statute (1993a: 855). Furthermore, Romano spends a great deal of time arguing that, whatever the imperfections of state regulation, any federal takeover law is likely to be worse.

This last defence is hardly a ringing endorsement of state competition. Rather than showing the 'genius' of American corporate law, it is rather an argument that we must live in a highly imperfect world. We find it hard to imagine that Romano, or indeed the other pro-state competition scholars we have discussed, would oppose a hypothetical federal statute that sharply limited the ability of states to restrict takeovers. Whether this is a realistic possibility is beside the point. Support for such a statute would underline the fact that state competition suffers from serious shortcomings. What, if anything, should be done about these shortcomings is another analytical question.

#### **Why supporters of state competition should reconsider**

One type of reaction by state competition supporters, as we have seen, views state takeover law as an anomaly, an exception, or an imperfection. This is most explicit

in Easterbrook and Fischel's writings. The sentiment here seems to be that even a process that has strong structural reasons to function well can fail from time to time, and these failures do not imply that the process is not a good one.

But it is not clear that one can brush aside takeover law as an anomaly or an isolated failure, and comfortably continue to believe that state competition is such a great process. To start with, takeovers might well have been the most important issue with respect to which state corporate law has had to develop a position in the last twenty years.

If states have produced bad takeover law, this was not a fluke, a one-time isolated mistake. We are talking about a gradual process developing over quite a few years, in many steps and decisions, and with much attention and occupation by state officials along the way. There were several waves of anti-takeover statutes, all representing the persistent attempts by states to place impediments in front of takeovers with little or no support in the academic literature. And as for judicial decisions, this involved not one case, but rather an issue that has been visited and revisited over many years. If state competition has persistently produced bad, even indefensible, results concerning the most important corporate issue of recent times, how can we be confident that it performs well elsewhere?

All this means is that it is hard to brush this away as an anomalous exception and continue to think that state competition can reliably produce good results. Easterbrook and Fischel's explanation of why states have adopted inefficient takeover legislation—the fact that these were mid-stream legislative changes—is in no way limited to takeovers. Mid-stream changes are possible with respect to any legal rule, not just takeover regulation, that managers might wish to change. Moreover, mid-stream changes are not only possible through a state changing its corporate code, due, say, to campaign contributions, but by a corporation reincorporating to another state as well.

Another common reaction by supporters of state competition is to point out that Delaware has not been as extreme as some other states in its anti-takeover statute. This is true. But through case law, and in particular the approval of the poison pill, Delaware has erected formidable barriers to takeovers. Delaware's anti-takeover position has had, as it typically does, a central and very influential role. The use of poison pills is now very widespread. The debate is over the body of law produced by state competition. And while states differ somewhat in the extent to which they restrict takeovers, they all by and large go much further in that direction than Winter, Easterbrook, Fischel, and Romano would approve of.

While the pro-state competition view has a serious problem accounting for existing state takeover law, needing to rely on excuses and anomalies, the view that Cary held, and that we are advocating, has no problem whatsoever explaining this. Our concern with the possible shortcomings of state competition for corporate charters is not only consistent with the state takeover law that we observe but helps explain why state law has evolved in the regrettable direction that it has. By reconsidering their largely unqualified endorsement of state competition, its supporters

can both gain a better explanation of why states have adopted restrictive takeover rules and retain their belief in the efficiency of a more permissive legal arrangement.

#### CONCLUSION

This chapter has sought to highlight the problems involved in state competition for corporate charters. On some important issues, states might have incentives to provide rules that are attractive to managers but not shareholders. Takeover law is one important area in which state competition might well have produced a body of law that excessively restricts takeovers. It is an area in which state competition is likely to fail. There are strong theoretical reasons to expect that state competition will work to produce a body of corporate law that excessively protects incumbent managers. The development of state takeover law, we have argued, is consistent with this view. It should lead the many who offer unqualified support for state competition to reassess their position.