

LIE BACK AND THINK OF EUROPE: AMERICAN REFLECTIONS ON THE EU TAKEOVER DIRECTIVE

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The extent to which firms should be permitted to resist hostile takeover attempts is the most hotly debated subject in American corporate law over the last twenty-five years, but it has, until recently, received comparatively little attention in Europe. With the passage of the European Union's Thirteenth Company Law Directive on Takeover Bids (the "Directive") in late 2003, however, hostile takeovers are now firmly on the front burner in Europe as well. It once appeared that the Directive would, with little fanfare, impose a definitive resolution of the issue throughout the European Union (EU) pursuant to which takeover defenses – barriers to a takeover attempt imposed by the board of directors of the target firm – would be virtually impossible to implement. The legislation, however, ended up being so controversial, and so riddled with compromise, that one of its erstwhile supporters called its final terms "more gruesome than many horror films."¹ Far from resolving the debate over takeover defenses in Europe, the Directive seems to have finally gotten it started.

This development is galling to those who want the EU to take an aggressively pro-takeover/anti-defense position, especially because they had previously faced very little opposition.²

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¹ Daniel Dombey, *Watered-Down EU Takeover Directive is a Missed Opportunity for Open Markets*, FINANCIAL TIMES, Dec. 30, 2003, at 20. Even some of the Directive's defenders suggested that they were disappointed with much of its content. See, e.g., *MEPs Approve Embattled Takeover Law*, THE ECONOMIST, Dec. 30, 2003, at 71 (quoting Chris Hune, Joint Rapporteur of the Directive, as saying "This is not anyone's ideal takeover directive, but we can't let the best be the enemy of the good.").

² This group includes the Directive's sponsor, EU internal market commissioner Fritz Bolkestein, who said that the legislation had "fallen victim to horse trading and unholy alliances of convenience" and that its passage was not an advance, but a setback in the drive towards integrated European capital markets. Patrick Blum, *Bolkestein Slams EU Ministers' Deal on Takeover Reforms*,

From the inception of the negotiation process in 1985, it had generally been agreed that the cornerstone of the Directive would be a rule imposing strict limits on the use of defenses against hostile takeover attempts.³ To that end, the European Commission had proposed a draft of the Directive that was intended to create a “level playing field” for takeovers across the EU, primarily by requiring member states to impose two anti-defense rules. The first, the “Passivity Rule,” would prohibit company subject to a hostile takeover bid from taking any action intended to frustrate the bid. The second, the “Breakthrough Rule,” would allow a bidder to render ineffective (or “break through”) certain structural takeover defenses implemented prior to the bid.⁴ Growing skepticism in the European Parliament as to the wisdom of facilitating hostile takeovers, however, meant that these provisions had to be watered down, and as approved, the Directive leaves member states free not to impose either rule.⁵ Because member states will presumably be subject to considerable political pressure to protect local firms from hostile bids, many will not impose the rules. Despite the obvious soundness of the Directive’s anti-defense principles, according to many critics, it is therefore likely to prove ineffectual in practice – defenses will remain in place and takeovers will continue to be difficult.

Viewed from across the Atlantic Ocean, this point of view seems a bit peculiar. While the Directive may turn out to be ineffective, the soundness of its principles is very much open to question. For at least twenty years, the United States has had

EFINANCIALNEWS, Nov. 28, 2003; *Lowest Common Denominator*, THE ECONOMIST, Nov. 7, 2003 (reporting that Bolkestein tried to persuade the European Commission to veto the Directive rather than approve its final form).

³ See Jeffrey N. Gordon, *An International Relations Perspective on the Convergence of Corporate Governance: German Shareholder Capitalism and the European Union: 1990–2000*, 43–49 (Feb. 2003), available at http://www.law.harvard.edu/programs/olin_center (discussing the history of the directive); Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids, 13–17 (Jan. 10, 2002) [hereinafter High Level Group Report], available at http://europa.eu.int/comm/internal_market/en/company/company/news/hlg01–2002.pdf.

⁴ Proposal for a Directive of the European Parliament and of the Council on Takeover Bids (as submitted by the European Commission), 2003 OJ (C 045 E) 8–10, 23–26, available at http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0534en01.pdf.

⁵ See *infra* Part II.

what the Directive is seeking to create in Europe: an active, unitary market for corporate control that spans a continent and is capable of effecting industrial restructuring on a massive scale. And yet takeover rules in the U.S. are fundamentally at odds with the principles underlying the Directive. There is no "level playing field" here. The rules governing takeovers vary substantially from state to state and from firm to firm. Boards of directors of target firms are not required to remain passive in the face of a hostile tender offer. Takeover defenses are, within limits, considered legitimate both by market participants and courts. Moreover, there is a broad consensus in the market and among policymakers that while the U.S. system of takeover governance is far from perfect, it works reasonably well on the whole. From this perspective, the Directive appears to be overly restrictive of defenses rather than overly permissive. Many of the Directive's critics ask why the Passivity and Breakthrough Rules were not made binding upon all member states. A better question, I submit, is why include them in the Directive at all?

I will argue in this article that that question has no satisfactory answer. Underlying the Passivity and Breakthrough Rules is the view that regulators know the universally optimal level of takeover defenses, i.e., none. Furthermore, any deviations from the preferred no-defense arrangement can be conclusively presumed to result from the exploitation of shareholders by incumbent managers (and their board allies) who seek to defeat economically-beneficial takeover bids for self-interested reasons. The U.S. experience casts serious doubt on both propositions. Even when managers' ability to impose defenses on unwilling shareholders is at its weakest, shareholders of U.S. firms almost invariably consent to the adoption of relatively mild defenses, and frequently accept strong ones as well. This behavior is difficult to square with the view that defenses are always detrimental to shareholders. The significant variation in the level of defenses chosen, moreover, suggests that the optimal level of defenses may differ considerably from firm to firm. In addition, the U.S. experience shows that the complete suppression of defenses is clearly not a necessary precondition to the existence of a functioning takeover market. From an American perspective, therefore, the architects of the Passivity and Breakthrough Rules

appear to be both excessively skeptical of defenses and excessively confident in their ability to divine rules on the subject that will be universally appropriate.

The U.S. experience also suggests an alternative approach to the regulation of defenses that would likely be preferable to the Directive's compulsory, top-down approach. If, as U.S. market practice suggests, some defenses are efficient in some circumstances (and if privately optimal defensive arrangements generally coincide with socially optimal ones),⁶ a better regulatory scheme may be one that creates conditions in which firms and investors can effectively bargain for the rules they prefer on a contractual basis. Regulators in such a system could remain basically agnostic about the virtues and vices of defenses. As in most other commercial contexts, they would rely on the parties involved to arrive at wealth-maximizing arrangements.

The legal regime governing takeovers in the United States, I submit, generally reflects this "contractarian" approach. Consistent with basic principles of contract law, American firms and investors can choose among a basically unlimited range of takeover arrangements and be fairly secure in the knowledge that those agreements will be enforceable in the event a hostile takeover attempt is made. In addressing classic problems of contractual interpretation and enforcement, moreover, the U.S. system features a variety of federal, state and stock exchange rules that roughly parallel analogous contract law doctrines. This is not to say that the U.S. system is ideal from a contractarian perspective. As we shall see, for example, American regulators, state legislatures in particular, sometimes change the applicable background law in a way that has the effect, if not the intent, of disrupting the parties' settled contractual expectations. Nevertheless, the American system at least provides a number of instructive principles that could be usefully applied in the European context.

Not only does the Directive fail to incorporate the American system's contractarian principles, however, it actually emulates the least defensible aspects of that system in its willingness to disrupt agreed-upon takeover arrangements. In fact, the Directive would go substantially further than the U.S. system in that regard. While such disruptions occur only sporadically in the

⁶ See *infra* note 129.

United States, they would be imposed systematically whenever the Breakthrough Rule applies. From a contractarian point of view, the Directive manages to achieve something close to the worst of both worlds in that it will both prevent value-maximizing arrangements from being adopted and disrupt those arrangements that are already in place. The Directive likely constitutes poor public policy (though calling it “gruesome” might be a bit of an overstatement). This is not, however, because its key provisions were made optional for EU member states, but because those provisions, however well-intentioned, are substantively unjustifiable. The best thing one can say about the Directive may be that it may ultimately prove to be ineffectual.⁷

The article is organized as follows: Part I summarizes the history of the Directive and its principal terms. Part II outlines the takeover regime applicable in the U.S., and contrasts it with key elements of the Directive. Part III surveys theoretical and empirical evidence from the U.S. experience regarding the strengths (and weaknesses) of the U.S. regime and the implications of that evidence for the Directive. Part IV considers the extent to which the lessons of the U.S. experience with takeovers are applicable to the EU in general and to the Directive in particular. Part V sketches a possible alternative approach to European takeover regulation based on a reconceptualization of the level playing field concept, and suggests that such an approach would be consistent in some respects with policies the EU is already pursuing.

⁷ A personal note at the outset: There is a certain awkwardness involved in an American arguing, as I do in this paper, that the U.S. system of takeover regulation (or at least certain aspects of it) would be better for the EU than that chosen by the governing bodies of the EU itself. In preemptive defense against accusations of jingoism (or, to use more current nomenclature, unilateralism), I would point out that the gist of my argument is not that benighted Europeans should slavishly imitate the American way of doing things. Quite to the contrary, in fact, I contend that because the Europeans (and others) with interests in an EU company should be fully capable of determining suitable rules governing its use of takeover defenses, any takeover regime that imposes a uniform level of defenses on all firms should be treated with skepticism, regardless of where it originates.

I. UNLUCKY THIRTEENTH – A BRIEF HISTORY OF THE DIRECTIVE

Understanding the Directive requires some knowledge of the circumstances in which it was negotiated. We begin, therefore, with a capsule history of how it came into being.

A. THE FIRST AND SECOND PROPOSALS

Like other EU directives on company law,⁸ the Directive was approved only after a long and torturous deliberative process. The effort began in 1985 with a Commission White Paper concerning the EU internal market, which led in 1989 to an initial draft directive.⁹ After receiving comments from the EU Economic and Social Committee and the Parliament, the Commission resubmitted its proposal in 1990.¹⁰ Inspired by similar provisions in the U.K. Takeover Code, this proposal contained a version of the Passivity Rule as well as a “mandatory bid” rule pursuant to which any acquiror of a large block position in a target company would be required to bid for all remaining shares at an equitable price.¹¹ While those rules were (at that time) relatively uncontroversial, a number of member states expressed a general concern that the proposal was too detailed and would intrude too severely upon company law at the national level.¹² In response to these concerns, the Commission submitted

⁸ The directive authorizing the incorporation of companies under EU rather than national law, for example, took thirty years to negotiate. *See generally* Council Directive Supplementing the Statute for a European Company with Regard to the Involvement of Employees 2001/86, 2001 O.J. (L 294/22). A proposed directive concerning intra-European cross-border mergers has been pending for 18 years. *See also* Proposal for a Directive of the European Parliament and of the Council on Cross-Border Mergers of Companies with Share Capital, *available at* http://europa.eu.int/comm/internal_market/en/company/company/mergers/docs/crossbordermergers-comm_en.pdf.

⁹ *See* High Level Group Report, *supra* note 3, at 13.

¹⁰ *See* Amended Proposal for a Thirteenth Council Directive on Company Law Concerning Takeover and Other General Bids 1990 O.J. (C 240) 7.

¹¹ *See id.* at 13–18.

¹² *See* High Level Group Report, *supra* note 3, at 13.

a second proposal in 1996.¹³ The second proposal left more matters to the discretion of member states, but retained the mandatory bid and passivity rules.¹⁴

In June 1999, after three more years of deliberations, the second proposal appeared to be on the verge of final approval when its text was agreed upon by the Council. The Council, however, made its agreement contingent upon negotiations between the U.K. and Spain over the status of Gibraltar, the Spanish expressing the rather non-obvious concern that the proposed directive might lead to the establishment of a separate Gibraltarian takeover authority.¹⁵

These negotiations were completed by June 2000, but by then the political winds had changed, especially in Germany. Early in 2000, Vodafone, a U.K. telecoms firm, completed its stunning hostile takeover of Mannesmann, an icon of German industry.¹⁶ In addition, a massive unwinding of German firms' interlocking cross-holdings seemed inevitable after the announcement by the German government of a plan to eliminate the capital gains tax assessed in connection with sales of such holdings.¹⁷ Together with a new company law limiting certain types of takeover defenses, this change seemed to suggest that Mannesmann would be just the first of many German firms to be swallowed up by raiders, and perhaps to portend the end of "Rheinish" capitalism altogether.¹⁸ Especially in light of the growing realization that some firms in other EU member states

¹³ Proposal for a 13th European Parliament and Council Directive on Company Law Concerning Takeover Bids, 1996 O.J. (C 162) 5.

¹⁴ For example, under the second proposal, member states would have had discretion to set the threshold at which the mandatory bid provision would be triggered. *See id.* at 162–165.

¹⁵ *See* High Level Group Report, *supra* note 3, at 14.

¹⁶ *See* Gordon, *supra* note 3, at 37–43, for a discussion of the Vodafone/Mannesmann transaction.

¹⁷ Prior to this change, the capital gains rate applicable to gain on a firm's sale of shares of another company was approximately 52%. *See* Douglas A. Shackelford et al., *Bringing Down the Other Berlin Wall: Germany's Repeal of the Corporate Capital Gains Tax* 40 (January 2001), available at <http://ssrn.com=abstract25670>. This punitive rate gave firms a powerful incentive to hold their interests in other companies indefinitely, and thus constituted a significant *de facto* takeover defense.

¹⁸ *See* Gordon, *supra* note 3, at 46.

were likely to remain protected by so-called “golden shares,”¹⁹ these developments led Germany, previously a staunch supporter of the second proposal, to view it with much less enthusiasm.²⁰

When the second proposal was sent back to Parliament, the Passivity Rule was seriously called into question for the first time, primarily by the German delegation.²¹ The main objection raised was that the Directive would not make all firms equally vulnerable to takeovers. Because golden share defenses would be unaffected, and because the Directive would not apply to firms organized outside of the EU, opponents charged that it would lead to defensive imbalances between different member states and between EU and non-EU nations, especially the U.S.²² For a time, it appeared that a compromise would be reached pursuant to which the Passivity Rule would be included in the Directive, but implemented only after a five year delay.²³ Even this was not enough to appease opponents of the proposal, however, and it was ultimately rejected by Parliament on a tie vote, 273 to 273.²⁴

¹⁹ “Golden” shares are shares carrying special governance rights (in particular, the right to veto takeovers or other significant actions) held by member state governments in previously state-owned firms. While common in several other member states, golden shares were not typically used as part of the German privatization program. When it began to appear that the European Court of Justice would likely uphold the legality of golden shares in many instances, therefore, the Germans feared that their companies would become disproportionately vulnerable to takeovers following the effectiveness of the directive. *See id.* at 47–48. *See also infra* notes 138–139 and accompanying text.

²⁰ *See* Paul Meller, *Europe Plan on Mergers Hits a Snag*, N.Y. TIMES, May 3, 2001, at W1.

²¹ *See* Victoria Hong, *EU Takeover Code Rejected*, THE DAILY DEAL, Aug. 24, 2001 (discussing the prominent role of German parliament member, Klaus-Heiner Lehne, in opposing the directive).

²² *See* High Level Group Report, *supra* note 3, at 15; Richard Painter & Christian Kirchner, *Takeover Defenses Under Delaware Law, the Proposed Thirteenth EU Directive and the New German Takeover Law: Comparison and Recommendations for Reform*, 50 AM. J. COMP. L. 451 (2002).

²³ *See* Gordon, *supra* note 3, at 49.

²⁴ *See* High Level Group Report, *supra* note 3, at 15. The second proposal, like the Final Directive, was subject to approval pursuant to the EU’s “codecision” procedure. Under this procedure, legislation is initiated by the Commission and following a sometimes complex back-and-forth among the Commission, the Parliament and the Council, takes effect in a form approved by the latter two bodies. *See* GEORGE A. BERMAN ET AL., CASES AND MATERIALS ON EUROPEAN UNION LAW 97–99 (2d ed. 2002).

B. FROM THE HIGH LEVEL GROUP REPORT TO THE
FINAL DIRECTIVE

Undeterred by this agonizingly narrow defeat, Commissioner Bolkestein engaged a group of company law experts (the “high level group”) to revisit several issues raised by the second proposal, including how a revised proposal could satisfy the now-imperative demand for a level playing field.²⁵ Because the final version of the Directive was based largely on the report’s recommendations, and because the report sets forth the policy rationales underlying the Directive with admirable clarity, I will describe it in some detail.

The report begins by observing that as a result of differences in share ownership structure, capital market development, availability of defenses and other factors, firms in different member states have different degrees of vulnerability to hostile takeover attempts – a level playing field, in other words, does not exist.²⁶ Without attempting to explain why this situation is one that needs to be fixed (an understandable omission, perhaps, in that the terms of the high level group’s assignment take the desirability of a level playing field more or less as given), the report then goes on to rehearse two familiar arguments for hostile takeovers: (i) that the premium over market price offered by the bidder for target shares represents (at least as a general matter) the synergies and/or improved management of the target that will result from the contemplated acquisition;²⁷ and (ii) that the threat of a takeover is necessary to induce managers to act consistently with

²⁵ See High Level Group Report, *supra* note 3, at 69–70. Specifically, the group was asked to consider “how to ensure the existence of a level playing field in the EU concerning the equal treatment of shareholders across Member States” in the takeover context. The group was also asked to address the price to be paid in the context of a mandatory bid and a mechanism by which a majority shareholder would be entitled to squeeze out the minority.

²⁶ See *id.* at 18.

²⁷ See *id.* at 19.

Takeovers are a means for bidders to create wealth by exploiting synergies between their existing business and the target company Takeover bids also offer shareholders the opportunity to sell their shares to bidders who are willing to offer a price above the prevailing market price. Such a price will be offered where the bidders believe that the resources of the company can be better developed and exploited under their operation and control.

Id.

shareholders' interests.²⁸ The Passivity Rule is necessary, the group argues, because target managers are likely to lose their jobs in the aftermath of a successful takeover and the target board is therefore faced with a significant conflict of interest when a bid is made. In view of this conflict, the board's role should be limited to advising the shareholders of its opinion of the bid and seeking alternative offers from other potential acquirors.²⁹ In addition, shareholders should not be allowed to authorize defensive tactics in advance of a bid being made, as they would necessarily do so in ignorance of the bid's terms.³⁰

According to the report, however, the Passivity Rule alone is inadequate because it would leave in place structural defenses already in effect at the time a bid is made. In particular, the Passivity Rule would not diminish the defensive effectiveness of arrangements that put disproportionate voting power in the hands of incumbent managers and their allies. To illustrate, suppose that Black Corporation has outstanding 1,000 Class A shares, all of which are held by the public, and 100 Class B shares, all of which are held by members of the founding Black family. Although all shares are equal in terms of dividend and liquidation rights, the Class A shares are limited to one vote each while each Class B share carries the right to cast twenty votes. This arrangement would make it impossible for a bidder to take control of the company without the consent of the Black family, as even a bidder who acquired all publicly held shares would be able to cast only 1,000 votes at subsequent shareholders' meetings compared to the family's 2,000. Merely requiring the Black board to remain passive would therefore do nothing to increase the company's vulnerability to a takeover attempt. Similarly, the

²⁸ See *id.*

[A]ctual and potential takeover bids are an important means to discipline the management of listed companies with dispersed ownership, who after all are the agents of shareholders. If management is performing poorly . . . the share price will generally under-perform in relation to the company's potential and a rival company and its management will be able to propose an offer based on their assertion of their greater competence.

Id.

²⁹ See *id.* at 20.

³⁰ See *id.* at 27–28.

Passivity Rule would be inapplicable to defenses like charter provisions that impose share transfer restrictions, voting caps and limits on shareholders' rights to replace incumbent directors. Even if Black had only a single class of shares, for example, a provision in its charter limiting the voting power of any single shareholder to a maximum of 10% of the total would make it very difficult for an acquiror to take control of the company, passive board or no. To overcome such defenses, therefore, more is needed.

The "more" recommended by the group was the Break-through Rule. Going beyond mere passivity, this rule would effectively re-write the terms of the target's governing documents in several respects. First, no contractual or charter provisions restricting the transfer of shares would be given effect in the event of a takeover bid.³¹ Second, if the bid resulted in the acquisition of 75% or more of the target company's "risk bearing capital" – i.e., the equity capital carrying uncapped dividend rights – any voting limitations or provisions establishing disproportionate voting rights in the target charter would be similarly disregarded at the first general shareholders' meeting following completion of the bid.³² Finally, limitations on the bidder's right to replace the incumbent board members and to amend the target's charter at that meeting would be eliminated as well.³³ Accordingly, if a hostile bidder were to acquire at least 825 Black shares (either Class A or Class B), the Black family's collective voting power would be reduced from 66% to 9% (100/1,100), and the bidder would be free to replace the Black board with its own nominees and amend the company's charter at the next shareholders' meeting.

³¹ *See id.* at 36–38.

³² *See id.* at 32–33. The types of voting limitations eliminated would include caps on the number of votes that could be cast by any one shareholder and time-phased voting rights pursuant to which long-term holders enjoy enhanced voting rights.

³³ This would be true, the report says, even if the limitation was a feature of the applicable company law, although it would not apply to limitations created pursuant to co-determination or other employee governance schemes created by law. *See id.* at 33. Change of control provisions in contracts to which the target is a party, however, would not be broken through, at least if entered into in good faith. *See id.* at 37.

Any preexisting terms in the charter to the contrary would simply be ignored.³⁴

The high level group acknowledged that implementation of the Passivity and Breakthrough Rules would not lead to a level playing field between the EU and the U.S. It defended this imbalance by arguing that while boards of U.S. firms have broad *de jure* discretion to employ defenses against hostile takeovers, they are under more *de facto* pressure from investors and others to accept value-enhancing bids than are their European counterparts. Therefore, the group argued, allowing EU targets the same types of defenses would be likely to have more dire consequences than it does in the U.S.³⁵ In the event an internationally level playing field is demanded as a political matter, the report suggested, the Passivity and Breakthrough Rules could be made to apply only to bids by other listed EU companies. Under this “reciprocity” principle, a target board would be subject to the Passivity and Breakthrough Rules if the hostile bidder was another listed EU firm, but not if it were a U.S. or privately-held European company.³⁶

Not surprisingly, the Breakthrough Rule proved to be controversial, especially in countries in which firms with disproportionate voting structures are common.³⁷ After failed attempts to make the rule more palatable by narrowing its scope, introducing a grandfathering mechanism and/or granting industry-specific exemptions, another deadlock seemed likely.³⁸ This time, however,

³⁴ The Breakthrough Rule is not entirely without precedent: French authorities imposed a similar rule on Danone in 1992, and a 1994 Italian statute had a similar effect. Unlike the Breakthrough Rule proposed by the High Level Group, however, these rules applied only to voting caps. See Barbara Dauner Lieb & Marco Lamandini, *The New Proposal of a Directive on Company Law Concerning Take-over Bids and the Achievement of a Level Playing Field* 20–21 (Dec. 2002), European Parliament Directorate General for Research Working Paper, at http://www.europarl.eu.int/comparl/juri/studies/study_complaw_en.pdf.

³⁵ See *id.* at 26–27.

³⁶ See *id.* at 56.

³⁷ See Council of the European Union Report from the Presidency to the Permanent Representatives Committee 21 n. 33 (May 7, 2003) (noting reservations taken by Finland, Belgium, the Netherlands, Sweden, Denmark and Luxembourg with respect to draft version of Breakthrough Rule).

³⁸ Marco Becht, *Reciprocity in Takeovers*, European Corporate Governance Institute – Law Working Paper No. 14/2003 (Oct. 2003), available at <http://ssrn.com/abstract=463003>; Council of the European Union Report from the Presidency to

a compromise based on a variation of the reciprocity principle was able to bridge the gap. Both the Passivity and Breakthrough Rules would be made optional at the national level, but member states would be required to allow firms to opt in to them individually. In addition, a firm otherwise subject to the rules could opt back out in the event of a bid by a company that is not itself bound by them. As one commentator puts it, the compromise envisions a “breakthrough club” the members of which would be more vulnerable to bids by other club members, but not to bids by firms outside the club.³⁹ Although this compromise would not achieve the goal of a level playing field on a general, EU-wide basis, it would, in theory, do so in the context of each individual takeover battle. A bidder and the target would either be mutually bound to, or mutually free from, the effects of the rules.

While the reciprocity compromise thrilled no one, and even led Commissioner Bolkestein to attempt to derail the Directive altogether, it satisfied the demand for a level playing field. Following some smoke-filled-room negotiations on extraneous issues,⁴⁰ the Directive was approved in Parliament by a 60% majority.⁴¹

C. TERMS OF THE FINAL DIRECTIVE

With this history in mind, let us review the most important provisions of the Directive in its final form:

Passivity – if the Passivity Rule applies, a target board will be required to obtain the prior approval of shareholders before

the Permanent Representative Committee 2 (May 7, 2003); *see also* John C. Coates IV, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, 2–3, Harvard Law and Economics Discussion Paper No. 450 (July 9, 2003); European Corporate Governance Institute – Law Working Paper No. 11/2003, *available at* <http://ssrn.com/abstract=424720>.

³⁹ *See* Becht, *supra* note 38, at 4.

⁴⁰ According to some reports, the U.K. reached a secret agreement with Germany to support the final version of the Directive in exchange for German help in defeating Commission proposals on temporary workers’ rights. *See* Daniel Dombey, *Watered-Down EU Takeover Directive is a Missed Opportunity for Open Markets*, FINANCIAL TIMES, Dec. 30, 2003, at 20.

⁴¹ *See MEP Approve Embattled Takeover Law*, EUROPEAN VOICE, Dec. 18, 2003, at 4.

adopting any antitakeover defenses or otherwise seeking to defeat a takeover bid.⁴² Shareholders may not authorize defensive tactics in advance of a bid being made.⁴³

Breakthrough – if the Breakthrough Rule applies, restrictions on the transfer of target securities, whether contractual or part of the target’s charter, will be rendered inapplicable during a bid.⁴⁴ At the first shareholders’ meeting following the bidder’s acquisition of 75% or more of the target’s voting stock: (i) contractual or charter provisions limiting voting rights will not be given effect; (ii) any extraordinary rights of shareholders to appoint or remove directors under the target charter will be disregarded; and (iii) shares of stock that would normally have super voting privileges will carry only one vote.⁴⁵ Notwithstanding earlier German objections, however, special rights conveyed by golden shares will remain in effect.⁴⁶

Level Playing Field/Reciprocity – a member state is permitted not to implement the Passivity and Breakthrough Rules so long as it allows companies subject to its jurisdiction to opt in to the rules.⁴⁷ A member state that does impose the rules is authorized to suspend their application with respect to a particular target company if (i) a hostile bid is made by a firm that is not a member of the “breakthrough club;”⁴⁸ and (ii) such a suspension

⁴² See Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, 2004 OJ (L142/12) art. 9, sec. 2 [hereinafter *Final Directive*]. Any decision taken prior to the bid but not fully implemented will also be subject to shareholder approval if it (i) is outside the ordinary course of business and (ii) would frustrate the bid. See *id.* art. 9, sec. 3.

⁴³ See Proposal for a Directive of the European Parliament and of the Council on Takeover Bids – Explanatory Memorandum, 2003 O.J. (C 45/E), available at http://europa.eu.int/eur-lex/en/com/pdf/2002/com2002_0534en01.pdf (commentary to Article 9 provides that “[T]he authorisation of the general meeting must therefore be given explicitly with a view to responding to a specific bid”).

⁴⁴ See Final Directive, *supra* note 42, art. 11, sec. 2.

⁴⁵ See *id.* art. 11, sec. 4.

⁴⁶ See *id.* art. 11, sec. 5a.

⁴⁷ See *id.* art. 11A, secs. 1 and 2.

⁴⁸ Because only EU firms are subject to the Directive, only those firms would appear eligible to “join” the club. This would appear to allow member states to discriminate against bidders from outside the EU – a target company might be required to remain passive in the face of takeover attempt by an EU firm but simultaneously be permitted to resist bids from non-EU firms. According to a

was approved by the target's shareholders within the preceding 18 months.⁴⁹

Recognizing its failure to impose uniformity on member states' takeover laws, and implicitly reiterating the view that uniformity would be desirable, the Directive includes a kind of reverse sunset provision. The Commission will be required to reassess it five years after it takes effect with a view towards making a new proposal that would impose a greater degree of "harmonization" on member states' takeover laws.⁵⁰

II. THE U.S. TAKEOVER REGIME COMPARED

The contrast between the Directive and the system of takeover regulation applicable in the U.S. is considerable. Each of the Directive's key principles is either absent from, or actively rejected by, the U.S. regime. On one level, this simply reflects obvious differences in attitude towards takeover defenses – i.e., American policymakers like them and the drafters of the Directive do not. A closer inspection, however, shows that the differences in specific rules are in some cases less stark than might first appear, and suggest a related disagreement that is both more subtle and ultimately, I think, more important.

A. PASSIVITY

Taking the most obvious point of comparison first, boards of U.S. target companies are not required to remain passive in the face of a hostile takeover attempt and need not, as a general matter, seek shareholder approval prior to taking defensive action.⁵¹ In practice, what this means is that a board is ordinarily free to adopt a poison pill—either in anticipation of, or in response to, a

memorandum circulated by law firm Cleary, Gottlieb, Steen & Hamilton, however, the Commission has informally indicated that all non-EU bidders will, in effect, be treated as members of the club for the purposes of the rule. The target member's state will be permitted to suspend the application of the passivity and Breakthrough Rules only with respect to bids by EU firms that could be, but are not, themselves subject to those rules. See Cleary, Gottlieb, Steen & Hamilton, *The Proposed EU Takeover Bids Directive* (Dec. 10, 2003) (on file with author).

⁴⁹ See Final Directive, *supra* note 42, art. 11A, sec. 3.

⁵⁰ See *id.* art. 20, sec. 1.

⁵¹ The Delaware Supreme Court has expressly rejected the idea of requiring any form of a passivity rule. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 n.10 (Del. 1985) ("It has been suggested that a board's response to a takeover

hostile bid.⁵² By giving all shareholders other than a hostile bidder the right to acquire shares of the target at a bargain price, the pill effectively prohibits non-board-approved acquisitions of company stock over a specified threshold (typically between 10 and 20%).⁵³ As long as a pill is in place, therefore, the target is takeover-proof.

A target board's ability to use a pill, however, is subject to some limits. First, a court can order the pill to be removed if its use is found to be inconsistent with the board's fiduciary duties to target shareholders. The severity of this restraint varies significantly from state to state. In the case of a Delaware corporation, for example, a board must be able to satisfy an "enhanced scrutiny" test by showing that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" when using a pill and that its actions were "reasonable in relation to the threat posed."⁵⁴ While courts applying this test generally give considerable deference to target directors' decisions,⁵⁵ it is not toothless.⁵⁶ On the other hand, some states reject

threat should be a passive oneHowever, that clearly is not the law of Delaware, and as the proponents of this rule of passivity readily concede, it has not been adopted either by courts or state legislatures.").

⁵² While a variety of other defenses are available, the pill is ordinarily both less costly to implement and more effective. *See generally* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEXAS L. REV. 271, 320–23 (2000). Pill adoption does not require shareholder approval, has no adverse accounting or tax consequences, is inexpensive and can be accomplished in as little as one day. *See generally* ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE, Sec. 5.01 [B] and [C] (6th ed. 2004). Unlike sales of "crown jewel" assets and similar tactics, the implementation of a pill can be easily reversed. Moreover, the defensive potency of pills with the now-standard "flip-in" feature is such that none has ever been triggered.

⁵³ This describes the effect of the "flip-in" feature of modern pills. Early pills, like the one deemed lawful in the Supreme Court of Delaware's seminal decision in *Moran v. Household Int'l Inc.*, 500 A.2d 1346, 1353 (Del. 1985), generally had only "flip-over" provisions. Because flip-over pills are triggered only upon a merger or other business combination of the target company, they leave open the possibility that a bidder could acquire control of the target through stock purchases without being affected by the pill. Such a strategy has rarely been attempted, however. *See* FLEISCHER & SUSSMAN, *supra* note 52, at sec. 5.04[D][2].

⁵⁴ *Unocal Corp.*, 493 A.2d at 955.

⁵⁵ *See, e.g.,* *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153 (Del. 1989) (citing as a "threat" justifying defensive tactics on the part of the target board the risk that shareholders will "tender into [an] offer in ignorance or mistaken belief of the strategic benefit which [an alternative, board-approved] business combination might produce"); *Unitrin, Inc. v. American General Corp.*,

the enhanced scrutiny approach as too strict, and instead apply the exceedingly deferential business judgment rule *simpliciter*.⁵⁷

Second, the target board can itself be removed if the bidder conducts a successful proxy contest. The likelihood of this happening depends to some degree on how quickly such a contest can result in the bidder taking control of the target board, which in turn depends on the law of the relevant state and the terms of the target's governing documents. There are, broadly speaking, three possibilities:

One proxy contest – If all target directors can be replaced at a single shareholders' meeting, a bidder will be able to take control of the target after a single successful proxy contest.⁵⁸

Two proxy contests – If the target has a classified or "staggered" board, only a minority of its directors will be up for reelection at any one meeting. Assuming a board with three classes (as is almost always the case), this means the bidder will,

651 A.2d 1361, 1388 (Del. 1995) (holding that second element of Unocal test prohibits only defensive measures that are either "coercive or preclusive" or fall outside a wide "range of reasonableness"). See generally Ronald Gilson & Reiner Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989).

⁵⁶ See, e.g., *Chesapeake Corp. v. Shore*, 771 A.2d 293, 328–29 (Del. Ch. 2000).

⁵⁷ See, e.g., IND. CODE ANN. § 23–1–35–1(f) (West 2004).

Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article.

Id.

⁵⁸ In most cases, the target's governing documents will be written so as to require any such takeover to be accomplished at an annual stockholders' meeting. In some cases, however, shareholders will be able to effect a mid-year "coup" by removing directors without cause or by creating a large number of new board vacancies and filling them with a bidder's nominees. When a majority of shareholders are permitted to act by written consent, such a coup can be effected via a consent solicitation rather than a proxy contest. See generally John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301, 1346 (2001).

in theory, have to wage proxy contests in each of two consecutive years in order to take control of the board.⁵⁹

Proxy contests ineffective – If a target is incorporated in a state that permits the adoption of “dead hand” pills⁶⁰ – i.e., pills that can be removed only by incumbent directors – the bidder will not be able to free itself of the pill even after it takes control of the board. It must instead wait for the pill to expire pursuant to its terms, which may take ten years (or even longer) – a period that in the world of mergers and acquisitions is roughly equal to eternity.⁶¹

Depending on the applicable state law and the terms of the target’s charter and bylaws, then, the U.S. system can give a target board an essentially unlimited ability to defeat takeover bids. On the other hand, the American rejection of the Passivity Rule does not always create an incumbent’s paradise. The adoption of a pill will force the bidder to accompany its tender offer with a proxy contest, but in many cases this will buy the target a reprieve of only a few months. In addition, the pill may become the subject of reasonably searching judicial review, at least if the target is incorporated in Delaware. The contrast with the strictures of the Passivity Rule is stark, but not total.

B. BREAKTHROUGH

The differences between the Breakthrough Rule and its closest analogs in the U.S. system are more subtle; in fact, there are a surprising number of parallels. Like the Breakthrough Rule, for

⁵⁹ This assumes that shareholders are unable to effect mid-year coups. *See generally* Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence and Policy*, 54 STAN. L. REV. 887, 913 (2002). If mid-year coups are possible, the defensive effect of a staggered board is likely to be nil.

⁶⁰ Dead hand pills have been upheld as valid in Pennsylvania (*see* AMP Inc. v. Allied Signal Inc., 1998 U.S. Dist. LEXIS 15617 at *34–35 (E.D. Pa. Oct 8, 1998) (*rev’d on other grounds* by 168 F.3d 649) and Georgia (*see* Invacare Corp. v. Healthdyne Technologies, Inc., 968 F. Supp. 1578, 1580–81 (N.D. Ga. 1997)). In addition, so-called “slow-hand” pills, which can be redeemed by a raider-elected board only after a six-month delay, are permitted in Maryland. *See* MD. CODE ANN., CORPS & ASS’NS §2–201(c)(2)(ii) (2004). All such pills, however, are *per se* invalid in Delaware. *See* Quickturn Design Systems, Inc. v. Shapiro, 721 A.2d 1281, 1291–92 (Del. 1998).

⁶¹ *See generally* John Eufon, *Should Dead Hand Pills Be Sent to an Early Grave?*, 25 SEC. REG. L.J. 303 (1997).

example, American common law has historically disfavored both restrictions on the transfer of stock⁶² and voting agreements.⁶³ While these traditional principles have little, if anything, to do with takeovers *per se*, they do reflect an emphasis on the free exercise of stock ownership rights that is highly consistent with the spirit of the Breakthrough Rule.

The effect of these breakthrough-like common law rules, however, has been dramatically reduced over the years. Share transfer restrictions are now generally considered valid, at least with respect to a shareholder who acquired the stock with knowledge of their existence,⁶⁴ and voting agreements are expressly permitted by statute.⁶⁵ In practice, transfer and voting restrictions are now usually treated more or less the same as garden-variety contractual commitments.

The history of disproportionate voting structures in the U.S. exhibits the same pattern. Nonvoting stock, which first became popular in the 1920's, was initially viewed by many as necessarily abusive. In Harvard professor William Ripley's memorable phrase, the issuance of nonvoting stock was the "crowning infamy" in a managerial plot to disenfranchise public shareholders.⁶⁶ Reflecting this sentiment, the New York Stock Exchange (the "NYSE") long maintained a prohibition on the listing of

⁶² See 12 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5461.3 (1990 rev. ed.) (citing cases).

⁶³ See, e.g., *Chew v. Inverness Mgmt. Corp.*, 352 A.2d 426, 430 (Del. Ch. 1976); *Macht v. Merchants Mortgage & Credit Co.*, 194 A. 19, 22 (Del. Ch. 1937); *Neuman v. Pike*, 591 F.2d 191 (2d. Cir. 1979); *Brady v. Bean*, 211 Ill. App. 279, 283–84 (1921).

⁶⁴ See, e.g., DEL. CODE ANN. tit. 8 §202 (2004) [hereinafter "DGCL"]; MODEL BUS. CORP. ACT § 6.27; cf. *Lett v. Westland Development Co.*, 112 N.M. 327, 815 P.2d 623 (1991).

⁶⁵ See, e.g., DGCL tit. 8, § 202 (2004); MODEL BUS. CORP. ACT § 6.27; see also FLETCHER ET AL., *supra* note 62, § 2064 ("Hostility towards [voting] agreements has lessened; in fact, there is a trend toward sustaining voting agreements except where clearly against public policy."); *Ringling Bros. v. Ringling*, 53 A.2d 441, 447 (Del. 1947) ("Generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit . . . so long as he violates no duty owed his fellow stockholders.").

⁶⁶ Stephen M. Bainbridge, *The Short Life and Resurrection of SEC Rule 19c-4*, 69 WASH. U. L.Q. 565, 569 (1991) (citing W. RIPLEY, MAIN STREET AND WALL STREET 77 (1927)).

nonvoting shares.⁶⁷ In the 1980's, however, NYSE-listed firms began to demand the right to create disproportionate voting structures in order to ward off hostile bids, and the NYSE announced a moratorium on the enforcement of its rule.⁶⁸

A wave of recapitalization transactions followed in which shareholders were apparently coerced into accepting disproportionate voting structures. To illustrate one common stratagem, suppose that the managers of White Corporation own a significant, but non-controlling, stake in the company. Nervous about the possibility of a hostile takeover, the White board, at the behest of management, offers to exchange the firm's existing common stock for shares of a new class with enhanced voting rights but reduced dividend rights. This offer presents White's public shareholders with a prisoner's dilemma: they know that management will accept the offer *en masse* in an attempt to take voting control of the company and thereby render it takeover-proof. While they have a collective interest in preventing that from happening, the best outcome for any one shareholder would be to reject the offer and let others foil the managers by accepting it. That way, White would stay vulnerable to a possible takeover bid *and* the shareholder would keep the high dividend stock. Because each public shareholder has the same incentives, however, they will all reject the offer, thus allowing voting control to end up in management's hands.⁶⁹

When the NYSE and other exchanges proved unable to address the concerns raised by this type of transaction, the Securities and Exchange Commission (the "SEC") stepped in.⁷⁰ It did not, however, revert to a blanket ban on disproportionate voting

⁶⁷ See generally Joel Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 694-97 (1986).

⁶⁸ See JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 565 (5th ed. 2000). The NYSE's decision was prompted by a planned issuance by General Motors of reduced voting stock in connection with a merger: The NYSE feared that GM would defect to Nasdaq or Amex, both of which had more liberal rules regarding disproportionate voting structures.

⁶⁹ See generally Jeffrey Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CALIF. L. REV. 3 (1988); Ronald Gilson, *Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807 (1987).

⁷⁰ See Bainbridge, *supra* note 66, at 577-78.

structures in the manner of the old NYSE rule, but instead focused on the coercive means in which such structures were sometimes created. Its rule 19c-4 denied listing privileges to companies effecting transactions like the one described in the preceding paragraph,⁷¹ for example, but did not apply to transactions in which the risk of coercion was thought to be low, such as issuances of nonvoting stock in IPOs.⁷² Although a federal court subsequently held that the SEC lacked authority to issue rule 19c-4,⁷³ each of the major exchanges now maintains a substantially similar rule.⁷⁴

Corporate law limitations on disproportionate voting structures generally follow the same pattern. While such structures are not considered inherently suspect, and in fact are sometimes expressly authorized by statute,⁷⁵ they can be prohibited if implemented in a coercive manner – for example, if management expressly or implicitly threatens to take action inconsistent with the best interests of the company unless it is given disproportionate voting power.⁷⁶

In sum, although both the Breakthrough Rule and the applicable provisions of U.S. law regulate voting limitations, share transfer restrictions, and disproportionate voting structures, they do so in markedly different ways. While the Breakthrough Rule reflects a belief that it is in the very nature of such defenses to harm shareholders, the U.S. regime tends to focus instead on the process pursuant to which the defenses are implemented.

C. LEVEL PLAYING FIELD/RECIPROCITY

Regarding the level playing field idea, the difference between the Directive and the American system is clearer: there is no comparable concept in U.S. law. As we have already seen, an American target's vulnerability to a takeover bid will vary considerably depending on the rules adopted by its state concerning

⁷¹ See Exchange Act Rule 19c-4(c)(3).

⁷² See Exchange Act Rule 19c-4(d)(1). See *infra* notes 169–181 and accompanying text.

⁷³ *Business Roundtable v. SEC*, 905 F.2d 406 (D.C. Cir. 1990).

⁷⁴ See, e.g., NYSE Listed Company Manual, Rule 313(A); Nasdaq Rule 4351.

⁷⁵ See, e.g., DGCL tit. 8 § 151(a); N.Y. BUS. CORP. LAW § 613 (McKinney 2004).

⁷⁶ See, e.g., *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271 (Del. Ch. 1986).

staggered boards, dead hand pills and fiduciary duties in the takeover context.⁷⁷ At one time, it appeared that courts would impose significant constraints on a state's ability to protect its firms from hostile bids under the rubric of the Commerce and Supremacy clauses of the U.S. constitution.⁷⁸ Subsequent cases, though, have suggested that these constraints are in fact rather loose,⁷⁹ if indeed they exist at all.⁸⁰ Accordingly, while there is a *de facto* floor in the level of defenses target companies are allowed – no state, for example, prohibits the use of pills, staggered boards, or the two in combination⁸¹ – there is no real ceiling.⁸²

⁷⁷ See *supra* notes 51–61.

⁷⁸ See *Edgar v. MITE Corp.*, 457 U.S. 624 (1982).

⁷⁹ See *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987).

⁸⁰ See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 508–09 (7th Cir. 1989) (opinion by Judge Easterbrook, a noted proponent of mandating target board passivity and an opponent of state antitakeover laws, suggesting that a state could impose an outright ban on mergers without violating the U.S. constitution). See generally RONALD GILSON & BERNARD BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 1317–99 (2d ed. 1995).

⁸¹ Oklahoma may be a partial exception, although only as a result of what appears to be an anomalous judicial decision. Following the decision of the Oklahoma Supreme Court in *International Brotherhood of Teamsters General Fund v. Fleming Cos.*, 1999 OK 3, 975 P.2d 907 (Okla. 1999), shareholders of an Oklahoma corporation may, without board action, adopt a resolution prohibiting the adoption or use of a pill. While not making the pill unlawful, this decision dramatically undercuts its usefulness as a takeover defense. See generally Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409 (1998). California is arguably a partial exception as well: As Subramanian points out, there is some reason to suppose that a California court might hold the flip-in feature of most modern pills to violate state law. See Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 3 (2003) (citing California corporate law treatise for the proposition that the flip-in would contravene Section 203 of the California Corporate Code). On the other hand, almost all modern pills contain both flip-in and flip-over features, and while the flip-in is the more potent of the two, the flip-over alone is sufficient to prevent the consummation of a takeover in almost all circumstances. See also *supra* notes 55–56.

⁸² Pennsylvania may have gone the furthest towards protecting its corporations, having adopted an aggressive series of antitakeover laws. See 15 PA. CONS. STAT. §§ 2561–68 (1995) (limiting voting rights of major shareholders), 15 PA. CONS. STAT. §§ 2541–48 (1995) (20% holder required to offer to purchase remaining shares at a “fair price”), 15 PA. CONS. STAT. §§ 2551–56 (1995) (limiting business combination transactions with major shareholders), 15 PA. CONS. STAT. §§ 2571–75 (1995) (disgorgement of bidder profits), 15 PA. CONS. STAT. §§ 515–16, 1715–16 (1995) (permitted consideration of non-shareholder interests), 15 PA. CONS. STAT. §§ 1525, 2513 (1995) (poison pill endorsement), 15 PA.

As to reciprocity, the idea that firm-by-firm variation in takeover vulnerability is an evil to be guarded against strikes the American observer as an odd one. In part, this is because the policy rationale underlying the reciprocity concept is obscure.⁸³ A more general reason, though, is that a toleration of differences among firms is inherent in the fundamentally permissive character of the U.S. system. All U.S. takeover rules are, in effect, only default positions. Assuming it observes all the requisite formalities, a firm can make itself takeover-proof, takeover-resistant, or takeover-prone, in each case with a reasonable degree of certainty that its choice will be respected. As some recent IPOs demonstrate, a variety of arrangements are in fact used in practice. Much-ballyhooed Google Inc., for example, has adopted a dual class capital structure that leaves effectively uncontestable control of the firm in the hands of its co-founders and CEO.⁸⁴ Most firms are less aggressively anti-takeover than Google, but have nevertheless gone public with significant protection in the form of staggered boards.⁸⁵ Still others have left themselves fairly vulnerable to takeover attempts by adopting only the

CONS. STAT. §§ 2585–88 (1995) (limitation on impairment of labor contracts following a business combination), and 15 PA. CONS. STAT. §§ 2581–83 (1995) (requiring “tin parachute” severance payments to workers terminated following a change of control). Perhaps more importantly, dead hand pills are also permitted under Pennsylvania law. *See* AMP Inc. v. Allied Signal Inc., No. 98–4405, 1998 U.S. Dist. LEXIS 15617, *14–16 (E.D. Pa. Oct. 8, 1998) (*rev’d on other grounds* by 168 F.3d 649).

⁸³ *See infra* Part V.

⁸⁴ Google is offering only low-vote Class A common stock in its IPO; the company’s insiders will retain a large majority of the Class B common stock, which has ten times the per share voting power of the Class A stock. *See* Amendment No. 9 to the Google, Inc. Registration Statement on Form S-1, filed with the SEC on August 18, 2004 (disclosing that, post IPO, the founders and the CEO will control approximately 38% of the company’s total voting power, and that the company’s officers, directors and employees will own in the aggregate approximately 84% of the total voting power).

⁸⁵ *See, e.g.,* Symmetry Medical Inc. Registration Statement on Form S-1, filed with the SEC on May 28, 2004.

default defenses provided under Delaware corporate law.⁸⁶ More exotic structures are possible as well, although rare in practice.⁸⁷

D. TWO REGULATORY MODELS: COMPULSORY AND CONTRACTARIAN

So what is one to make of the differences between the American system and the regulatory regime envisioned by the proponents of the Passivity and Breakthrough Rules? As noted earlier, the obvious theme is that the American regime generally allows the use of takeover defenses, while the Directive generally prohibits them. This is not, however, simply a familiar case of *laissez-faire*, management-friendly American capitalism contrasting with the more heavily-regulated European version. Far from being purely deregulatory, the American system features a complex and pervasive web of rules imposed by the courts, Congress, state legislatures, the SEC and the stock exchanges. The more revealing question is not which system is more or less regulated, but what the salient differences between their respective regulatory philosophies are.

The answer, I submit, is that while the Directive envisions the imposition of takeover rules that are compulsory for both firms and shareholders, American rules create a basically contractarian system in which defenses are permitted if shareholders give their *ex ante* consent or, in some cases, have an *ex post* veto.⁸⁸ This will strike many as a counter-intuitive claim. Proponents of the Passivity and Breakthrough Rules assert that the

⁸⁶ See, e.g., Critical Therapeutics, Inc. Registration Statement on Form S-1, filed with the SEC on May 26, 2004.

⁸⁷ A firm could, for example, adopt a charter provision that bans defenses altogether, or go even further by requiring all decisions regarding acquisition proposals to be made by an independent trustee or by the shareholders directly. On the other hand, a firm could also adopt a radically antitakeover posture through a charter amendment, for example by vesting all management authority in its CEO. To my knowledge, however, none of the foregoing arrangements has ever been implemented.

⁸⁸ This is a specific application of the contractarian model of the corporation writ large, which depicts the corporation as a nexus of formal and informal contracts between managers, employees, investors and other constituents. Each participant agrees to provide specified inputs – labor, capital, etc. – in exchange for benefits that are either specified in advance or determined pursuant to an agreed-upon procedure. While the model acknowledges the role of mandatory public law, it places private contracts and contract-like arrangements at center stage.

rules would, if properly implemented, ensure shareholder control of decisions about defenses, and that more permissive rules, such as those in place in the U.S., would allow shareholders' views to be ignored. In fact, the opposite of this assertion is closer to the truth.

1. *The Directive's Compulsory Approach*

Consider the Directive first. When the Passivity Rule applies, shareholders are not permitted to grant the board a general authorization to resist takeovers, but must instead wait until a bid is made.⁸⁹ While this may seem like a minor limitation, what it means in practice is that shareholders may not authorize any meaningful defenses at all. If they oppose a bid in sufficient numbers to approve defensive measures against it, after all, no defense is necessary. They can defeat the bid on their own by simply declining to tender.⁹⁰ If a defense is to have any effect, therefore, it must be binding upon shareholders at the time the bid is made. Because the Passivity Rule prohibits shareholders from agreeing to be so bound, it protects them from all real defenses – whether they like it or not.

The Breakthrough Rule has a similarly disempowering effect. Although it does not forbid shareholders from agreeing to a company's adoption of takeover defenses, it achieves basically

For a classic exposition of the model, see Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989).

⁸⁹ See *supra* note 43 and accompanying text.

⁹⁰ There are circumstances in which a shareholder would, at least in theory, want to tender into an offer and yet to vote against it. Suppose that the bid is "front-end loaded" – i.e., it is for only part of the target's shares, and the price to be paid for the remaining shares is either low or uncertain. In that case, a shareholder might elect to tender even if she thinks that the bid price is inadequate: If she doesn't, she might get stuck with an even worse price when squeezed out later by the bidder. See generally Eloffson, *supra* note 61, at 314–15. On the other hand, her decision as to how to vote on any proposed defenses against such an offer would not be similarly affected, as she can vote to defeat the offer without her vote having any adverse consequences if the offer succeeds. See generally Bebchuk et al., *supra* note 59, at 126. This kind of disjuncture between tendering and voting incentives is unlikely to arise under the Directive, however, as its mandatory bid rule makes front-end loaded bids effectively impossible – a successful bidder for a controlling block of the target will be required promptly to make an offer for all remaining shares at a price at least equal to the initial bid. See Final Directive, *supra* note 42, art. 5.

the same result by making most of those agreements unenforceable. Suppose a company and a group of its shareholders would like to enter into an agreement pursuant to which the shareholders would accept limits on their ability to accept hostile bids, but would be given enhanced rights in other areas (the right to veto management's choice of auditor, say). If the Breakthrough Rule applies, such a trade-off will likely be impossible, as shareholders will retain an unwaivable right to "break through" the agreement in the event of an attractive offer.⁹¹ Because the shareholders cannot commit to live up to their side of the bargain, managers are unlikely to agree to the sought-after concessions. In this respect, the rule is quite similar to the common law principle that holds a minor's contractual obligations to be unenforceable.⁹² Like children under the common law, shareholders are protected by the Breakthrough Rule, but at the cost of being disabled by it.

2. *The American System's (Basically) Contractarian Approach*

A defender of the Passivity and Breakthrough Rules might respond by observing that the American system has compulsory aspects of its own. U.S. takeover law, after all, permits target boards to adopt defenses without shareholder approval, and indeed in the face of vociferous shareholder opposition. Arguably, then, the American system gives shareholders no more influence over a firm's defensive posture than they have when they are subject to the Passivity and Breakthrough Rules.

To see why this argument is (mostly) incorrect, we must distinguish between two phases of a shareholder's involvement with a firm: the initial investment and the "midstream" period. When the initial investment occurs, the relationship established between the company and the shareholder strongly resembles a

⁹¹ It would be possible to immunize the agreement from the Breakthrough Rule by making sure that a reliable bloc of insiders holds at least 26% of the company's risk bearing capital. Such an arrangement would obviously not be economically feasible in every case, however.

⁹² See, e.g., *Kiefer v. Fred Howe Motors, Inc.*, 39 Wis. 2d 20 (1968) ("The general rule is that the contract of a minor, other than for necessities, is either void or voidable at his option.").

contractual one.⁹³ As we have seen, the key determinants of the firm's vulnerability to a hostile bid are the terms of its charter, (which will indicate, among other things, whether it has a disproportionate voting structure or a staggered board) and the state in which it is incorporated.⁹⁴ Because the firm must publicly disclose both,⁹⁵ as well as any other factors likely to impede a bid,⁹⁶ the shareholder assents, at least implicitly, to the company's defensive posture at that point. True, she will probably not be in a position to bargain with the company about particular defenses. She is free, however, to put her money in less sheltered companies – if she is passionate on the subject, in fact, she can invest in the United Kingdom (U.K.), which enforces a strict version of the Passivity Rule.⁹⁷ Rules governing stock transfer restrictions have the same effect. If the shareholder invests with knowledge of a restriction, it is likely to be enforceable against her.⁹⁸ As with defenses generally, she is free not to invest if she finds a restriction onerous. Although no actual contract is signed, therefore, the investment process results in an implicit understanding concerning the company's defenses. I will refer to this understanding as the “defense agreement.”

The defense agreement having been struck, the goal of a contractarian system of takeover regulation in the midstream period is to ensure that both sides get the benefit of the terms for

⁹³ In fact, courts not infrequently describe charters and bylaws as contracts, and interpret them with reference to contractual canons of construction. *See, e.g.*, *Centaur Partners v. National Intergroup, Inc.*, 582 A.2d 923, 928 (Del. 1990).

⁹⁴ *See supra* notes 54–61 and accompanying text.

⁹⁵ *See* Regulation S-K, Item 601 (requiring copies of a company's charter and bylaws to be filed as exhibits to its annual report on Form 10-K).

⁹⁶ Under Regulation S-K, Item 202(a)(5), a company is generally required, when issuing securities, to include in its registration statement a description of:

any provision of [its] charter or bylaws that would have an effect of delaying, deferring or preventing a change in control of the [company] and that would operate only with respect to an extraordinary corporate transaction involving the [company] (or any of its subsidiaries), such as a merger, reorganization, tender offer, sale or transfer of substantially all of its assets, or liquidation.

Id.

⁹⁷ *See* Robert Stern, *United Kingdom*, in *A PRACTITIONER'S GUIDE TO TAKEOVERS AND MERGERS IN THE EUROPEAN UNION* 553–57 (Maurice Button et al., eds., 3d ed. 2001).

⁹⁸ *See supra* note 65.

which they bargained. Some of the mechanisms for achieving this goal are fairly straightforward and intuitive, in particular corporate law rules that prevent either boards or shareholders from changing the key terms of the agreement without the consent of the other.⁹⁹ As in the case of ordinary contracts, however, protecting parties' expectation interests often requires more complicated rules as well. Many of the features of the American system discussed above can be understood in this light.

3. *Incomplete Contracting*

One issue that arises in a contractarian model of takeover regulation is that it may be difficult to govern all aspects of a firm's use of defenses through the application of pre-determined rules. It is highly unlikely, for example, that a company's charter would specify the circumstances in which the board would be permitted to enter into agreements with change of control provisions. Although such provisions can have a significant impact on a firm's vulnerability to a hostile bid, this is unusual.¹⁰⁰ Moreover, they are typically demanded by bank lenders and other counterparties for reasons that have nothing to do with takeover defense.¹⁰¹ Rather than craft pages-long charter provisions distinguishing acceptable and unacceptable change of control provisions, therefore, firms and shareholders agree to leave decisions

⁹⁹ Under DGCL section 242, for example, a proposed charter amendment must be approved first by the board and then a majority of shareholders before it can take effect. A similar approval process is required before a Delaware corporation can reincorporate in another state. See DGCL §§ 251, 252. Although the function of these provisions is clear from a contractarian perspective, I note that they are more or less inexplicable from the point of view of a simple principal/agent model of the corporation. In that model, the board is merely the instrument through which shareholder wishes are expressed – accordingly, one would expect corporate law rules that require boards to approve whatever changes to the defense agreement shareholders might demand. Instead, however, the law effectively treats boards and shareholders as independent parties where charter amendments and reincorporation decisions are concerned.

¹⁰⁰ See, e.g., 1 MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS & FREEZEOUTS, §6.03[5] at 6–96.3 (2004) (arguing that the defensive efficacy of change of control provisions is “highly doubtful”). But see Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PENN. L. REV. 577, 618 (2003) (citing cases in which change of control provisions appear to have had an effect on the outcome of a hostile takeover attempt).

¹⁰¹ Bank lenders, joint venture partners and other parties who envision an extended, and potentially complex and interactive, relationship with a company frequently

regarding those provisions to the board. While this delegation can be assumed to have been agreed to by a shareholder at the time of her initial investment, the same assumption cannot necessarily be made with respect to the board's use of its authority.

The question, therefore, is how to prevent the board from abusing its discretion. The American system does this by providing for *ex post* judicial review of the board's actions to ensure compliance with its fiduciary duties. In Delaware, for instance, a board that enters into a contract with a change of control provision for defensive purposes (or takes any other defensive action) must be able to show that its decision was sufficiently reasonable to pass muster under the enhanced scrutiny test.¹⁰² This reasonableness requirement can be thought of as a partial substitute for the bargaining that might have occurred between shareholders and the firm had the action in question been addressed in the company's charter. As in an ordinary contractual dispute, the judge resolves the issue by filling the gaps created by ambiguities in the defense agreement.¹⁰³ This *ex post* review is both expensive and prone to inaccuracy, but may be the best way of handling issues that are resistant to contractual resolution.

It is true that courts applying the enhanced scrutiny test do not weigh the claims of shareholders and boards even-handedly, but instead give decisions of the latter considerable deference.¹⁰⁴ Furthermore, outside of Delaware, this deference is often almost complete. In states that apply the traditional business judgment

seek assurances that the managers with whom they are negotiating will remain in control of the company throughout the course of the relationship. Change of control clauses typically provide them a degree of protection in this respect by allowing them to terminate the relationship without penalty if a change of control occurs. *See, e.g.,* LIPTON & STEINBERGER, *supra* note 100, § 6.03[5], 6–96.3 (observing that lenders began demanding change of control provisions in response to wave of leveraged buyout transactions that occurred in the mid- to late-1980s).

¹⁰² *See, e.g.,* In re Dairy Mart Convenience Stores, C.A. No. 14713, slip op. at 31–32 (Del. Ch. May 24, 1999) (“The enhanced scrutiny of Unocal/Unitrin applies whenever a board unilaterally adopts a defensive measure in reaction to a perceived threat to corporate policy including circumstances where a board acts in response to a specific takeover threat and when it adopts measures designed to ward off future potential advances.”); *cf. Glazer v. Zapata Corp.*, C.A. No. 12958 (Del. Ch. May 14, 1993).

¹⁰³ *See generally* E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS § 7.16 (3rd ed. 2004).

¹⁰⁴ *See supra* notes 57–59 and accompanying text.

rule, a board's decision to adopt a defense need not satisfy a standard of reasonableness, but instead will be upheld if merely rational.¹⁰⁵ Giving the board this degree of latitude would appear to be inconsistent with the contractarian model in that, contrary to ordinary principles of contractual interpretation, courts in these jurisdictions effectively resolve all ambiguities in the defense agreement in favor of one side.

On the other hand, the incomplete contracting problem only arises in the takeover context if the defense agreement gives the board the general authority to take defensive action. If lax judicial scrutiny of board decision-making were intolerable to shareholders, they could insist on charter provisions prohibiting defenses. A flat prohibition would be easy to draft – a single sentence would suffice – and fairly easy for a court to enforce.¹⁰⁶ The only real cost of such an approach would be that all defenses would be banned, not just unreasonable ones. Interestingly, although proponents of the Passivity and Breakthrough Rules assume that this “cost” would actually be an unambiguous benefit, market participants in the U.S. seem to take the opposite view. As we shall see, they overwhelmingly prefer to rely on the courts, the apparent one-sidedness of judicial review notwithstanding, rather than ban defenses altogether.¹⁰⁷

4. *Collective Action Problems*

A second challenge for a contractarian model of takeover regulation is the collective action problem that shareholders face in dealing with management in the midstream period. According to the standard theory, because the costs of providing a coordinated response to management activities fall on shareholders individually and the benefits accrue to them as a group, each has an incentive to free ride on the efforts of others and a suboptimal

¹⁰⁵ See, e.g., IND. CODE ANN. § 23-1-35-1(g) (West 2004) (“If a determination [to take defensive action] with the approval of a majority of the disinterested directors of the board of directors, that determination shall conclusively be presumed to be valid unless it can be demonstrated that the determination was not made in good faith after reasonable investigation.”).

¹⁰⁶ There could be disputes, for example, about whether a board decision was intended to have a defensive effect or whether that effect was incidental to a decision made for other reasons. Courts routinely resolve questions of intent in other contexts, however.

¹⁰⁷ See *infra* notes 175–194 and accompanying text.

amount of coordination will occur.¹⁰⁸ Therefore, although the key components of the defense agreement – i.e., the firm’s charter and its state of incorporation – can be amended only with shareholder approval,¹⁰⁹ this protection may prove ineffective. By exploiting shareholders’ collective action problems, management may be able to induce them to approve changes that they in fact oppose.

The White hypothetical considered earlier is a classic example of how collective action problems can lead to the inefficient adoption of defenses.¹¹⁰ If public shareholders of White Corp. could coordinate their actions costlessly, they would all agree to trade their ordinary common stock for high-vote, low-dividend stock, and would thereby keep voting control of the company in public hands. Collective action problems, however, make the necessary degree of coordination difficult, if not impossible, to obtain. Each public shareholder can therefore be expected to reject the offer so as to avoid being stuck with the worst possible outcome: owning low-dividend stock in a takeover-proof company.

The response of the U.S. system to this problem – rule 19c-4 and its successors – is highly consistent with the contractarian model. Rather than banning disproportionate voting structures altogether, these rules focus on whether shareholders are unfairly pressured into approving them. A disproportionate structure in place at the time the firm goes public is considered unobjectionable even if it completely insulates the firm from the threat of a takeover, as that fact is part of the defense agreement at the time of each public shareholder’s initial investment. On the other hand, a board cannot impose a disproportionate structure in the midstream period through a coercively-imposed, and

¹⁰⁸ See generally Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

¹⁰⁹ See, e.g., DGCL § 242 (charter amendment); MODEL BUS. CORP. ACT § 10.03(b)(2) (same). A change in a company’s state of incorporation is typically accomplished by creating a new, wholly owned subsidiary in the “target” state and then merging the company into the subsidiary. Such a transaction, like any other merger, is subject to shareholder approval. See, e.g., DGCL § 251(c); MODEL BUS. CORP. ACT § 11.01(a).

¹¹⁰ See *supra* note 69 and accompanying text.

therefore effectively unilateral, charter amendment.¹¹¹ In this respect, the rules closely resemble analogous contract law principles. A court examining a disputed amendment to an agreement will not ordinarily examine its substantive fairness, but will instead look only to whether it was entered into without fraud or coercion.¹¹²

5. *Changed Circumstances*

The third, and most difficult, issue that a contractarian model of takeover regulation must address is the problem of changed circumstances. How should the defense agreement be interpreted if unforeseen events drastically change the consequences of an agreed-upon term? While this issue also arises in other contractual settings,¹¹³ it is unusually acute in the context of takeover regulation due to the typically indefinite duration of corporate arrangements and the severity and frequency of exogenous changes in financial markets, background law and other factors that affect takeover activity.

Consider the effect of a change in background law regarding the use of pills. If you buy shares in a company that is incorporated in Delaware and has a single class of directors, you can feel

¹¹¹ It is true that the rules apply to some transactions where the risk of shareholder coercion seems rather low. For example, Rule 19c-4 effectively prohibited charter amendments imposing voting right caps (which limit the percentage of the company's voting power exercisable by any one shareholder) or time-phased voting rights (provisions giving long-term holders enhanced voting rights), even if shareholders approved them in circumstances apparently unaffected by collective action problems. See Rule 19c-4(c)(1),(2). At least part of the SEC's justification for this was that shareholders asked to approve disproportionate voting structures are rationally apathetic about the contents of complex proxy solicitations, and may therefore vote in favor of management proposals unthinkingly. See Exchange Act Release No. 25891 (July 7, 1988). This rationale – which implies that shareholders can *never* be trusted to look out for their own interests, at least in the midstream period – reflects a compulsory rather than a contractual regulatory approach. On the other hand, however, the rule only applies if there is a reduction in voting rights of an already outstanding class of common stock that is registered under the 1934 Act. Hence, it would not apply to voting caps and time-phase voting limits in place before the company goes public.

¹¹² See FARNSWORTH, *supra* note 103, § 4.21–22.

¹¹³ See generally John Eloffson, *The Dilemma of Changed Circumstances in Contract Law: An Economic Analysis of the Foreseeability and Superior Risk Bearer Tests*, 30 COLUM. J. LAW. SOC. PROB. 1 (1996).

confident that both the board and any pill it adopts will be subject to relatively quick removal in the event of an attractive hostile bid. The absence of a staggered board means that a hostile bidder can remove all the incumbent directors after a single proxy contest; because dead hand pills are illegal in Delaware, moreover, the bidder will be able to terminate any pill immediately upon taking control.¹¹⁴ If, on the other hand, you decide to invest in a Pennsylvania corporation, especially one with a staggered board, you have effectively agreed to give incumbent directors *carte blanche* to veto hostile bids. Even the intrepid bidder that is willing to face both Pennsylvania's battery of antitakeover statutory provisions¹¹⁵ and the possibility of having to win two proxy contests a year apart risks having its efforts stymied in the end by an irremovable, and perfectly legal, dead hand pill.¹¹⁶

Suppose, however, that you invest in a state where the legality of dead hand pills has never been considered and a court subsequently holds them to be permissible. Even worse, perhaps, suppose they were considered illegal at the time of your investment because of a judicial decision on the subject, but the decision was subsequently reversed by a statutory amendment? In either case, the board will have acquired an almost unlimited power to block hostile bids, even though (i) you and your fellow shareholders never consented to such an arrangement, and (ii) your initial investment may have been based in part on the assumption that the company would be relatively easy to take over.

Changed circumstances can cut in a pro-takeover direction as well. As Marcel Kahan and Edward Rock have pointed out,

¹¹⁴ Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1288–89 (Del. 1998).

¹¹⁵ See 15 PA. CONS. STAT. §§ 2561–2568 (1995) (limiting voting rights of major shareholders), 15 PA. CONS. STAT. §§ 2541–2548 (1995) (20% holder required to offer to purchase remaining shares at a “fair price”), 15 PA. CONS. STAT. §§ 2551–2556 (1995) (limiting business combination transactions with major shareholders), 15 PA. CONS. STAT. §§ 2571–2575 (1995) (disgorgement of bidder profits), 15 PA. CONS. STAT. §§ 515–516, 1715–1716 (1995) (permitted consideration of non-shareholder interests), 15 PA. CONS. STAT. §§ 1525, 2513 (1995) (poison pill endorsement), 15 PA. CONS. STAT. §§ 2585–2588 (1995) (limitation on impairment of labor contracts following a business combination), and 15 PA. CONS. STAT. §§ 2581–2583 (1995) (requiring “tin parachute” severance payments to workers terminated following a change of control).

¹¹⁶ AMP Inc. v. Allied Signal Inc., No. 98–4405, 1998 U.S. Dist. LEXIS 15617 at *34–35 (E.D. Pa. Oct 8, 1998) (*rev'd on other grounds* by 168 F.3d 649).

for instance, when the Delaware General Corporation Law was amended in 1969 to give shareholders the ability to act by written consent, the change was considered purely a matter of convenience. As hostile bids became common in the early 1980's, however, shareholders' power to take action outside of a meeting began to assume substantive significance as a way of quickly replacing a board during a takeover battle.¹¹⁷ A board that had accepted action by written consent solely in the interests of streamlined corporate administration found that it had brought a Trojan horse within its walls.

There is, pretty obviously, no perfect response to this problem in a contractarian system, as no legal regime can either prevent circumstances from changing, or perfectly recreate the substance of parties' agreements after major changes have occurred. So how does the American system respond? In some cases, policymakers intervene with cautious, relatively moderate new rules that, while not necessarily attempting to restore parties' pre-existing expectations, appear at least to take those expectations into account. For example, when it became clear that the takeover wave of the early 1980's had left companies radically more susceptible than before to hostile bids, part of Delaware's response was the landmark decision of its Supreme Court in *Moran v. Household*, which validated the adoption of pills.¹¹⁸ While *Household* undoubtedly handed a major victory to target boards, it did so in a carefully balanced way. The decision made clear that the legality of pill use would be conditioned upon both the continued availability of judicial review under the enhanced scrutiny test and shareholders' ability to remove the board following a proxy contest.¹¹⁹ The board's new authority, therefore, would be subject both to quasi-contractual limits in the form of judicial monitoring and *ex post* override by shareholders. While this balance of power was certainly not identical to that which existed before the 1980's takeover wave began, it was probably not wholly dissimilar either.

¹¹⁷ 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, 901 (2002); DGCL tit. 8, § 228(a) (2003). See also Bebchuk et al., *supra* note 59.

¹¹⁸ *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

¹¹⁹ *Id.* at 1354-55.

Whether the *Household* decision constituted wise public policy is of course debatable. Less open to question, I think, is that it represents an implicit attempt to reverse a perceived imbalance in the board/shareholder relationship by tweaking, rather than rewriting, the rules governing that relationship. As such, it fits fairly well within a contractarian model of takeover regulation. Given that no theoretically pristine method of addressing changed circumstances is possible, piecemeal, reasonably balanced regulatory intervention is probably the best way of limiting the impact of exogenous changes on boards' and shareholders' contractual expectations.¹²⁰

Some regulatory interventions, however, are neither piecemeal nor balanced. The legislative history of many state antitakeover statutes, for instance, reflect not so much a desire to maintain parties' expectations regarding takeover defenses as a crude belief that hostile takeovers of local firms are inherently harmful and should be prevented.¹²¹ Still more troubling from a contractarian perspective, a substantial number of these statutes

¹²⁰ Regulatory interventions of this type bear a close resemblance to those contemplated by section 272 of the RESTATEMENT (SECOND) OF CONTRACTS, which gives courts the power to "grant relief on such terms as justice requires including protection of the parties' reliance interests" if necessary to "avoid injustice." RESTATEMENT (SECOND) OF CONTRACTS § 272(2) (1981). The RESTATEMENT, it is true, is somewhat unusual. The problem of changed circumstances in contract law is usually dealt with through doctrines that excuse non-performance by the party burdened by the changed circumstance rather than through equitable adjustment of the terms of the agreement. See, e.g., U.C.C. § 2-615 (1977) (breach excused "if performance as agreed has been made impracticable by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made"). It is not clear, however, how the concept of excused non-performance could be transposed into the takeover setting (a target board accused of breaching its fiduciary duties by adopting a defense, for example, will never claim that it should be excused from observing its duties, but will instead argue that no breach has occurred).

¹²¹ A typically straightforward sentiment was expressed by a Georgia legislator in 1997 in support of an antitakeover statute intended to help Georgia-based Healthdyne Technologies fend off a takeover attempt by an out-of-state bidder: "We're trying to stop the hostile takeover of Healthdyne and give the same right to other Georgia companies to control their destiny." INVESTOR RESPONSIBILITY RESEARCH CENTER INC., STATE TAKEOVER LAWS, Georgia-3 (1998) (quoting State Senator Steve Thompson). See also Lucian Ayre Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 124 (2001) (arguing that the only common theme that can be inferred from the passage of various state antitakeover laws is the desire among state officials to protect local firms from takeovers).

have been passed as a result of lobbying by politically well-connected target firms in the midst of takeover battles.¹²² The enactment of such a law resembles a unilateral rewriting of the defense agreement by the target board – an outcome clearly at odds with the contractarian model.¹²³

Even this problem has at least a partial remedy, however. A shareholder can essentially eliminate the risk of a sudden, target-inspired state antitakeover statute by investing solely in Delaware corporations. Alone among the states, Delaware depends on the proceeds of its corporate franchise tax to fund a substantial fraction of its annual budget.¹²⁴ In addition, its policymakers are keenly aware of the possibility that it could be displaced as the country's leading corporate jurisdiction if it came to be seen as egregiously insensitive to shareholders' interests.¹²⁵ Finally, its small size means that few of its corporations have significant operations there, and therefore that political pressure to protect local firms from hostile takeovers (and consequent job losses) is much weaker than in most other states. Taken together, these factors make it virtually unthinkable that Delaware would implement a sudden, significant change in its takeover law in order to

¹²² See, e.g., Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365, 372; William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 750–51 (1998).

¹²³ That an antitakeover statute is passed in these circumstances does not necessarily prove that it constitutes poor public policy. It could be that a hostile bid brings to light issues that the legislature had never had occasion to consider previously and to which the statute is an appropriate response. In the typical case, though, the bidder (and the target shareholders who want to accept its offer) will have very strong contractarian grounds for opposing the statute.

¹²⁴ See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 688–90 (2002) (states other than Delaware generate only trivial amounts from franchise taxes); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 594 (2003) (approximately 15–20% of Delaware's annual budget comes from franchise taxes).

¹²⁵ See Kahan & Kamar, *supra* note 124, at 741 n.230. Prominent Delaware attorney A. Gilchrist Sparks III speaking at hearings held in connection with the passage of Delaware's mild antitakeover statute:

[W]hy . . . moderate . . . ? Why [not] the most restrictive thing we can pass? . . . [T]o the extent that our legislation is viewed either in the short run or the long run as unbalanced and unreasonable, we all know that ultimately . . . we might have to pay the price . . . of the federal government coming in and taking . . . that privilege from us.

Id.

benefit any single besieged company.¹²⁶ This is not to say that Delaware's rules are necessarily perfect or that its policymakers are impervious to political pressure from target companies, but only that the state has strong incentives to refrain from regulatory interventions that seriously violate the pre-existing expectations of any class of market participants. These incentives, in other words, lead it to act in a manner basically consistent with the contractarian model.¹²⁷

In sum, while the Directive seeks to liberate shareholders in the takeover setting, it does so, somewhat paradoxically, through compulsory means. When the Passivity and Breakthrough Rules apply, shareholders are not merely prevented from being forced to accept defenses, but are actually forbidden from authorizing them. In contrast, while the American system gives boards the power to disregard shareholders' views during a takeover contest, it generally does so, somewhat paradoxically, only after

¹²⁶ *Id.* at 740–41 (arguing that the “safest course” for Delaware policymakers to take in order to avoid federal preemption is “to ensure that neither shareholders nor managers are highly dissatisfied with Delaware law”).

¹²⁷ This claim brings us at least to the edges of the long-standing debate regarding whether competition among states, particularly Delaware, to attract incorporation business leads to an anti-shareholder race to the bottom, see, for example, William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974), a pro-shareholder race to the top, see, for example, Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977), exists at all, see Kahan & Kamar, *supra* note 124, or is fundamentally indeterminate due to the presence of the federal government, see Roe, *supra* note 124. For the purposes of this article, however, I need take sides in that debate only to the limited extent that my endorsement of the contractarian model, and belief that Delaware law is generally consistent with that model, is inconsistent with the “strong” form of the race-to-the-bottom argument, i.e., that Delaware attracts corporations because of its solicitude for managerial interests and consequent disregard of the interests of shareholders. A contractarian system cannot significantly, systematically disadvantage any voluntarily participating party over an extended period because virtually all its rules are mere defaults, and the disadvantaged party will insist on contracting around the offending rule as a condition of his participation. The authority establishing the default rules, however, can do so inefficiently (transaction costs and other effects can make it costly to contract around a suboptimal default rule), and it can be argued that Delaware has done so. A proponent of the contractarian model could, for instance, believe that *Household* was wrongly decided, and that pills should be allowed only if authorized in the company's charter. Even if Delaware law (or any other regime) is substantively suboptimal, in other words, it can be consistent with the contractarian model so long as it contains appropriate procedural mechanisms to allow parties to contract around its rules, prevent unilateral midstream changes, etc.

shareholders have implicitly or explicitly consented to the grant of that power. The American system's means of ensuring the validity of shareholders' consent are necessarily, and sometimes unnecessarily, imperfect. The inherent incompleteness of the defense agreement, collective action problems, and changed circumstances all create issues that can be mitigated, but never eliminated. Even taking its imperfections into account, though, the American system gives both firms and shareholders a reasonable degree of assurance that agreed-upon takeover arrangements, whether they render a company completely defenseless, completely invulnerable, or somewhere in between, will remain in force when a bid is made.

III. WHICH MODEL IS BETTER?

Characterizing the Directive as compulsory and the American system as contractarian does not, of course, tell us which system is more likely to lead to desirable policy outcomes. In this section, we will examine that question first from a theoretical perspective, and then with reference to the inferences that can be drawn from empirical observations of actual market practice.

A. BASIC THEORETICAL RATIONALES

As the High Level Group Report indicates, the case for the Passivity and Breakthrough Rules focuses on the "agency costs" that are incurred as a result of a divergence in the interests of target directors (the agents) and shareholders (the principals) in the takeover context.¹²⁸ This problem manifests itself in two ways. First, because a successful hostile bid will typically result in the replacement of the target's directors and senior managers, the target board (which is usually presumed to be dominated by managers) has an incentive to resist even those bids that would be unambiguously beneficial for shareholders. Second, even in the absence of an actual hostile bid, the possibility that such a bid could be made helps to keep managers honest. For example, a CEO who shirks and engages in wasteful empire-building, or otherwise extracts private benefits of control, will cause his firm's stock price to fall and thereby create an opportunity for a hostile bidder to profit by replacing him. Takeover defenses, therefore,

¹²⁸ See High Level Group Report, *supra* note 3, at 19.

increase the agency costs shareholders incur in monitoring management both by helping boards defeat actual bids (*ex post* costs), and by blunting the threat of potential bids (*ex ante* costs). By radically limiting the use of defenses, the Passivity and Breakthrough Rules promise to increase shareholder (and, by implication, social) wealth.¹²⁹

Underlying this analysis is the assumption that the costs of defenses are never, or at least almost never, outweighed by countervailing benefits. The case for the contractarian model begins with the claim that this assumption is incorrect, not because defenses are always efficient, but because they are in some circumstances. If so, shareholders may benefit most from a regime that allows them to bargain with firms (either expressly or implicitly) regarding the appropriate level of defenses on a case-by-case basis. Assuming reasonably effective rules addressing the incomplete contracting, collective action, and changed circumstances issues discussed earlier, such bargaining can be expected to produce efficient takeover arrangements, just as voluntary exchanges between rational parties are expected to produce value-maximizing results in other contexts.¹³⁰

This argument, of course, makes assumptions of its own. In particular, it assumes that tolerably effective rules governing the negotiation and enforcement of defensive arrangements can be implemented.¹³¹ Our review of the American system of takeover regulation, however, suggests that while no contractarian system will be perfect, one in which defensive arrangements generally reflect the mutual consent of boards and shareholders is at least possible. In addition, if market forces were so ineffective as to be necessarily incapable of constraining inefficient defensive arrangements, this would also call into question the case for takeovers generally, which itself relies on the existence of reasonably

¹²⁹ The analysis of the High Level Group on these points closely parallels that of Frank Easterbrook and Daniel Fischel, the best-known American proponents of mandating target board passivity. See, e.g., 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 (1981).

¹³⁰ See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (5th ed. 1998).

¹³¹ It also assumes that the cost of inefficient arrangements will fall on firms and/or shareholders rather than third parties.

efficient capital markets.¹³² As the High Level Group report makes clear, therefore, the key point of contention between proponents of the Passivity and Breakthrough Rules and advocates of the contractarian model is whether defenses can be expected to be efficient in a non-trivial number of cases.¹³³ Although the issue cannot be definitively settled on the level of theory, there are a number of reasons to suspect that they can be.¹³⁴

B. DO GOOD DEFENSES EXIST?

1. Collective Action Problems Revisited

As noted earlier, it has long been understood that dispersed shareholders face a collective action problem in their dealings

¹³² This point is made at greater length in Part IV. See *infra* notes 201–06 and accompanying text.

¹³³ See High Level Group Report, *supra* note 3, at 18.

¹³⁴ The following, I note, is far from a complete list of such reasons. Others include (i) a board's superior knowledge regarding a hostile bid, the possibility that further negotiation could result in the bid being increased, the value of alternatives, etc., (ii) the arguably distortive effect of "coercive" raider tactics, see Elofson, *supra* note 61, at 314–15, (iii) the possibility that the prospect of hostile bids will either encourage managers to focus exclusively, and inappropriately, on maintaining their firms' short-term share price, (iv) the possibility that a board deprived of the ability to adopt defenses openly will do so surreptitiously, and in the process reduce the value of the firm and (v) the extent (if any) to which the interests of non-shareholder constituencies, or society as a whole, should be allowed to trump those of shareholders in the takeover setting. Regarding the latter, note that the firm-specific investments rationale for defenses described below, see *infra* notes 148–53 and accompanying text, is cast in terms of how consideration of stakeholders' interests may redound, over the long term, to the benefit of shareholders. Under what is sometimes called the "entity" model of the corporation, in which the directors' fiduciary duties run to the corporation as a whole rather than shareholders exclusively, see, for example, Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV. 1169, 1171 (2002), courts would presumably allow a board to resist a hostile bid that would result in a net loss to the collective interests of all corporate constituents, even where accepting it would be unambiguously favorable to shareholders in both the short and long term. The debate as to whether the entity model or its rival, the shareholder-only "property" model, better describes the U.S. corporation as it is, or as it should be, is one of the oldest in corporate law, and its resolution is (well) beyond the scope of this article. See *id.* at 1170–71; Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189, 1189–90 (2002).

with managers.¹³⁵ The problem also arises, however, in their relationship with potential acquirors. Suppose that stock of Green & Co., a widget manufacturer with no takeover defenses, currently trades at \$50, and that the typical premium paid in widget industry acquisitions is 20%. Suppose further that Blue Inc. is interested in buying Green, and would be willing to pay up to \$100 per share. In these circumstances, a Blue bid at \$60 per share is likely to succeed. Collective action problems will effectively prevent the shareholders from negotiating with Blue, and the current market price plus a customary premium is likely to approximate the shareholders' reservation price.¹³⁶ If, on the other hand, shareholders could coordinate their actions without cost, they might agree to hold out for an offer of, say, \$90, which is an offer that would presumably be forthcoming.

Takeover defenses can serve as a means of overcoming the shareholders' collective action problem in this situation. With a reasonably potent arsenal of defenses, the Green board can credibly threaten to block Blue's bid unless it is increased to \$90, just as the shareholders would if they were able effectively to coordinate their actions. Assuming faithful board behavior, therefore, defenses can benefit shareholders by giving the board more power to negotiate on their behalf.¹³⁷ As critics of defenses point out, of course, board faithfulness cannot necessarily be assumed. A board that is given power to veto bids may use it either to entrench itself or to obtain private benefits for its members from

¹³⁵ See *supra* note 108 and accompanying text.

¹³⁶ See Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 485 (2003) (noting that "shareholders wear their reservation price on their sleeves" – that is, their assessment of the value of the company can be seen from the price at which its stock trades). One might think that a tender offer offering *any* premium would be accepted by most shareholders. In fact, this will generally not be the case. The possibility that Green might receive a premium offer was presumably reflected in its pre-bid stock price, and this possibility will be eliminated if Blue's bid is successful, as Green cannot be acquired more than once. To attract the requisite number of tender offers, therefore, Blue will have to compensate Green shareholders for the opportunity costs they bear as a result of missing out on any subsequent offers.

¹³⁷ This is a point that even critics of defenses concede. See, e.g., Lucian Ayre Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973, 1008 (2002) ("To be sure, it is theoretically possible that the optimal strategy for shareholders would be to tie their own hands and give management an irreversible mandate to bargain.").

the acquiror. Defenses can, therefore, simultaneously solve shareholders' collective action problems vis-à-vis the bidder and exacerbate the collective action problems they face in dealing with the board.

To proponents of the Passivity and Breakthrough Rules, the latter problem is always worse than the former. It is far from obvious that this is the case. If the Green board has a sterling reputation, for example, rational shareholders might decide to trust it with the power to resist hostile bids. After all, having placed their faith in the board's ability to manage the company, it would not be terribly surprising if they decided to trust it to sell the company as well. Even if the board is not as highly regarded, moreover, shareholders might decide that it will be induced to act in accordance with their interests by what economists call "bonding devices" (which can be sticks like the threat of reputational loss, lawsuits or informal shareholder pressure or carrots like golden parachute compensation arrangements that provide for large payouts in the event of a takeover).¹³⁸ On the other hand, if the board is comprised exclusively of the CEO's golfing buddies, and available bonding devices are thought to be inadequate, shareholders might be disinclined to give it any authority in excess of the legal minimum.¹³⁹

Other factors could influence shareholders' decisions about defenses as well. For example, the bargaining power provided by defenses is likely to be smaller in situations where the bidder has more than one potential target in mind.¹⁴⁰ If Green insists on receiving \$90 per share, for instance, Blue might turn its attention to another widget manufacturer that it can acquire for the equivalent of \$80 per share.¹⁴¹ Accordingly, shareholders' preferences regarding the appropriate level of defenses Green should be allowed to use might depend in part on their assessment of

¹³⁸ See generally Kahan & Rock, *supra* note 117, at 26–27 (describing how golden parachutes affect the incentives of target company managers in the takeover context).

¹³⁹ See Mark Gordon, *Takeover Defenses Work. Is That Such a Bad Thing?*, 55 STAN. L. REV. 819, 831–32 (2002) (arguing that abuse of takeover defenses generally occurs only when the target board has unusually severe conflicts of interest).

¹⁴⁰ See, e.g., Subramanian, *supra* note 81, at 644.

¹⁴¹ In effect, of course, this is merely a change in Blue's hypothesized reservation price from \$100 per share to \$80. Presumably the \$100 figure also reflected its next-best-available investment option.

how difficult it would be for an acquiror effectively to replicate its assets – the greater the difficulty, the larger the potential gains from the use of defenses. Again, because this factor will vary from firm to firm, there is reason to doubt that any one level of permitted defenses will be universally optimal.

2. *Facilitation of Firm-Specific Investments*

Another reason shareholders might benefit from giving a board veto power over hostile bids is that doing so can facilitate firm-specific investments by employees and counterparties.¹⁴² Suppose, for example, that Brown Corporation, a company with substantial defenses, is considering building a large factory. To make the project feasible, the government of the state in which the factory would be located would have to make substantial investments in the local infrastructure (new roads, etc.). In return, the state would like to receive a firm commitment from Brown as to how long it will keep the factory running and the number of people it will employ there. Brown, however, is reluctant to give any guarantees. Although it intends to make the factory its primary manufacturing facility, and says it would be willing to operate it at a loss for several years if necessary to achieve that goal, the exigencies of business might force it to change course. Because state officials recognize the legitimacy of this concern, and because they have confidence in the sincerity of Brown's CEO (a woman of impeccable character and a long history of demonstrated concern for the state's well-being), the state decides to make the necessary investments without any guarantee from the company.

If takeover defenses had been forbidden, however, the state might have taken a harder line, as it would have had to weigh the risk that the following scenario would unfold: (i) the factory proves to be at least temporarily uneconomic, (ii) the resulting losses drag down Brown's stock price and thereby attract a hostile bid, (iii) the successful bidder replaces Brown's current CEO

¹⁴² Lynn Stout is probably the best-known proponent of this theory. See, e.g., Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667 (2003). For earlier work along the same lines, see Andrei Shliefer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in *CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES* 33 (Alan J. Auerbach ed., 1988).

and (iv) the new CEO, a ruthless cost-cutter, closes the factory. Even if state officials are confident that Brown's CEO will keep the factory open long enough to justify the state's investment in infrastructure, therefore, they would have had no assurance that she wouldn't be replaced with someone less scrupulous following a successful hostile bid.¹⁴³ In addition, they would have faced an increased risk that the Brown CEO would herself renege on her implicit agreement in order to discourage a hostile bid from being made. Absent defenses, then, the threat of a takeover might have made the deal an untenable one from the state's perspective.¹⁴⁴

What this hypothetical illustrates is that one of the presumed benefits of facilitating hostile takeovers through limits on defenses – that doing so will force managers to grasp every possible advantage for shareholders¹⁴⁵ – comes at a cost. People are often reluctant to enter into contracts, especially long-term and therefore somewhat open-ended ones, with those whom they think will grasp at every possible advantage. Instead, they will only deal with, or will offer better terms to, parties they expect to approach the issues that will inevitably arise in a spirit of compromise. By forcing every company into ruthless cost-cutter mode, therefore, rules restricting the use of defenses can hurt firms, and thus their shareholders, by driving potentially valuable counterparties away.

On the other hand, this concern would not justify the use of defenses by all firms. Many companies are already sufficiently

¹⁴³ Of course, they will not have complete assurance on this point in any circumstances (she could, after all, get hit by a bus the day after the factory opens). The problem will be unusually acute in these circumstances, however, in that the very quality that makes her an attractive person to do business with from the state's perspective – her willingness to be patient with the factory even if it generates some losses – is exactly the quality that could cause her to be replaced via a hostile takeover.

¹⁴⁴ The state could obtain a limited degree of protection by insisting on a contractual term pursuant to which its obligations would be contingent upon the CEO's continued service or would cease in the event of a change of control of Brown. Such a provision would be of little avail, however, if the change occurred after the roads are built – at that point, the state has few obligations from which it could be released. Furthermore, that type of provision would not do much to guard against the possibility that the Brown CEO could be pressured to close the factory herself in order to ward off a hostile bid.

¹⁴⁵ See *supra* notes 128–29 and accompanying text.

focused on the short-term bottom line that employees and counterparties are not likely to think that a hostile takeover would materially change their relationship with the company.¹⁴⁶ Companies also vary in the extent to which they are dependent on implicit agreements to encourage firm-specific investment. If a company's primary economic relationships are simple, short-term ones, for example, counterparties may feel that the express terms of their contracts protect them adequately and that they need not rely on the company's good faith.¹⁴⁷ If so, they will be relatively indifferent to the identity of the company's managers – in the event a ruthless cost-cutter takes over the company and breaches their contracts, they will be able to protect themselves effectively by suing. As before, then, this analysis suggests that there may not be a single set of takeover defenses that will be optimal for all companies.

3. *Non-Pecuniary Private Benefits of Control*

A third possible benefit of takeover defenses is that they can facilitate optimal trade-offs between cash flow and control rights in situations where corporate insiders have significant non-pecuniary private benefits of control. Suppose, for example, that Gray is the sole stockholder of Gray & Co., a firm he founded. Through decades of hard work, Gray has made his company a highly successful competitor in its industry. Not surprisingly, he derives substantial personal satisfaction from the firm's success; in fact, he would not dream of selling it at any price. Gray subsequently becomes aware of a major growth opportunity (say, entry into a new line of business) that is likely to prove enormously lucrative for his company. Unfortunately, the financing required

¹⁴⁶ See, e.g., Ann Zimmerman, *Costco's Dilemma: Be Kind to its Workers, or Wall Street?*, WALL ST. J., Mar. 26, 2004, at B1 (describing Costco's strategy of providing relatively generous wages and benefits so as to attract and retain good employees, and comparing that strategy to what it says is rival Wal-Mart's more cost-conscious approach).

¹⁴⁷ Suppose, for instance, that the company is a broker in a commodities market with large numbers of both end users and suppliers and that the company's employees can, and often do, move easily between different firms in the industry. In this case, neither the company's counterparties nor its employees will have much reason to fear expropriation of their firm-specific investments, as those investments are likely to be modest. In addition, the relative brevity of their relationships with the company will make it easier to draft contracts that cover all likely contingencies.

to take advantage of the opportunity greatly exceeds the firm's internally generated cash flow and its available lines of credit. Gray then hires an investment banker who tells him that the cheapest way to raise the necessary funds would be to sell 70% of the company in an IPO. This, however, he is unwilling to do, because with a majority of the stock in public hands, he could eventually lose control of his "baby" as a result of a hostile bid. The psychological benefits he derives from retaining unchallengeable control of his company are more valuable to him than the ability to finance the investment cheaply.¹⁴⁸

In these circumstances, the optimal financing strategy might be for Gray & Co. to create a disproportionate voting structure and then sell its low-vote stock in an IPO. Gray would keep all of the high-vote stock, and therefore control of the company, while public investors would buy a right to receive a majority of the firm's cash flow. While the investors would presumably demand a discount for forgoing full voting rights,¹⁴⁹ they would get what they want most, a chance to participate in the possibly considerable upside of the investment. Gray, meanwhile, would be able to take advantage of the opportunity without running any risk of a hostile takeover if the investment is not successful. In other words, this outcome would be efficient in that both cash flow rights and control rights would be assigned to the parties that value them most. In a world where effective disproportionate voting structures were forbidden, though, this result would not be possible. Gray would have to come up with an alternative (and, by hypothesis, more expensive) form of financing,¹⁵⁰ or

¹⁴⁸ As Coates points out, there are a number of contexts – particularly in the case of family owned firms – in which controlling shareholders are likely to come to similar conclusions. See Coates, *supra* note 38, at 14.

¹⁴⁹ See *infra* notes 190, 196 and accompanying text.

¹⁵⁰ One alternative would be to have Gray & Co. finance the investment with junk bonds instead of low-vote stock. Compared to more traditional forms of debt financing, the risk/return profile of junk bonds is close to that of equity – i.e., both potential returns and the likelihood of loss are relatively high. Because junk bonds do not carry voting rights, moreover, this financing strategy would leave Gray with complete control of the company. On the other hand, Gray might object to junk bond financing on the ground that if the investment were to fail, the bonds would likely go into default and the bondholders could take control of the company in a bankruptcy proceeding.

simply decline to pursue the opportunity.¹⁵¹

As in the case of firm-specific investments, the broader point is that a rule limiting the use of takeover defenses can be a double-edged sword for shareholders. Such a rule can benefit them by making it harder for corporate insiders to extract pecuniary private benefits of control through excessive salaries and the like. However, private benefits of control do not always come out of investors' pockets. In our hypothetical, the satisfaction Gray derives from running the company he created does not cost shareholders anything.¹⁵² When such non-pecuniary private benefits exist, shareholders might rationally agree to tolerate defenses (even defenses of which they disapprove as a general matter) in exchange for something else, such as the ability to purchase cash flow rights at a discount. By denying shareholders the ability to make such exchanges, a rule against defenses could end up hurting them more than it helps.¹⁵³

¹⁵¹ A related point is that a takeover defense can function as an efficient way of attracting and retaining senior managers. Job security is often a key factor influencing the decision of a senior manager to accept or reject a job offer. Because takeover defenses limit the risk that the manager will be fired as a result of a hostile takeover, he will, other things being equal, prefer an employer with defenses to one without them. Even if shareholders oppose defenses as a general matter, therefore, they might decide to allow them in order to attract or retain managerial talent.

¹⁵² Put differently, the wealth effects of governance rules regarding corporate control rights are not always (and maybe not ever) zero-sum. If they were, the common assumption that private benefits of control are necessarily inefficient would be correct, because no pareto-efficient transactions permitting insiders to consume private benefits would be possible. For example, if Gray were to sell 50% of his company's shares in an IPO and prospective investors knew that he would subsequently use his control of the company to extract benefits with a value of \$100, they would pay an aggregate of \$50 less than they otherwise would for the IPO shares – a result that would leave no party better off than they would be under a no-private-benefits rule. Because investors would not have perfect information, moreover, they would have to assume that Gray would extract the maximum level of benefits possible under existing law. Unless he then did so, he would end up worse off than he would have if private benefits had been prohibited.

¹⁵³ Lucian Bebchuk has proposed a variation on this theme. In his model, corporate insiders retain a controlling block of stock at the time of the firm's IPO and, in view of their ability to extract private benefits (pecuniary and otherwise), will be unwilling to cause the company to issue new shares that would dilute their control – even if this means forgoing profitable investment opportunities. Although

C. EMPIRICAL EVIDENCE

Having established that there are theoretical reasons for believing that defenses can be efficient in at least some circumstances, let us now examine the question from an empirical perspective.¹⁵⁴

1. *Ex Post Costs and Benefits*

Critics of defenses argue that in the archetypal case of a successful defense where: (i) a premium, hostile offer is made for shares of a target company; (ii) the target board resists the offer on the ground that the bid, although above market, is inferior to the target's true value as a stand-alone company; (iii) the target's defenses ultimately force the bidder to withdraw; and (iv) the target remains independent, shareholders usually end up worse off than they would have had they been able to accept the offer. This argument has substantial empirical support, suggesting that defenses do indeed impose *ex post* costs on shareholders.¹⁵⁵

As we have seen, however, defenses have *ex post* benefits as well. Defenses often give boards negotiating leverage to obtain higher bids, either from initial bidders or third parties.¹⁵⁶ At present, at least, it is impossible to say how substantial these benefits are in the average case. Empirical studies have repeatedly shown that bidders usually pay higher premiums for targets with poison pills, a result consistent with the claim that the bargaining power advantages of defenses are considerable.¹⁵⁷ The implications of

shareholders disapprove of defenses as a general matter, they see the loss of prospective investment opportunities as a bigger problem. Accordingly, they consent to the adoption of a defense in order to allow insiders to retain control even after the issuance of new shares. See Lucian Ayre Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 720–21 (2003).

¹⁵⁴ The following discussion, it should be noted, does not purport to summarize the vast empirical literature concerning takeover and takeover defenses that has been developed over the last twenty-five years, but only the evidence that is most germane to an assessment of the contractarian model of takeover regulation *vis-à-vis* the compulsory model reflected in the Directive.

¹⁵⁵ See, e.g., James F. Cotter & Marc Zenner, *How Managerial Wealth Affects the Tender Offer Process*, 35 J. FIN. ECON. 63, 86 (1994); Bebchuk et al., *supra* note 59, at 934.

¹⁵⁶ See *supra* notes 140, 146 and accompanying text.

¹⁵⁷ See, e.g., Subramanian, *supra* note 81, at 637 (summarizing results of pill premium studies).

these studies, however, are less clear than they seem. As a number of commentators have pointed out, because a target board can adopt a pill at any time, there is no substantive difference between a company with a pill and one without.¹⁵⁸ Accordingly, the studies do not provide direct support for the bargaining power hypothesis, which posits a correlation between high premiums and the legal availability (and not merely the presence) of defenses. On the other hand, it could be the case that the adoption of a pill has a signaling effect that causes higher premiums in a manner consistent with the bargaining power hypothesis. A target's decision to install a pill is not a non-event. It demonstrates that the target board is not subject to bonding devices that prevent it from using defenses and therefore may strengthen the *de facto*, if not the *de jure*, defensive posture shown to actual or potential bidders, and this could lead to higher premiums.¹⁵⁹ As signaling effects are typically ambiguous, however, the plausibility of this interpretation is open to question.¹⁶⁰

Two additional factors complicate the analysis of defenses' *ex ante* benefits. First, no study has yet found a statistically significant correlation between higher premiums and strong defenses, such as staggered boards or dead hand pills.¹⁶¹ This could

¹⁵⁸ See, e.g., Coates, *supra* note 52, at 287–88; Subramanian, *supra* note 81, at 638 (arguing that “the results from the pill premium studies are ambiguous at best, and perhaps meaningless”).

¹⁵⁹ In fact, if the relatively inconsequential act of adopting an already-authorized pill has a measurable impact on premiums, the pill premium studies might significantly *understate* the bargaining power gains to be had from the more momentous step of giving a board the authority to do so. Adopting a pill in response to a bid is analogous to a gunfighter in a western movie drawing a pistol from his holster during a stand off on Main Street – assuming the gun was visible before, the act is of real consequence only in that it signals to his adversary something about his intentions. If drawing the gun nevertheless substantially changes his bargaining position, it seems likely that an event with consequences that are not limited to mere signaling (e.g., someone taking the gun away from him) would alter his bargaining position to a correspondingly greater degree.

¹⁶⁰ The signal sent by a board's decision to adopt a pill will vary greatly depending on the circumstances. A decision to adopt a pill in response to unsolicited overtures from a potential bidder, for example, will ordinarily send a rather strong signal of intended resistance, while the decision to leave an existing pill in place during the negotiation of a friendly transaction will normally send a very weak one, or none at all.

¹⁶¹ See, e.g., Subramanian, *supra* note 81 (dead hand pills); Bebchuk et al., *supra* note 59 (staggered boards).

be because the bargaining power benefits of defenses are concentrated at the weaker end of the defensive spectrum – i.e., that standard pills lead to significant increases in premiums, but the incremental benefits provided by staggered boards or dead hand pills are relatively small. However, it could also be the case that the bargaining power hypothesis, while theoretically valid, in fact has little practical application. Second, even if it were definitively established that takeover defenses caused increased premiums in completed transactions, this would not prove that the benefits outweigh the implicit cost of discouraging low-premium, but possibly still attractive, bids from being made. In short, the viability of the bargaining power hypothesis is likely to remain the subject of debate.

2. *Ex Ante Costs and Benefits*

If the evidence concerning the *ex post* wealth effects of defenses is ambiguous, the situation is even worse from an *ex ante* perspective. Here, the key problem is that much of the evidence is equally consistent with both pro- and anti-defense arguments. Studies suggesting that defenses lead to increased labor costs,¹⁶² for example, could be read to support the agency cost theory – the claim that takeover defenses hurt shareholders by blunting managers' incentives to increase profits. As Lynn Stout observes, however, such evidence is equally consistent with the theory that defenses *help* shareholders by giving boards greater freedom to allocate extracontractual benefits to employees and thereby encourage valuable firm-specific investments.¹⁶³ The latter theory could, in principle, be supported or undermined by tests of the hypothesized relationship between firm-specific investments and defenses, but the ineffable nature of many of those investments (e.g., investments by employees in personal relationships with others in the firm), makes both their magnitude and value hard to quantify.¹⁶⁴

¹⁶² See, e.g., Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 RAND J. ECON. 535 (1999).

¹⁶³ See Stout, *supra* note 142, at 689–90.

¹⁶⁴ One could, for example, test for a correlation between the presence of defenses and the average length of service of a firm's employees on the theory that the longer an employee stays with the firm, the greater his or her firm-specific investments will be. While that theory would seem at least facially plausible, average

In sum, then, it is difficult, and maybe impossible, to measure accurately the wealth effects of defenses by isolating particular costs and benefits. In addition, not only are the individual calculations fraught with problems, it is not at all clear how to net them against each other. Even if we could say with confidence that increases in *ex post* agency costs associated with a defense were greater (smaller) than corresponding gains from added bargaining power, for example, it could still be the case that the defense is beneficial (detrimental) to shareholders once *ex ante* effects are considered.

3. Market Practice – Theory

An alternative approach to assessing the welfare effects of takeover defenses is to examine how their costs and benefits are reflected in the decisions of market participants. As the high level group points out, market forces should eventually cause seriously inefficient defensive practices to “wither and die out” so long as firms and investors are free to contract around them.¹⁶⁵ If public law permits defenses that are highly detrimental to shareholders, one would expect firms to attract investment by enacting charter provisions preventing their use. Conversely, if defenses are efficient and the applicable public law imposes a default rule prohibiting them, one would expect to see shareholders agree to defense-authorizing charter provisions. As a general matter,

length of service will often not be a very reliable proxy for the value of those investments – among other issues, it could be that only firm specific-investments by a limited class of employees (e.g., executives, creative personnel, etc.) would have real benefit for the company, and therefore that the average length of service for employees as a whole is not a particularly meaningful metric.

¹⁶⁵ High Level Group Report, *supra* note 3, at 22. See also Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1432–33 (1989). The authors noted:

Unless prices are systematically wrong about the effects of features of governance, as opposed to being noisy and uninformative, managers still have appropriate incentives. The long run will arrive sooner or later, and terms that are not beneficial to investors will stand revealed; the firm will lose out in competition for investors' money.

Id.

therefore, defensive practices that achieve widespread acceptance in the market can be assumed to maximize the joint welfare of firms and investors.¹⁶⁶

To be sure, this approach has complications of its own. As we have already seen, for example, the collective action problem shareholders face in monitoring management during the mid-stream period can lead to the adoption of inefficient defenses.¹⁶⁷ Assuming tolerably effective disclosure and anti-fraud rules, competition for capital should provide some check on firms' ability to impose defenses on unwilling shareholders. As a practical matter, firms need to attract equity investment on an ongoing basis, and those that are visibly contemptuous of the interests of their existing public shareholders will be unable to do so on reasonable terms.¹⁶⁸ Nevertheless, the presence of collective action problems means the connection between optimal outcomes and common market practice among established firms may become rather attenuated. While extremely inefficient defensive practices should indeed wither and die out over time, in other words, those that are only somewhat inefficient might persist indefinitely.

On the other hand, not all companies have public shareholders to exploit. Firms engaged in IPOs, for example, tend to be majority owned by managers and sophisticated, well-represented parties such as venture capital funds. If these insiders cause a pre-IPO firm to adopt an inefficient defense, public investors will presumably demand a discount in the IPO to reflect the reduced value of the offered shares and will thereby cause the cost of the defense to fall on the insiders themselves. Similarly, if investors value charter provisions that limit or prohibit the use of defenses, insiders have a strong interest in accommodating them, as doing

¹⁶⁶ This reasoning is an application of the famous Coase theorem, which holds that absent transaction costs, wealth-maximizing parties will bargain to an efficient allocation of alienable legal entitlements regardless of the initial allocation of those entitlements. See R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

¹⁶⁷ See *supra* text accompanying notes 109–13.

¹⁶⁸ Public rules, of course, provide additional limits on insiders' ability to exploit shareholders' collective action problems – as discussed earlier, for example, Exchange Act Rule 19c–4 and its successors effectively prohibit coercive exchange offers and similar transactions that affect pre-existing voting rights. See *supra* text accompanying notes 109–13.

so will increase the price the insiders receive for their shares. In view of these incentives, scholars have frequently assumed that defensive practices adopted by IPO firms will invariably be efficient.¹⁶⁹

In fact, the efficiency assumption is probably a bit too strong, as flaws in the IPO process could lead to the adoption of inefficient defenses. For example, as one commentator has suggested, IPO firms might tend to defer to their lawyers' judgment as to what defenses to add to their charters, and lawyers might favor defenses for self-interested reasons. Because a lawyer could later be blamed if a lack of defenses leads to a hostile takeover, but is unlikely to be blamed for causing a slight, and probably imperceptible, drop in the IPO offering price, he might recommend defenses that are detrimental to both pre- and post-IPO shareholders in order to protect his reputation.¹⁷⁰ Similarly, if the adoption of defenses is thought to be associated with insiders' positive assessment of a company's prospects and those prospects are otherwise unobservable to prospective investors, a firm might install suboptimal defenses so as to signal (accurately or not) its high value.¹⁷¹

¹⁶⁹ See, e.g., Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 306 (1976); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 204–05 (1991) (arguing that takeover-friendly governance rules are invariably efficient and stating as fact their (incorrect) assumption that IPO firms will adopt such rules uniformly).

¹⁷⁰ See Bebchuk, *supra* note 153, at 733.

¹⁷¹ See *id.* at 737. Bebchuk hypothesizes that prospective investors are unable to distinguish between high value (H) and low value (L) IPO firms and therefore that the price investors will be willing to pay for any IPO firm's shares will be based on the average value of H and L firms. He further supposes that (i) adoption of an inefficient defense would allow insiders to extract additional private benefits from the firm following the IPO and (ii) more private benefits can be obtained from H firms than from L firms. If so, H firm insiders might not be fully compensated by investors for forgoing the defense, as the investors would not be able to observe the full extent to which doing so would reduce the amount of private benefits to be extracted. Therefore, H firm insiders might find it advantageous to cause the firm to adopt the defense despite the discount investors would demand in response. As this phenomenon came to be understood in the market, moreover, L firms might also begin to adopt the defense in order to avoid signaling their low value.

Note, however, that these possible market imperfections (assuming they exist at all), will make a difference only at the margin. The unfaithful lawyer theory, for instance, makes sense only when the reduction in value of the IPO shares is slight. If the firm adopts a highly inefficient defense at the lawyer's suggestion and the attendant reduction in the offering price is substantial, the lawyer will face an immediate and relatively certain reputational loss (as opposed to the contingent, deferred risk that his anti-defense advice will someday contribute to a successful hostile takeover).¹⁷² The potential scope of the signaling theory is also small. It applies only to the extent high value IPO firms are somehow prevented from demonstrating their worth to prospective investors through disclosure of positive information.¹⁷³ Accordingly, while there is likely some gap between defensive practices common among IPO firms and optimal takeover arrangements, it is probably not a chasm.¹⁷⁴

¹⁷² I would propose the following as an alternative (and I think somewhat more plausible) lawyer-based explanation for the adoption of inefficient defenses, although it too has explanatory power only at the margins: high quality lawyers dominate, and are known to dominate, the market for mergers and acquisitions advisory work. Consequently, a law firm that exhibits familiarity with mergers and acquisitions concepts will be able to signal to clients and potential clients that its services are of high quality. One way a firm can do this in the IPO context is by recommending the adoption of defenses – the more elaborate and sophisticated the better – even if the recommended defenses have the effect of lowering demand for the IPO shares.

¹⁷³ Returning to Bebchuk's model, insiders at an H firm would not have to bear the cost of an inefficient defense if there were some mechanism by which the company could credibly distinguish itself from L firms. *See infra* note 171. Happily, such a mechanism in fact exists: SEC rules require IPO firms to provide extensive financial and operational disclosures in their offering documents, and these documents feature prominently in the extensive marketing efforts that occur as part of the IPO process. The IPO marketing process is not perfect, of course, but I am aware of no evidence suggesting that it is incapable of allowing investors to distinguish high value from low value firms. A second flaw in Bebchuk's model is that it ignores other possible signaling effects of defense adoption. For example, prospective investors might see the adoption of a defense as a tacit admission on the part of manager/insiders that they have doubts about their ability to run the company successfully and therefore require protection from hostile acquirors who might seek to replace them. To avoid giving this impression, IPO firms might forego the adoption of even efficient defenses. All in all, then, I think Bebchuk's theory is admirable more for its ingenuity than for its plausibility.

¹⁷⁴ Although space does not permit an analysis of all possible theories of IPO market failure, two others should be mentioned. First, Michael Klausner has suggested that in the case of an IPO firm controlled by a financial investor such as a venture capital or private equity fund, it is conceivable that the fund would agree to the

4. Market Practice – Evidence

The question then becomes whether defenses are in fact widespread. With respect to the relatively weak defensive package typically provided under default law – a standard poison pill and no staggered board – the answer is unequivocally yes. Since at least the late 1980's, it has been clear that courts will give target boards wide latitude over the use of pills, and therefore that shareholders who want substantial limits on pill use will have to bargain for those limits on a private basis.¹⁷⁵ Their failure to do so has been virtually total. The relevant empirical studies on IPO firms that have been conducted – covering a total of 470 firms – reveal that *none* of them adopted charter provisions limiting their boards' decision-making authority over pill adoption and use.¹⁷⁶ Evidence concerning the rules adopted by midstream firms is almost as one-sided. According to IRRC data, only 54 (3.6%) of the 1,499 companies in its database in 1995 took any

installation of a suboptimal defense in order to develop a reputation for being magnanimous towards managers and thereby attract more potential investments. Michael Klausner, *Institutional Shareholders, Private Equity and Antitakeover Protection at the IPO Stage*, 152 U. PA. L. REV. 755 (2003). While possibly accurate, this theory does not actually make a claim of market inefficiency. If a fund determines that its interests would be best served by partially sacrificing its interests as a shareholder in order to ingratiate itself with managers, this is not in itself a reason to doubt the private or social optimality of its decision. Second, a number of commentators have suggested that IPO firms might adopt inefficient defenses because of pre-IPO collective action problems. If, for example, pre-IPO managers own only a fraction of the firm's shares, they may have an interest in causing the firm to adopt a value decreasing defense because they would enjoy all of the private benefits associated with the defense but bear only part of the cost. The problem with this theory is not theoretical but empirical. The most sophisticated study conducted on the subject found a *positive* correlation between defense adoption and insider share ownership at pre-IPO firms, a result clearly at odds with the collective action problem theory. See Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83, 100–02 (2001).

¹⁷⁵ In *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989), the Delaware Supreme Court strongly implied that a target board can ordinarily “just say no” – i.e., refuse to redeem a pill in response to a hostile bid regardless whether alternative transactions or higher bids are being sought – so long as it does not interfere unduly with shareholders' right to vote its members out of office. See also *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545 (D. Del. 1995) (affirming validity of “just say no” defense under Unocal and its progeny).

¹⁷⁶ See Daines & Klausner, *supra* note 174, at 94; Coates, *supra* note 58, at 1357.

pill-limiting action between 1990 and 1995.¹⁷⁷ In the majority (61%) of those cases, moreover, the action taken was merely the redemption of a pill, an action that can usually be undone at any time without shareholders' consent.¹⁷⁸ There was considerable speculation in the late 1990s and early 2000s that shareholders might be able to limit boards' adoption of pills unilaterally through the use of binding resolutions.¹⁷⁹ This strategy, however, was largely abandoned, with hardly a peep of protest from investors, at the first hint that the Delaware Supreme Court might disapprove.¹⁸⁰ Other innovations designed to limit perceived abuses

¹⁷⁷ This information is reported on a firm-by-firm basis (i.e., not summarized) in *IRRC CORPORATE TAKEOVER DEFENSES 1995* (Virginia K. Rosenbaum ed.). The reported numbers may be slightly understated: (i) they do not reflect the small number of firms that limited their pill use prior to 1990, and therefore may not have felt the need for further restrictions in the period studied, and (ii) they do not include firms (if any exist) that promised to limit their pill use but failed to make this promise public (e.g., if a firm told its institutional shareholders privately that it would not adopt a pill without their approval, this information would not have been available to the IRRC, and therefore would not have been reported in its database). On the other hand, several firms I have included in the group of those having taken anti-pill action by virtue of their pill terminations went on to adopt new pills later.

¹⁷⁸ *See id.*

¹⁷⁹ *See* RONALD J. GILSON, UNOCAL FIFTEEN YEARS LATER (AND WHAT WE CAN DO ABOUT IT) 21–28 (Columbia Law Sch. Ctr. for Law and Econ. Studies, Working Paper No. 177, Stanford Law School John M. Olin Program in Law and Econ., Research Paper No. 201, 2000); RONALD J. GILSON, LIPTON AND ROWE'S APOLOGIA FOR DELAWARE: A SHORT REPLY (Columbia Law Sch. Ctr. for Law and Econ. Studies, Working Paper No. 197, Stanford Law School John M. Olin Program in Law and Econ., Working Paper No. 229, 2001). The issue initially arose as part of a dispute between the Teamsters General Fund and Fleming Companies, Inc. The Teamsters proposed a shareholder resolution that purported to amend Fleming's bylaws so as to cancel the company's pill and to require any future pill to be approved by shareholders. When Fleming excluded the proposal from its proxy materials, the Teamsters sued it in federal court. Fleming defended its exclusion of the proposal on the ground that giving it effect would allow shareholders to intrude upon the managerial authority granted to the company's directors under Oklahoma law. The district court rejected this argument, a decision that was affirmed upon appeal following certification of the question to the Oklahoma Supreme Court. *Int'l Bhd. of Teamsters Gen. Fund v. Fleming Cos.*, 975 P.2d 907 (Okla. 1999).

¹⁸⁰ In *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998), the court held that dead hand pills are *per se* invalid under Delaware law on the ground that the limits such pills impose on directors' authority are permissible only if set forth in the company's charter. Although the decision had nothing directly to do with shareholders' resolutions, it led many commentators to conclude that the court would use similar reasoning to declare binding resolutions

of pills, such as features designed to make pills “chewable,” also withered on the vine as a result of shareholder apathy.¹⁸¹ If investors strongly disapprove of pills, in other words, you certainly could not tell by examining their investment decisions.

It is true that over the past decade shareholder proposals directed against pills (and other defenses) have become more frequent and have received increasing levels of shareholder support.¹⁸² Even now, however, anti-pill activism is directed at only a small fraction of companies.¹⁸³ In addition, the relevance of the phenomenon would be questionable even if it were more widespread. A contractarian analysis suggests that the unilaterally expressed preferences of either boards or shareholders cannot be expected to tell us much, if anything, about what defensive arrangements are optimal. Rather, efficiency can be inferred only from arrangements that are mutually agreed upon. Because voting is a unilateral action, it allows no such inference.¹⁸⁴

invalid as well. See, e.g., John C. Coates IV & Bradley C. Faris, *Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives*, 56 BUS. LAW. 1323, 1334–35 (2001). Some attempts were made to create binding resolutions that would effectively limit pill use without raising this anticipated objection. Although several attempts stood a reasonable chance of getting around the anticipated *Quickturn* problem, none caught on and the issue quickly fizzled. No Delaware court has yet ruled on the subject.

¹⁸¹ A chewable pill is one that contains provisions (i) rendering the pill’s defensive features inapplicable to bids that meet specified price or other criteria or (ii) is subject to redemption by shareholders, either generally or upon the occurrence of specified events. Martin Lipton introduced one of the first versions of the chewable pill in 1987. In Lipton’s version, the pill is redeemable by shareholders in the event of an unsolicited takeover bid, but only if, among other things, the bidder owned 1% or less of the target’s shares prior to the bid; in addition, the bid must be all cash and be made for all the target shares. Two years later, the California Public Employees’ Retirement System introduced a substantially more chewable version of this pill, allowing the bidder to own up to 20% of the target’s stock and pay for up to 20% of the offer with consideration other than cash. See Maria Carmen S. Pinnell, *IRRC Corporate Governance Service 2002 Background Report E: Poison Pills* (February 2002).

¹⁸² See, e.g., Bebchuk, *supra* note 153, at 723–24.

¹⁸³ See, e.g., Klausner, *supra* note 174, at 757–58 (reporting in Table 1 that the percentage of firms in the IRRC database subject to anti-pill shareholder resolutions rose from a low of 0.7% in 1995 to 2.5% in 2002).

¹⁸⁴ This may appear to be a counter-intuitive claim given the widely (though not universally) accepted principle of “shareholder primacy” – the idea that U.S. corporations are to be managed for the benefit of their shareholders. But a simple principal/agent model of the corporation, in which the board is duty-bound to follow any instructions shareholders give it, does not necessarily follow from the

Furthermore, it may be unsafe to assume that shareholder voting patterns even reflect actual shareholder preferences. Institutional shareholders frequently engage in informal negotiations with managers of struggling firms about governance, compensation, operational and other issues. This gives shareholders an incentive to vote for anti-defense proposals without regard for the efficiency of the defense in question, as doing so increases pressure on management to accede to shareholders' other demands. An anti-defense proposal with strong shareholder support is a convenient stick with which to beat poorly performing or otherwise recalcitrant managers. Voting for such a proposal may therefore be a negotiating tactic rather than a reflection of the impact of the defense on shareholder welfare.¹⁸⁵ Accordingly, the existence of the occasional anti-pill shareholders' resolution does not contradict the evidence from market practice that when shareholders make investment decisions, they almost universally accept the package of defenses typically granted to firms under default public rules.

The popularity of the default package does not mean, however, that the market wholeheartedly embraces defenses generally. The default package in many states is not particularly strong – as discussed earlier, for example, a Delaware corporation without a staggered board will generally be able to resist an attractive

shareholder primacy principle. In fact, as we have seen, U.S. corporate law effectively treats the board and shareholders as basically independent parties whose relationship is governed primarily by contractual or quasi-contractual terms. For reasons we have discussed in Part III, shareholders may benefit from this arrangement despite the surrender of control it requires. Put differently, the separation of ownership and control implied by American corporate law may assist, rather than retard, the goals of the shareholder primacy norm. In this regard, note that most U.S. corporate laws insulate boards from shareholder control only as a matter of default law – under title 8, section 141(a) of the Delaware Code, for example, a firm could adopt a charter provision providing for greater shareholder oversight of board decisions (e.g., through binding shareholder resolutions) or even to forgo board governance altogether. As Lynn Stout observes, that such alternative arrangements are not adopted in practice suggests that the principal/agent model of corporate governance is incomplete at best. *See Stout, supra* note 142, at 693–94.

¹⁸⁵ Some commentators have made the related argument that many institutional investors effectively delegate their voting decisions to proxy recommendation firms, Institutional Shareholder Services in particular, and that such firms have an incentive to create the appearance of shareholder discontent in order to increase demand for the governance advisory services they provide to companies. *See, e.g.,* Charles M. Nathan, *Show Business*, THE DEAL, Mar. 29, 2004, at 36.

hostile bid for only a few months.¹⁸⁶ Also, as defenses become stronger, they are adopted less frequently. While the majority of IPO firms have staggered boards, for example, a substantial number do not.¹⁸⁷ Staggered boards are also common, but far from ubiquitous, among midstream companies.¹⁸⁸

Complete defenses, moreover, are fairly rare. For example, disproportionate voting structures are adopted by only a relatively small percentage of IPO firms.¹⁸⁹ The unpopularity of such structures may be due to the fact that, unlike more moderate defenses, they have a measurable effect on IPO pricing. While investors seem to be apathetic about whether a company has a staggered board or the ability to adopt a pill, they demand discounts when offered low-vote stock in an IPO.¹⁹⁰ (On the other hand, there is no sign that disproportionate voting structures are headed for extinction, the percentage of IPO firms offering low-vote stock having stayed basically steady throughout the 1990s).¹⁹¹

Firms' responses to state antitakeover laws provide further evidence of the distinction market participants draw between moderate and extreme defenses. These laws typically allow firms to opt out, and thereby make themselves more vulnerable to

¹⁸⁶ See *supra* notes 52–62 and accompanying text.

¹⁸⁷ See Bebchuk, *supra* note 153, at 725–26 (summarizing in Figure 1 the results of studies collectively showing a general rise in the incidence of staggered boards among IPO firms from 35% in 1988–92 to 82% in 2002).

¹⁸⁸ See Bebchuk et al., *supra* note 59, at 892 (reporting that takeover targets have effective staggered boards (i.e., staggered boards that cannot be evaded through mid-year coups) approximately fifty percent of the time).

¹⁸⁹ See *infra* note 191.

¹⁹⁰ See, e.g., Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1562–63 (1989) (summarizing results of studies). To my knowledge, no evidence exists to suggest that customary defenses – i.e., pills and staggered boards – affect IPO pricing.

¹⁹¹ Field finds disproportionate voting structures in 7% of IPO firms from 1988–92 (including 5% which offered only low-vote stock). See Laura Casares Field, *Control Considerations of Newly Public Firms: The Implementation of Antitakeover Provisions and Dual Class Shares Before the IPO*, February 10, 1999, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=150488, at 7. Coates finds 11% with such structures in 1991–92 (including 8% selling low-vote stock), and 6% in 1998 (but does not report the percentage selling low-vote stock in that year). See Coates, *supra* note 58, at 1357. Daines and Klausner find 6% for 1994–97 but do not report the percentage selling low-vote stock. See Daines & Klausner, *supra* note 174, at 95.

takeover attempts. While this right is rarely exercised by firms subject to ordinary, relatively mild antitakeover laws, firms frequently opt out of the handful of laws that provide essentially complete protection from takeovers.¹⁹² Similarly, while states with ordinary antitakeover laws attract (or retain) more incorporations than they would otherwise, the most extreme laws tend to drive firms away.¹⁹³

Two conclusions can be drawn from this evidence. First, contrary to what the high level group might expect, firms and investors in the United States consistently gravitate towards arrangements that provide boards some, although usually not complete, power to defeat hostile takeover attempts. In the absence of any plausible theory of massive, systematic and prolonged market failure, the affinity firms and investors have for defenses appears to be genuine.¹⁹⁴ Second, again contrary to what the high level group would predict, not all firms adopt the same defensive posture. While almost all accept at least the default package of defenses, fewer adopt staggered boards, and fewer still insulate themselves from the threat of a takeover completely. One size does not appear to fit all.

5. *Implications*

As it happens, both of these propositions are highly consistent with the claims of the contractarian approach to takeover regulation generally and the U.S. system's application of that approach in particular. By providing for moderate defenses as a matter of default law, the U.S. system reduces the transaction costs that would be incurred if no-defense or strong-defense rules

¹⁹² See, e.g., Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1831 (2002) (reporting that 2.3% of firms opt out of Delaware's antitakeover statute, while 37% opted out of at least some parts of the Pennsylvania, Ohio and Massachusetts statutes).

¹⁹³ See *id.* at 1844.

¹⁹⁴ See *supra* notes 170–74 and accompanying text. Any number of market flaws, including those we have discussed and others (e.g., simple irrationality), could have an effect at the margins. In addition, if the wealth effects of a defense are small, even minor imperfections could have a large effect on the frequency with which it is adopted. A defense could therefore become very popular despite being mildly inefficient.

were chosen as defaults.¹⁹⁵ In addition, substantial variations in firms' defensive arrangements suggest that U.S. policymakers are right not to make the default rules mandatory. As demonstrated by the discounts investors demand when offered low-vote stock in an IPO, deviations from the default rules can have significant wealth effects.¹⁹⁶ Consistent with a contractarian analysis, therefore, the U.S. system also correctly requires that such deviations be consented to by both boards and shareholders.

On the last point, as we have seen, the U.S. system falls well short of perfection from a contractarian point of view. Even aside from the inevitable difficulties of addressing the effect of changed circumstances on parties' contractual expectations, state legislatures and other governmental authorities sometimes amend background law in a way that appears to disregard those expectations almost completely.¹⁹⁷ In broad terms, however, the approach taken by the U.S. system appears to be both consistent with the contractarian model and vindicated by market practice.

Assuming the lessons of the U.S. experience are relevant in the EU context (a subject to which we shall return in the next Part), the implications for the Directive are exactly to the contrary. When the Passivity Rule applies, it will impose what appears to be a suboptimal level of defenses – zero – on target firms. The effect of this mistaken approach will be greatly compounded, moreover, by the fact that firms and investors will not be able effectively to contract around it. Finally, while a contractarian analysis would emphasize the importance of enforcing agreed-upon arrangements, the Breakthrough Rule would systematically disrupt those arrangements.¹⁹⁸ Put bluntly, then, the

¹⁹⁵ If a no-defense default rule were imposed, for example, current market practice suggests that most, and perhaps nearly all, firms would incur the costs necessary to amend their charters to provide for mild defenses.

¹⁹⁶ See *supra* note 194 and accompanying text.

¹⁹⁷ See *supra* note 120 and accompanying text.

¹⁹⁸ If there were reason to believe that the defenses subject to the Breakthrough Rule had typically been unfairly imposed on unwilling shareholders, the heavy handed intervention contemplated by the rule might be justified. Rather than make such a claim, however, the high level group offers an explanation that is both cavalier and tautological. Disproportionate voting rights and other structural defenses should be broken through without compensation, it says, because "[t]he loss of these . . . rights would be the result of a public policy choice made by the European Union and the Member States in order to create a level playing

rules would simultaneously reject the best qualities of the American system of takeover regulation and emulate that system's worst qualities. One suspects (and hopes) that the impact of the rules will be substantially limited by the fact that member states have the option not to implement them. The fact remains, however, that the regulatory philosophy of the Directive is based on what appears to be a simplistic and fundamentally misguided model of defenses and their potential uses and abuses. Given that the Directive obligates the Commission to revisit the subject of takeover defense regulation in the relatively near future (and to consider a revised directive that would impose a greater degree of EU-wide uniformity when doing so) this is a source of concern.¹⁹⁹

IV. DO THE LESSONS OF THE AMERICAN EXPERIENCE APPLY TO EUROPE?

The foregoing conclusion, of course, rests on the assumption that there are sufficient similarities between American and European markets to allow for a useful comparison between them, and it is not obvious that this is the case. Differences in capital market structure, legal and market institutions, and even cultures could mean that a system that works well in the U.S. would be inappropriate in Europe.²⁰⁰ Accordingly, one could defend the Passivity and Breakthrough Rules on the ground that although defenses can be value-enhancing in the American context, they are invariably inefficient for European firms. The high level group report proposes two theories along these lines.

field for takeover bids across the Union." High Level Group Report, *supra* note 3, at 35.

¹⁹⁹ See *supra* note 50 and accompanying text.

²⁰⁰ Of course, this reasoning could just as easily be said to undermine the case for the Directive, which will apply to all twenty-five EU member states. Even if there is one set of rules that will work for markets as diverse as the U.K., France and Germany, for example, it is far from obvious that the same rules will be appropriate for, say, Cyprus, Slovakia and Malta. See Allen Farrell, *Why Continental European Takeover Law Matters*, in MODERN COMPANY AND TAKEOVER LAW IN EUROPE (forthcoming) (Harvard John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 454, at 6, 2003) (questioning appropriateness of imposing a uniform mandatory bid rule on all EU member states).

A. MARKET INEFFICIENCY

First, the report says that while “fully integrated and well developed” securities markets might be able to distinguish efficient from inefficient defenses, most EU member states do not have such markets.²⁰¹ Accordingly, decisions about defenses should not be left to the markets, but should be made by regulators instead. In addition, according to the report, member states with less-developed securities markets should be obliged to conform to the Passivity and Breakthrough Rules because investor protection is generally weaker in markets where defenses are permitted.²⁰²

There is much to quibble with in this reasoning. As to the latter point, for instance, it is not at all clear that the factual predicate is correct – to take an obvious counterexample, U.S. corporate and securities laws combine tolerance of defenses and relatively strong investor protections.²⁰³ The more fundamental problem with the argument, however, is that it proves too much. If markets are incapable of assessing the welfare effects of defenses, they will also be incapable of assessing the value of takeover bids. In seeking to rebut the case for a contractarian system of takeover regulation in Europe, therefore, the argument undermines the rationale for takeovers generally, which itself relies on contractarian assumptions – e.g., that voluntary transactions between rational parties, such as hostile acquirors and target shareholders, can be expected to maximize their joint welfare.

Recall that the reason takeovers are thought to create wealth is that the premium – the difference between the pre-bid market capitalization of the target and the aggregate bid price – is believed to represent expected improvements in the efficiency of the target’s operations once the bid is consummated (e.g., through the replacement of slothful target managers).²⁰⁴ If the market in which the target’s stock trades is seriously inefficient,

²⁰¹ High Level Group Report, *supra* note 3, at 22–23.

²⁰² *See id.* at 23.

²⁰³ *See, e.g.,* Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT’L L. & BUS. 207, 207 (1996) (describing the U.S. securities regulatory regime as comprehensive and “often praised”).

²⁰⁴ *See supra* note 27 and accompanying text. *See also* High Level Group Report, *supra* note 3, at 19.

this assumption is very likely to be incorrect. In that case, the target's stock price will not represent a reasonable estimate of the risk-adjusted present value of the cash flows the target will generate, but instead will be determined to a large extent by noise trading and/or manipulation. If so, the premium, rather than representing expected operational improvements, will be basically arbitrary as well.²⁰⁵ Defenses adopted by firms traded in such markets may be wealth-reducing, but takeovers, whether hostile or friendly, are likely to suffer from the same defect. Absent some reason to think that market forces will police the use of defenses much less effectively than takeover bids, therefore, the fact that some European markets may function poorly does not justify rules that ban the former in order to facilitate the latter.²⁰⁶

B. WEAK BONDING DEVICES

The second ground the high level group suggests for distinguishing the American and European markets has more force.

Takeovers are a means for bidders to create wealth by exploiting synergies between their existing business and the target company. . . . Takeover bids also offer shareholders the opportunity to sell their shares to bidders who are willing to offer a price above the prevailing market price. Such a price will be offered where the bidders believe that the resources of the company can be better developed and exploited under their operation and control.

Id.

²⁰⁵ For an extreme example of this phenomenon, see *Watch Your Back, in A Survey of Russia*, THE ECONOMIST, May 22, 2004, at 11–12 (describing how raiders have acquired control of some Russian firms for a fraction of their market value through a combination of fraud, force and exploitation of corrupt and/or overwhelmed judicial and regulatory systems). Note that even in a relatively efficient market there may be substantial disparities between a firm's "true" value and its market capitalization. See, e.g., Fisher Black, *Noise*, 41 J. FIN. 529, 533 (1986).

[W]e might define an efficient market as one in which price is within a factor of 2 of value, i.e., the price is more than half of value and less than twice value By this definition, I think almost all markets are efficient almost all of the time. "Almost all" means at least 90%.

Id.

²⁰⁶ If anything, one would probably expect inefficient defenses to be subject to a greater degree of market constraint than welfare-reducing takeover bids. While the valuation of a company's stock, especially in the absence of a reasonably efficient securities market, requires an assessment of numerous complex and constantly changing factors, the wealth effects of defenses are, relatively speaking, simple and static.

While on paper American boards have the power to implement defensive measures, it observes, in fact they are subject to a variety of bonding devices that usually prevent this power from being abused. Institutional investors, reputational constraints and the threat of litigation can be expected to put substantial pressure on boards to accept attractive bids.²⁰⁷ Rules mandating that the boards of listed companies consist mostly of independent directors reduce the risk that insiders will resist takeover attempts for self-interested reasons.²⁰⁸ Furthermore (although this was not mentioned by the group), American managers often have golden parachute compensation arrangements that dramatically dull the pain of being taken over, and therefore increase managers' receptivity to unsolicited bids.²⁰⁹ Because none of these factors apply in Europe, at least to the same extent, defenses may be more prone to abuse by European boards.²¹⁰ It could be the case, therefore, that a welfare-enhancing American defense will, if allowed to cross the Atlantic, become a pernicious European one.

Note, however, that this reasoning does not rebut the case for a contractarian system of takeover regulation, but merely suggests reasons why the results produced by such a system

²⁰⁷ High Level Group Report, *supra* note 3, at 40–41.

²⁰⁸ See, e.g., NYSE Listed Company Manual § 303A.01.

²⁰⁹ See *supra* text accompanying note 138.

²¹⁰ Large payments to target executives pursuant to golden parachutes, for example, are socially unacceptable in many European countries and illegal in some. See, e.g., Peter O. Mühlert, *Make It or Break It: The Break-Through Rule as a Break-Through for the European Takeover Directive?*, in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 711, 723 (Guido Ferrarini et al. eds., 2004) (describing provisions of German corporate and securities laws that limit executive compensation in the takeover context). In some respects, however, the globalization of the economy and the extraterritorial reach of some U.S. laws may be narrowing the gap between Europe and America in terms of the scrutiny to which boards' behavior is scrutinized. See, e.g., *All American Now?*, THE ECONOMIST, Jan. 10, 2004, at 52 (reporting that each of the SEC, the U.S. Attorney's Office and the Manhattan District Attorney's office were involved in various investigations of the Parmalat scandal shortly after it broke and that American plaintiffs' firm Milberg, Weiss was the first to file suit against Parmalat insiders and advisers); Christopher Rhoads, *European Body Aims to Globalize Corporate Rules*, WALL ST. J., Jan. 12, 2004, at B2 (describing OECD initiative to establish global corporate governance guidelines).

might be different in Europe.²¹¹ As in the U.S., rational shareholders might drive a harder bargain on the subject of defenses if they believe the available bonding devices to be weak. This does not mean, though, that they will never find it in their interests to agree to a defense – as we have seen, there is reason to believe that optimal defensive arrangements vary considerably from firm to firm. This is not to say that the group’s point is irrelevant from a contractarian perspective. If bonding devices are generally weaker in the EU than they are here, efficient negotiation between boards and investors might lead to no-defense arrangements in most cases. If so, the transaction-cost minimizing rule would provide for such arrangements as a default – i.e., boards would be permitted to take defensive action, but only to the extent authorized by the charter or as otherwise approved by shareholders. This rule would be significantly more pro-takeover than the default rule applicable in the U.S., but it would be just as consistent with the contractarian model.²¹²

Before we rush to embrace this option, though, we must take into account the possibility that shareholders will actually benefit from a combination of defenses and relatively weak bonding devices. As we have seen, one reason shareholders might agree to the adoption of a defense is that insulating board decisions from shareholder influence could, somewhat counter-intuitively, work to their advantage – either by encouraging employees and third parties to make valuable firm-specific investments or by facilitating the sale of cash flow rights by insiders

²¹¹ In fairness, the High Level Group did not raise this point as a justification for the mandatory nature of the Passivity and Breakthrough Rules, but rather as part of its argument as to why a level playing field between the U.S. and the EU is not needed. See High Level Group Report, *supra* note 3, at 40–41.

²¹² I would point out here that advocacy of such a no-defense default rule is as far as almost any American academic now goes towards the views the high level group. Although scholars in the U.S. (unlike practitioners and policymakers) have traditionally been skeptical of most defenses, the high level group therefore exaggerates when it suggests that the academic literature in the U.S. is in line with its position. See High Level Group Report, *supra* note 3, at 42 (claiming that “there is a large body of both economic and legal literature [in the U.S.] arguing that directors should be prohibited from engaging in defensive actions”). In fact, virtually no one in the U.S. now argues that defenses should be prohibited as a matter of mandatory law. See, e.g., Ferrell, *supra* note 200, at 573 (contending that, although the U.S. system permits defenses to be used excessively, the high level group’s position is “troubling” in that it would not permit even those defenses clearly authorized by shareholders).

with significant non-pecuniary private benefits of control.²¹³ The separation of ownership and control, in other words, might not be a bug, but a feature. Hence, we cannot necessarily infer that shareholders will respond to weak bonding devices by demanding stricter limits on the use of defenses.

While recognizing the hazards inherent in any international comparison of governance practices, I therefore see no reason to dismiss the evidence from American market practice as irrelevant to the European situation, nor do I see why a contractarian model of takeover regulation could not work in Europe. Of course, the EU should not, and could not, robotically transplant American legal and market practices into the European context. Appropriate modifications would be necessary, and improvements possible. To apply basic contractarian principles in Europe, however, would not be to impose a foreign system, but merely to use the same market forces that are already presumed to create value-enhancing takeovers to govern takeover defenses as well. In fact, the Directive itself is not without contractarian elements. In particular, by requiring firms to disclose publicly their defensive arrangements, it will satisfy a necessary, though not sufficient, condition to the creation of a contractarian system.²¹⁴

V. CONCLUSION – THE LEVEL PLAYING FIELD REVISITED

So where should the EU go from here? A full answer to this question is obviously beyond the scope of this article, but some preliminary thoughts are in order. In this respect, let us take as our starting point a part of the Directive we have given only cursory treatment: the level playing field concept.

The rationale for the level playing field idea is not immediately obvious,²¹⁵ but it appears to reflect a fear that defenses will

²¹³ See *supra* notes 142–53 and accompanying text.

²¹⁴ See Commission of the European Communities Proposal for a Directive of the European Parliament and of the Council on Takeover Bids, art. 10, 2002/0240(COD), 8.

²¹⁵ The idea is sometimes described as though there were something self-evidently unfair about a firm with defenses making a bid for an undefended target. From the point of view of target shareholders, though, the unfairness inherent in that scenario is hard to discern. As we have seen, there are perfectly good reasons

be abused not by self-interested insiders, but by member state governments.²¹⁶ On this theory, member states will permit defenses in order to create takeover-proof “national champions” that will, after building up pan-European operations, skew their investment and employment policies in favor of home country interests without being constrained by the risk of themselves becoming targets.²¹⁷ That some member states pursue activist industrial policies and regularly intervene in takeover matters suggests that this fear is not an unreasonable one.²¹⁸ The problem is the contemplated remedy. For reasons that have nothing to do with economic nationalism, a complete ban on defenses, or any other one-size-fits-all rule, would likely be suboptimal for many firms. Furthermore, mandating a specified level of defenses would not address the real concern underlying the level playing field concept, which is not defenses *per se*, but rather the possibility that member states will intervene in the market for corporate control to further beggar-thy-neighbor industrial policies. Making all firms equally subject to takeover bids (even if could be

why some firms might have stronger defensive arrangements than others. *See* Part III. More fundamentally, there is no apparent connection between the defenses a bidder is allowed to maintain and the welfare of target shareholders. If a target is prevented from adopting an efficient defense or allowed to adopt an inefficient one, the injury sustained by its shareholders will be the same regardless of the rules applicable to the bidder. Except insofar as they may affect the value of any bidder stock offered as consideration, any defenses maintained by the bidder should therefore be a matter of complete indifference to target shareholders.

²¹⁶ *See* Jeffrey N. Gordon, *An American Perspective on Anti-Takeover Laws in the EU: The German Example*, in REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 541, 546 (Guido Ferrarini et al. eds., 2004).

²¹⁷ *See id.* For example, a French firm could go on an acquisition spree, buying operations in a number of other member states. The French government might have an incentive to support this strategy on the ground that the firm could subsequently be expected (or encouraged) to favor French interests over foreign ones when deciding where to open factories, etc. In theory, at least, one way the French government could provide support is to allow the firm to maintain takeover defenses – that way, the firm would be able to make economically wasteful, but pro-French, investment decisions without having those decisions increase the risk of a takeover.

²¹⁸ *See, e.g., Creating Euro Giants*, THE ECONOMIST, May 22, 2004, at 55–56.

done),²¹⁹ would not eliminate, or even significantly reduce, the incidence or severity of such intervention.²²⁰

What this analysis suggests is that it might be possible to reformulate the level playing field idea in a way that is both better suited to achieve its true purpose and consistent with a contractarian approach to takeover regulation – i.e., as the justification for imposing a passivity rule not on target boards, but on member states. Under such an approach, the playing field for European takeovers would be deemed level in the sense that target firms would all be subject to the same, or at least comparable, market constraints in their use of defenses, and that none would be permitted to escape those constraints by appealing to a national government for help during a takeover battle. A firm could have takeover defenses provided that (i) it was able to obtain express or implicit shareholder consent; and (ii) no defense could be added, or made more potent, through action of the relevant member state. These requirements could be expected both to produce reasonably efficient defensive arrangements and to

²¹⁹ Many European firms are majority owned by individual shareholders or family groups, meaning that they will remain takeover-proof even if subjected to the most draconian restrictions on defenses. See Coates, *supra* note 38, at 686–87. Unless it were to take the truly radical step of requiring all firms to maintain majority public ownership, therefore, the EU will be unable to ensure that the playing field is truly level.

²²⁰ A member state has a variety of means at its disposal to influence the outcome of a takeover battle, not the least of which is simply declaring its preferred outcome, especially in circumstances where such a statement could be seen as carrying an implicit threat to retaliate against firms that act contrary to its wishes. Relative to this kind of direct approach, the leverage a member state will obtain by allowing local firms to adopt defenses will probably be very limited. For one thing, merely allowing defenses does not in itself guarantee that local firms will pursue the investment policies favored by its national government. Even if the market for corporate control is taken out of the picture, product and labor markets will provide some constraints on economically wasteful investment decisions. For another, the constraints imposed on such decisions by the market for corporate control will normally be fairly loose even in the absence of any defenses. The effect those decisions have on a firm's share price will ordinarily be swamped by the effects of general macroeconomic trends, industry-specific events, etc., and share price is only one among many factors that determine the likelihood that a company will become a target. Because the likelihood that any act of national favoritism will materially increase the risk of a hostile takeover is therefore small, the benefit accruing to the member state government as a result of allowing a defense will be small as well.

reduce significantly the risk that defenses would be used to further any mercantilist agenda a member state might pursue.²²¹

There would, of course, be complications involved in such an approach. At a minimum, a new directive would have to require member states to impose basic contractarian rules, in particular, rules preventing significant changes to defensive arrangements without the approval of both boards and shareholders.²²² There would also be the problem of midstream firms with existing defensive arrangements that had either never been genuinely consented to by shareholders, or had been put in place before their defensive qualities became apparent.²²³ In some cases, it could be appropriate to subject those arrangements to mandatory shareholder reauthorization.²²⁴ Finally, a body of rules would have to

²²¹ To illustrate, suppose that an Italian firm is considering making an economically irrational investment decision out of national loyalty – say, by closing a Swedish factory when closing an Italian one would be much more cost-effective. In this case, the cost of the decision would fall in part on the affected Swedish employees and in part on the firm's shareholders, and the (smaller) benefit would accrue to the Italian employees. The Italian government might find that an appealing trade-off, and might be willing to allow the firm to adopt defenses to protect it from the possible consequences of the decision. The firm's shareholders, however, would obviously have no reason to consent to the defense.

²²² As noted earlier, the other fundamental requirement of any contractarian system – disclosure of all defensive arrangements – has already been provided for as part of the Directive. *See supra* note 214 and accompanying text.

²²³ Some commentators argue that the staggered boards maintained by many American firms provide an example of the latter phenomenon. Most staggered boards, they claim, were installed either before the poison pill was invented or during a period in which it appeared that courts would impose fairly strict limits on pill use. Subsequent decisions, however, made it clear that courts would give boards broad leeway in their use of pills and thereby radically strengthened the defensive importance of staggered boards by making it more difficult to evade the pill through a proxy contest. Because shareholders could not have foreseen this development, they cannot be said to have truly consented to staggered boards as they currently exist. *See* Bebchuk et al., *supra* note 59 at 939–44. *But see* Kahan & Rock, *supra* note 117, at 518–20 (rejecting the foregoing analysis on the ground that the defensive effects of staggered boards were reasonably apparent all along).

²²⁴ As an alternative to the Breakthrough Rule, Coates has proposed a requirement that disproportionate voting structures be re-approved by shareholders (voting on a one-share, one-vote basis) at periodic intervals, e.g., every ten or twenty years. Such a requirement, he says, would avoid an immediate and permanent disruption of existing disproportionate voting structures, many of which may be efficient, but would also avoid situations in which firms remain takeover proof long after the original rationale for the structure is gone. *See* Coates, *supra* note 38, at 26–27. I agree that this approach would be preferable to the Breakthrough

be developed to determine the circumstances in which a member state would be permitted to take action that has incidental effects on the market for corporate control, as a blanket ban would be impractical.²²⁵

Interestingly, the EU has already taken great strides towards addressing the latter issue. In three cases decided on the same day in 2002, the European Court of Justice established a framework for determining the compatibility of golden share arrangements with the “free movement of capital” provision of the EC Treaty.²²⁶ Under this framework, a golden share provision that is facially discriminatory (such as a cap on the percentage of a firm’s shares that can be held by foreigners) is *per se* invalid. In

Rule. At the same time, though, I would be somewhat skeptical of claims that even long-established disproportionate structures can be assumed to have outlived their usefulness: While the relevant political, economic and business background may have changed dramatically since a disproportionate structure was initially adopted, its purpose – to inhere control of the company in a small group (e.g., a founding family) – may not have. The case for mandatory shareholder reauthorization will usually, I suspect, be stronger in cases where there it can be shown that shareholders never genuinely consented to the defense in question.

²²⁵ For example, member states would need to remain free to amend their corporate laws even if doing so had some incidental impact on firms’ takeover vulnerability. Also, there could be (presumably limited) circumstances in which defeating or furthering a takeover attempt is crucial to meeting some legitimate governmental need.

²²⁶ Case C–367/98, *Commission v. Portuguese Republic*, 2002 E.C.R. I–04731, *available at* http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=61998J0367&model=guichett; Case C–483/99, *Commission v. French Republic*, 2002 E.C.R. I–04781, *available at* http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=61999J0483&model=guichett; Case C–503/99, *Commission v. Kingdom of Belgium*, 2002 E.C.R. I–04809, *available at* http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=EN&numdoc=61999J0503&model=guichett. Article 73b(1) of the EC Treaty provides that “[w]ithin the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.” TREATY ESTABLISHING THE EUROPEAN COMMUNITY, Nov. 10, 1997, art. 73(b)(1), O.J. (C 340) 3 (1997) [hereinafter EC TREATY], *available at* <http://europa.eu.int/abc/obj/treaties/en/entoc05.htm>. This broad principle is qualified in Article 73(d)(1)(b), which authorizes member states to limit the movement of capital for law enforcement purposes or in furtherance of any other measures that are “justified on grounds of public policy or public security.” EC TREATY art. 73(d)(1)(b). *See generally* Johannes Adolff, *Turn of the Tide?: The “Golden Share” Judgments of the European Court of Justice and the Liberalization of the European Capital Markets*, 3 GERMAN L. J. 1 (2002).

addition, an arrangement that is non-discriminatory, but nevertheless has the effect of inhibiting the market for corporate control, (e.g., a cap on the percentage of a firm's shares that can be acquired by any person without the approval of the member state) must satisfy a fairly strict proportionality test. Among other things, it must: (i) further a legitimate governmental interest; (ii) be no more restrictive than is necessary to achieve that interest; and (iii) be applied on the basis of objective, non-discriminatory and previously-disclosed criteria.²²⁷

The court's reasoning suggests that this framework will not be limited to golden shares, but instead will be at least potentially applicable to any intervention by a member state in the takeover market. For example, an American-style antitakeover law adopted by a member state to protect a local firm from a hostile bid would be subject to (and would, in most circumstances, seem likely to fail) the proportionality test. Moreover, the Commission appears to be taking an aggressive approach to challenging even less overt acts of interference. During the recent, ultimately successful attempt by the French firm Sanofi-Synthelabo to acquire French-German Aventis, for example, the French government indicated that it approved of Sanofi's bid and would look with disfavor on an attempt by Swiss firm Novartis to break up the deal. In response, the Commission publicly announced that any attempt by the French government to intervene in the matter would be subject to scrutiny under the EC Treaty.²²⁸ At least in

²²⁷ In *Commission v. Portuguese Republic*, the court struck down laws authorizing (i) limits on the percentage of a privatized firm's shares that could be held by non-Portuguese investors, see Case C-367/98, 2002 E.C.R. I-04731, ¶¶ 40-41, and (ii) a prohibition on investors of any nationality acquiring more than a specified percentage of a privatized firm without the prior authorization of the Portuguese government. See *id.* ¶¶ 43-53. In *Commission v. French Republic*, the court rejected a golden share arrangement pursuant to which the French government held the right to veto any attempt to transfer specified assets of Société Nationale Elf-Aquitaine or to acquire more than 10%, 20% or 33% of that company's shares. See Case C-483/99, 2002 E.C.R. I-04781, ¶¶ 1, 39-54. However, the court upheld the golden share provisions at issue in *Commission v. Kingdom of Belgium*. Case C-503/99, 2002 E.C.R. I-04809. Those provisions, which related to two firms involved in energy distribution, give the Belgian government a limited authority to veto proposed transfers of certain firm assets or other decisions deemed contrary to the country's energy policies. See *id.* ¶¶ 36-57.

²²⁸ See Renee Cordes & Ross Tieman, *EC Boosts Novartis Bid for Aventis*, THE DAILY DEAL, Mar. 29, 2004.

embryonic form, therefore, a passivity rule applicable to member states is already in existence.²²⁹

Whether it would be politically feasible to add the other basic elements of a contractarian system (and whether such a system would satisfy the many proponents of the level playing field concept) I would not venture to guess. I would note in this respect, however, that (i) the most controversial parts of the Directive – the Passivity and Breakthrough Rules – are also the least compatible with a contractarian approach and (ii) the Directive's most contractarian provision – the requirement that all defensive arrangements be disclosed – seems to have attracted no opposition at all. While claiming no expertise in European politics, I see this as grounds for optimism. Like the European Court of Justice golden share jurisprudence, in fact, it may reflect on some level the same intuitive adherence to contractarian principles that underlies, and is imperfectly reflected in, the American system of takeover regulation. The European and American systems may, in the end, prove to be not so different after all.

²²⁹ As noted earlier, it once seemed as if the supremacy and/or commerce clauses of the U.S. constitution might play a similar role in the American takeover market. It now appears, however, that constitutional limits on a state's ability to influence the outcome of takeover bids are quite weak. *See supra* notes 78–80 and accompanying text.

