

Takeover Defenses Work. Is That Such a Bad Thing?

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INTRODUCTION

In *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*,¹ Professors Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian (BC&S) purport to demonstrate that hostile takeover targets that have a poison pill rights plan and an “effective” staggered board can—“and most of the time do”²—remain independent rather than sell themselves to the initial raider or another buyer. As presented, their findings turn conventional wisdom on its head and justify, in their view, significant “reconsideration” of the law regarding takeover defenses. Are they on to something here? Should we, indeed, be shocked—*shocked!*—to learn that takeover defenses work?

The BC&S Study has caused a minor stir among the tight knit group of academics and M&A practitioners who have sparred over the efficacy of takeover defenses on and off over the past twenty years.³ “Takeover defenses

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1. Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002).

2. *Id.* at 890.

3. For a sample of this debate, see Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 130 (1979); 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); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Lucian Arye Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV.

are good because they help decent, hard-working companies fend off structurally coercive and opportunistically timed raids.” “No, they’re bad because they discourage would-be acquirers from pursuing economic efficiency-enhancing transactions.” “Yes, they’re good because they provide companies with the time and the leverage to negotiate better deals from their suitors.” And so on. Ultimately, the conventional wisdom—at least among practitioners—has come around to a pragmatic view that in the “real world,” the legal, practical, and economic considerations tend to even out in a rough justice sort of way: that is, when a public company receives a hostile takeover offer at a price that is attractive to a majority of its stockholders, it may leverage its takeover defenses to get a better deal or find a better offer, but its days of independence are probably numbered.

This is not mere theory. M&A lawyers routinely advise public company boards that while the “just say no” defense⁴ exists as a legal matter, it may not be available as a practical matter, especially in the face of a determined bidder with a premium bid that is favored by a significant majority of stockholders. The reason for this should be obvious. Public company directors represent, and have a fiduciary duty to act in the best interests of, the company’s stockholders.⁵ If someone makes a bid at a price that is attractive to a majority of stockholders, directors will be pressured to (1) accept the bid (after attempting to negotiate it upward), (2) find a better bid from another party, or (3) take affirmative steps to show that the company can achieve greater value through independent growth. If the directors cannot succeed at option (3)—and do so in a hurry—the directors should expect to find it difficult to justify in

973 (2002) [hereinafter Bebachuk, *The Case Against Board Veto*]; Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037 (2002) [hereinafter Lipton, *Pills, Polls, and Professors Redux*].

4. The “just say no” approach, which is accepted in Delaware, should be contrasted with the “just say never” approach, which is not. “Just say no,” which is perhaps better characterized as “just say later,” refers to the ability of a board of directors to maintain takeover defenses, such as a poison pill rights plan, as long as the directors believe it is in the stockholders’ best interests to do so and subject to the ability of the stockholders to remove the incumbent directors in an election contest and replace them with directors nominated by the hostile raider. The development of the “just say no” defense is discussed in Bebachuk et al., *supra* note 1, at 904-07. The “just say never” defense is a defensive scheme that is truly impenetrable unless and until the incumbent directors determine to change course. An example of this would be the so-called “dead hand” poison pill rights plan which, once adopted, can be removed only by the incumbent directors, and not by directors nominated by a hostile bidder. The “just say never” defense is not legal in Delaware. See *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1290-93 (Del. 1998) (invalidating a “delayed redemption” or “slow-hand” rights plan, and, by extension, any “dead-hand” or “no-hand” rights plan).

5. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (“[O]ur analysis begins with the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation’s stockholders.”); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939).

their own minds (and to stockholders, in court, and in the court of public opinion) that remaining independent is in stockholders' best interest. This logic is thought to apply with equal force to companies with staggered boards⁶ because if a raider were to succeed in removing one-third of the directors and replacing them with directors friendly to the raider, the remaining directors would be expected to fold rather than continue to hold out against the expressed preference of the stockholders whose interests the directors are supposed to represent. The point of the advice is not that directors must or even should fold when faced with a hostile bid, but that directors should be under no illusion that the fabled concept of "just say no" somehow changes the nature of their obligation to act in the manner they reasonably believe to be in the best interest of stockholders.

That is how the balance works, or is thought to work, in practice. As a legal matter, the balance works something like this: A target board of directors may maintain a poison pill defense and effectively block a hostile takeover as long as the directors continue to believe that doing so is in the best interests of stockholders and as long as the directors actually remain in office. The BC&S Study correctly points out that since the Delaware Supreme Court's decision in *Paramount Communications, Inc. v. Time, Inc.*⁷ no Delaware court has ever ordered a board of directors to redeem its poison pill.⁸ Therefore, the bidder can only be sure of obtaining control over the target directors' objections if the bidder can wage an election contest to remove the incumbent directors and replace them with ones that will redeem the pill. BC&S call this the "ballot box safety valve."⁹ BC&S argue that companies with an effective staggered board (ESB)¹⁰ are essentially immune to the removal threat because virtually no bidders are willing to commit themselves to or to endure the minimum delay

6. The concept of a staggered board is well explained by BC&S:

The default law in all states requires that all directors stand for election at each annual shareholder meeting. However, all states provide an exemption from this requirement if the board is staggered. In a company with a staggered board, directors are grouped into classes (typically three), with each class elected at successive annual meetings. For example, a board with twelve directors might be grouped into three classes, with four directors standing at the 2001 annual meeting, four more directors standing for reelection in 2002, and the remaining four directors standing for reelection in 2003. With three classes, directors in each class would be elected to three-year terms.

Bebchuk et al., *supra* note 1, at 893.

7. 571 A.2d 1140 (Del. 1989).

8. Bebhuk et al, *supra* note 1, at 906.

9. *Id.* at 890, 903, 907.

10. A target is said to have an "effective staggered board" if it has a staggered board, with at least three classes of directors, and is not capable of being dismantled such that it is possible to obtain control of a majority of the board in fewer than two annual election meetings. In particular, target shareholders must not have the ability to act by written consent in lieu of a meeting, to call a special meeting, to remove directors without cause or to "pack the board" by increasing the number of directors and filling the vacancies created. Bebhuk et al., *supra* note 1, at 910, 912-13.

of at least one year created by the ESB. Therefore, in their view, the ballot box safety valve is illusory for an ESB target. Whether this is true, or whether in fact the ESB—which provides a clear (but lengthy) path to victory—actually helps set precisely the right balance depends in significant measure on whether the conventional wisdom described above is correct. Can boards be trusted to make the right choice, even if they have the freedom not to?

The BC&S Study says the conventional wisdom is wrong, and that boards cannot be trusted if protected by an ESB defense. Unfortunately, there is less to the Study's empirical findings than meets the eye, and, as a result, the Study fails to convince on its key points and fails to convince that the broad, inflexible new rule BC&S would propose is indeed more appropriate and more value-enhancing than the existing balance of power. It also fails to convince that it has accomplished anything other than to identify the extreme exceptions to a set of rules that otherwise works just fine.

The following proceeds in three Parts. In the first, I identify a handful of analytical problems with the Study intended to demonstrate that the Study provides an insufficient foundation for its broader conclusions and policy prescriptions. In the second, I look at BC&S's broad and inflexible policy prescription—that the ESB effect be taken away from public company boards in the takeover context¹¹—and argue that, to the contrary, ESBs can be and often are used in a responsible and value enhancing manner, and that before we take away or lessen the effectiveness of these tools for everybody, we ought to invest some effort to find a more focused solution that separates the users from the abusers. In the third, I offer a short conclusion in which I argue that the BC&S Study has not succeeded in proving either that (1) the costs of ESBs outweigh the potential benefits, particularly when we move from considering the effect of the background legal rules only on hostile takeovers to considering their effect on all public company merger and acquisition activity, or (2) a broad, inflexible rule that upsets the existing balance of power between bidders and targets is, in fact, necessary, especially when more focused solutions may be available. Because of these shortcomings, all the BC&S Study really succeeds in proving is that ESBs work very well. Maybe this is not such a bad thing after all.

I. ANALYTICAL CONCERNS

The BC&S Study contains three basic findings. The first is that companies with an ESB are much more likely to remain independent after receiving a

11. Specifically, they propose that “after the loss of one election that is effectively a referendum on the offer, incumbents should be required to redeem the [poison pill rights plan] and allow the bidder (whose offer has received shareholder support) to proceed with its bid.” *Id.* at 944-45. In other words, for takeover purposes, every staggered board would be turned into a “straight” or annual term board.

hostile takeover bid than are companies without an ESB.¹² Specifically, of ninety-two companies that were the targets of hostile takeover bids from 1996 through 2000, those that had an ESB remained independent roughly half of the time, or about twice as often as those without an ESB.¹³ Second, remaining independent in the face of a hostile bid makes stockholders worse off compared with selling to the initial suitor or to another buyer.¹⁴ Third, the aggregate harm to stockholders of those companies that receive hostile takeover bids but remain independent because of an ESB outweighs any countervailing benefit (in the form of an increased premium) to stockholders of hostile takeover targets that allow themselves to be acquired, but, perhaps, use the ESB to get a better price.¹⁵ Based on these findings, the Study concludes that the presence of ESBs reduces overall returns for stockholders of hostile bid targets.¹⁶

A powerful conclusion, to be sure, but there are a few problems.¹⁷ The first is that the authors stack the deck in favor of their conclusion by using an overly narrow data set. The Study looked at ninety-two hostile (unsolicited) bids from 1996 to 2000. But if what we are doing is trying to determine whether adopting an ESB is a good thing or bad thing for public companies in general, there is no particular basis for limiting the data to hostile transactions. The BC&S Study points out that ESBs have a negative effect on stockholder wealth because they allow hostile takeover targets to remain independent more often, and remaining independent, according to their data, is “generally rather bad for target shareholders.”¹⁸ But, as the BC&S Study also points out, ESBs also have (or may have) a positive effect, in that ESBs provide target managers greater bargaining power to negotiate a higher price (usually thought of as a higher premium to the target’s pre-bid trading price) from the acquiror in those cases where the target company does not remain independent.¹⁹ The overlooked point is that if ESBs give targets additional leverage to negotiate a better premium in *hostile* transactions, it stands to reason that ESBs should have the same effect in *friendly* transactions as well (because the target can more effectively counter the acquiror’s implicit threat to “go hostile” if its various demands are not met). Therefore, before drawing any conclusion about the overall effect of ESBs on shareholder value, BC&S need to look at *all* deals

12. *Id.* at 929-33.

13. Nine months after the initial bid, 60% of ESB targets remained independent versus 34% for non-ESB targets. Thirty months after the initial bid, 47% of ESB targets remained independent versus 23% for non-ESB targets. *Id.* at 930, 933.

14. *Id.* at 934-36.

15. *Id.* at 935-36.

16. *Id.* at 936-39.

17. The BC&S Study authors have not made available, and this author has not had access to, the data underlying the BC&S Study, including the list of the 92 hostile takeover bids reviewed.

18. Bebchuk et al., *supra* note 1, at 935.

19. *Id.*

in any given time period to determine whether companies with ESBs receive higher premiums than those without. If so, the aggregate benefit of ESBs would almost certainly overwhelm any loss associated with any lower likelihood of being acquired in a hostile bid, and would mean that BC&S's conclusion about the effect of ESBs on stockholder value would be 180 degrees wrong.

Because friendly deals far outnumber hostiles (3038 to 92 in the 1996-2000 period covered by the Study²⁰) this point would be true even if the negotiating-leverage benefit were quite small, as BC&S contend.²¹ I suppose one could question whether it exists at all, but it seems an impossible feat of logic to argue, on the one hand, that ESBs present "a serious impediment to a hostile bidder seeking to gain control over the [incumbent directors'] objections"²² and are "extremely potent as an antitakeover device,"²³ while at the same time arguing that, on the other hand, boards are unable to use this extremely potent force to extract a better price from any genuinely interested suitor. Interestingly, the BC&S Study indicates that the bargaining power effect turns out to be quite small as an empirical matter, though the sample size is too small to draw definite conclusions. Specifically, they find that for successful bids, the final acquisition premium (above the pre-bid trading price) is 54.4% for ESB targets, and 49.6% for non-ESB targets—a 4.8% difference that they argue is not statistically significant.²⁴ One implication of this, which the BC&S Study does not explore, is that the incremental deterrent effect of an ESB may not be nearly so extreme as BC&S argue, at least relative to an "effective annual term" (EAT)²⁵ target (as opposed to all non-ESBs).²⁶ In any event, the fundamental point remains that even a 4.8% benefit (or even a fraction of that) applied over thousands of friendly deals amounts to a massive net benefit to stockholders of companies that employ an ESB.

This is a benefit that can be and should be measured, and, in fact, a similar approach has been used in a number of studies of the effectiveness of the so-called "poison pill" rights plan. These studies, which look at the takeover premiums received by the target company in all deals in a given period (both hostile and friendly), have determined that companies that have these plans in

20. Based on 3130 transactions involving publicly traded U.S. companies during the relevant period, as reported in MERGERSTAT REVIEW 2001, at 6 tbls.1-3, less the 92 transactions identified as hostile by BC&S.

21. Bebchuk et al., *supra* note 1, at 935-36. Because the largest deals by dollar value have historically been friendly rather than hostile, the conclusion would likely be even more pronounced if the analysis were done on a dollar-weighted basis (rather than on average returns), which BC&S have not done.

22. *Id.* at 890.

23. *Id.* at 903.

24. *Id.* at 935-36.

25. *See infra* note 31.

26. *See infra* text accompanying notes 36-38.

place prior to receiving a bid ultimately receive substantially higher takeover premiums than those that do not have them.²⁷ Professor Coates has argued elsewhere that these studies are flawed, at least with respect to poison pill effectiveness, because every public company board has the ability to adopt a poison pill in response to a hostile bid, and therefore every public company should benefit from the additional premium attributable to the poison pill, even if the company does not actually have a poison pill in place pre-bid.²⁸ In other words, there is no meaningful distinction from an antitakeover perspective between a company with a pre-bid poison pill and one without. This analytical infirmity would *not* exist in a similar study of ESB effectiveness because it is not true that a public company board can transform itself into an ESB after a hostile bid has been received. Therefore, the pre-bid presence or absence of an ESB provides a meaningful distinction among acquisition targets and makes it possible to determine whether ESB companies receive higher takeover premiums than do non-ESB companies.

A second problem with the BC&S stockholder return analysis is that in concluding that hostile takeover targets that remain independent experience inferior returns compared to targets that sell out, the Study fails to correct for, or take into account, the harm done to the target by the hostile bid itself. The fact of having received a hostile bid—and more generally any protracted period of uncertainty that surrounds both hostile takeover fights and nonhostile merger negotiations—can impose enormous costs on a target, wreak havoc with capital budgeting and strategic planning, damage relationships with suppliers and customers, and negatively affect employees uncertain about their future.²⁹ In other words, it is no wonder that the hostile bid targets that remain independent tend to underperform in the months or even years following a bid when the bid itself tends to have crippling effects.

From one perspective, it is perfectly appropriate *not* to correct for the effects of the hostile bid and subsequent fight. In Professor Subramanian's

27. See, e.g., Robert Comment & G. William Schwert, *Poison or Placebo? Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures*, 39 J. FIN. ECON. 3, 31 tbl.4 (1995); Georgeson Shareholder, *Mergers & Acquisitions: Poison Pills and Shareholder Value / 1992-1996* (Nov. 1997); J.P. Morgan & Co., *Median Control Premiums: Pill v. No Pill* (July 1997).

28. John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 287-88 (2000).

29. See, e.g., Lipton, *Pills, Polls, and Professors Redux*, *supra* note 3 at 1059.

In general, a company that becomes the target of an unsolicited takeover bid must institute a series of costly programs to protect its business during the period of uncertainty as to the outcome of the bid. To retain key employees, in the face of the usual rush of headhunters seeking to steal away the best employees, expensive bonus and incentive plans are put in place. To placate concerned customers and suppliers, special price and order concessions are granted. Communities postpone or reconsider incentives to retain facilities or obtain new facilities. The company itself postpones major capital expenditures and new strategic initiatives. Creditors delay commitments and seek protection for outstanding loans.

Id.

view, the question is: *Once the hostile bid has been made*, what should the board do?³⁰ If that is indeed the question, knowing that companies that have received bids but remained independent experience inferior returns is obviously very relevant. The problem with this view is that it turns every hostile bid into a self-fulfilling prophesy. The very act of making the bid would appear to thrust the target board into a decisionmaking realm where three Harvard professors have produced statistical proof that the board should not, in the exercise of its fiduciary duties, seek to remain independent. But surely the law should not give force to this self-fulfilling prophesy. Even if one believes that remaining independent is the inferior choice *on average*, it does not follow that every takeover bid should be welcomed. This is, of course, exactly why practitioners design takeover defenses not only to help fend off a raid once begun, but to deter the hostile bid in the first place—to require any would-be acquiror or merger partner to deal directly with the target board from the beginning, rather than take a public and disruptive approach. BC&S would probably say that they are not against takeover defenses generally, but instead believe that poison pill and EAT³¹ provisions provide sufficient deterrent effect, whereas an ESB is too powerful and goes too far. This seems to ignore how negotiating power and leverage actually work in the real world. A roadblock only works if there is no immediately easy way around it. An EAT company—i.e., one with a complete panoply of takeover defenses other than a staggered board—is completely vulnerable to a hostile takeover bid at least once a year. This vulnerability explains why ESBs play an important role in the balance of power even if the actual magnitude of the difference in antitakeover effect between an EAT and an ESB is not very large on average.³² The presence of an ESB means the majority of directors cannot be removed on little or no notice.³³ Without ESBs, the balance of bargaining power between bidders and targets gets tilted in favor of raiders, at least once a year. That the balance should differ based upon the time of year is illogical at best. ESB companies are harder to acquire at a price not approved by a majority of the target's directors than are non-ESB companies, and therefore it is logical to

30. Conversation with Guhan Subramanian, Assistant Professor of Business Administration, Harvard Business School, in Cambridge, Mass. (April 25, 2002) (emphasis added).

31. A company that has defenses that make it possible for an acquiror to replace the target's entire board of directors in an election contest in connection with the target's annual meeting, but make it impossible to do so at other times during the year, is said to have an EAT defensive scheme. See Bebchuk et al., *supra* note 1, at 912.

32. *Cf. id.* at 901.

33. As a technical matter, the presence of an ESB requires an acquiror to endure a delay of at least one year, and probably more, if it wants to acquire the target without the consent of the incumbent board. Of course, that delay may be far less in practice: Unless the incumbent directors determine that it is in the best interests of the stockholders to hold out after losing one election, the difference between an EAT and an ESB is nil.

assume that ESBs (1) are in fact a useful tool for forcing would-be acquirors to deal with the board, rather than “go hostile” and (2) provide the target board with greater leverage to negotiate a better deal if a deal is in the best interests of stockholders. The real question is whether public company directors can be trusted to use the tool properly, a question I explore below. For purposes of my current point, however, suffice it to say that treating the hostile bid as an exogenous variable in the shareholder return analysis amounts to a second instance of stacking the deck in favor of a particular result.

A third issue is that BC&S fail to distinguish among different types of “hostile bids” in ways that are highly relevant to their analysis and that reveal in yet another way that their undisclosed data set is stacked against ESBs. Nearly half of the forty-five hostile bids in the Study made against ESB targets were the weakest form of bid (the so-called “bear hug” bid), compared with about 25% for non-ESB targets.³⁴ A bear hug bid is an offer that is not accompanied by either a tender offer or a proxy fight and often (though not always) indicates a lower level of commitment and seriousness on the part of the acquiror.³⁵ Whether this is so in every case, it should be no surprise that targets of all types (ESB and non-ESB) show a higher incidence of remaining independent with respect to bear hug bids; and if there are twice as many bear hug bids in the ESB data set, the overall incidence of remaining independent will be unfairly inflated for ESBs.

A fourth issue, related to the previous two, is that although the BC&S Study ultimately recommends that ESB targets be turned into EAT targets for takeover purposes,³⁶ the Study fails to make any assessment of whether an ESB has a stronger antitakeover effect than an EAT.³⁷ This is a particularly puzzling omission because it would have been quite easy to do. (Certainly, it is no harder than identifying the ESBs among the ninety-two targets in the sample.) The BC&S Study purports to show that hostile takeover targets that do not have an ESB remain independent less often than those with an ESB. But not having an ESB is not the same thing as having an EAT. For all we know, the greater incidence of selling among non-ESBs may be because companies without an ESB may also lack other crucial antitakeover protections, such as a

34. Bebchuk et al., *supra* note 1, at 926 tbl.2.

35. A common saying among M&A lawyers is that all the bidder has committed to is the cost of the postage stamp needed to mail the bear hug letter. This is not entirely fair, of course, because the act of publicly stating one’s interest in a particular acquisition exposes the acquiror to a number of risks (for example, a strategic acquiror may create the irreversible perception among the investing public that it “needs” to do this deal in order to execute on its growth plans), particularly if the target is large relative to the size of the acquiror; however, experience does indicate that a fair number of “bear hug” bids really are less serious than other types of bids.

36. Bebchuk et al., *supra* note 1, at 950 (“In effect, our approach would convert ESB targets into EAT targets for takeover purposes . . .”).

37. *Id.* at 912.

charter provision prohibiting stockholders from acting by written consent. This is exactly what happened in the well-known case of IBM's successful 1995 bid for Lotus Development Corporation. Lotus found itself essentially defenseless because its charter permitted stockholder action by written consent. It therefore had neither an ESB nor an EAT, and it surrendered in less than a week.³⁸ The point here is not that there is no theoretical difference between an ESB and an EAT; as I have said, ESBs solve a vulnerability problem of the EAT and therefore make for a more complete defense that ensures the proper balance of power at all points in time. The BC&S Study alleges, however, that practitioners fail to appreciate the magnitude of this difference. It also implies that ESBs are more highly correlated with "bad" decisionmaking than are EATs. It is incumbent upon the authors to prove these points if they wish to push them.

A fifth problem is BC&S's failure to break out from their analyses the results solely for Delaware targets. The BC&S Study's analyses and policy prescriptions are grounded in and directed toward Delaware statutory and case law.³⁹ In particular, BC&S's policy prescription—that public company boards should not be allowed to wield the ESB defense—arises from the authors' belief that their Study disproves a key factual assumption upon which Delaware takeover jurisprudence is based, namely, the existence of a "ballot box safety valve,"⁴⁰ which, they argue, is "illusory" in the case of a company with an ESB.⁴¹ However, only about half of the targets in the BC&S Study (forty-seven out of ninety-two) were Delaware corporations subject to Delaware law.⁴² For all we know, the lower incidence of independence for ESB targets may have been concentrated in other jurisdictions with different legal features that help explain the results. Therefore, it would be interesting to know whether any of the Study's principal findings would change if only the forty-seven Delaware targets were included in the sample set.⁴³ In particular, looking only at Delaware targets, do those with ESBs remain independent in

38. Bizarrely, BC&S cite this as an example of how the ballot box safety valve works effectively, even though (1) Lotus had essentially no time to find and negotiate a better transaction, (2) no stockholder vote was held, and (3) Lotus had no leverage to negotiate a better price. *Id.* at 911. While IBM did raise its initial bid by \$4, it most likely did this in order to obtain swift negotiating access to Lotus's top software developers who represented Lotus's most valuable assets.

39. *See, e.g., id.* at 944 ("We focus on the corporate law of Delaware, the most important law domicile for U.S. corporations, and on solutions that can be implemented taking as given the existing structure of Delaware case law.").

40. *Id.* at 945.

41. *Id.* at 890.

42. *Id.* at 926 tbl.2.

43. Targets from states that expressly follow Delaware fiduciary duty law as it relates to takeovers could also be included.

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the face of hostile bids more often than those that do not? And is the difference statistically significant?

A sixth and last problem I will mention is that BC&S assume that in each case where the hostile bid target remained independent, independence was achieved over the objection of stockholders. Unless BC&S want to posit that stockholders favor any and every takeover bid regardless of price and timing—which I assume they would not, because it undermines their argument that stockholders are adequate guardians of their own interests, at least as to matters of price, and therefore directors should yield to the stockholders’ expressed preference⁴⁴—there must have been cases where remaining independent was the preferred choice of both the directors and stockholders or where stockholder choice was not patently clear. While it is unlikely that removing these cases would reverse the findings, the number of these cases is worth knowing because when we are dealing with a sample size that is already quite small compared to the universe of M&A activity,⁴⁵ removing from the sample those instances where there was no divergence of preference between the board and stockholders would help us to determine whether BC&S have really proven that the existing rules don’t work, or merely that the existing rules work for all but a very small number of exceptional cases.

II. DO WE REALLY NEED THE BROAD INFLEXIBLE NEW RULE OF DIRECTOR BEHAVIOR AND JUDICIAL INTERVENTION THAT BC&S PROPOSE?

Not only do BC&S fail to prove that their basic conclusions would be correct if the data were analyzed in the correct way, they compound the problem by proposing a policy reconsideration far grander than the underlying support can bear. In particular, they want us to conclude that ESBs are somehow correlated with “bad” decisionmaking by some boards, and therefore the ESB defense should be taken away from every board in every instance (at least in the takeover context). They do this by proposing that the law

should not allow [directors]⁴⁶ to continue blocking a takeover bid after they lose one election conducted over an acquisition offer . . . [A]fter the loss of one election that is effectively a referendum on the offer, incumbents should be required to redeem the [poison pill rights plan] and allow the bidder (whose offer has received shareholder support) to proceed with its bid.⁴⁷

44. See, e.g., *id.* at 944-45.

45. The difference between the number of ESB companies in the sample that remained independent and the number of non-ESB companies in the sample that remained independent is just 11 in the short run, and 10 in the long run. *Id.* at 930 fig.3, 933 fig.4.

46. The actual quotation states that the law should not allow “managers” to continue blocking takeover bids, but managers and directors are not necessarily the same thing, and it is directors, not executives, who have the power to redeem or maintain the poison pill. See *infra* text accompanying notes 57-63.

47. Bebchuk et al., *supra* note 1, at 944-45.

Unfortunately, the mere correlation they purport to discover is not strong enough to support the far-reaching conclusion that they draw, and their broad prescription is no more sensible than outlawing cars to eliminate drunk driving.

Look at it this way: The Study purports to show that 47% of boards of hostile takeover targets choose to remain independent even though independence is not, on average, the value-maximizing choice. The implication of this is that many, if not most, boards of directors fail, wittingly or not, to act in the best interest of stockholders in these circumstances. Even if this were true—and based on the foregoing I am not convinced that it is—we must still ask the simple question: *Why?* Is this happening because of the ESB?

It seems highly unlikely that the mere presence of an ESB (as opposed to an EAT or any other takeover defense arrangement) should change the nature or quality of board decisionmaking. Takeover defenses serve legitimate and useful purposes, including providing a company time and leverage to negotiate a better deal or find a better alternative, rebuff an inadequate or opportunistically timed bid, or remain independent and pursue its long-term business strategy—if the board determines that doing any of those things is in the best interests of stockholders. Seen in this light, takeover defenses, including ESBs, are tools that a board may or may not employ when confronted with a takeover attempt, but they do not determine *how* a board should act in any particular circumstance, and they do not relieve a board of its obligation to act in the best interests of stockholders.⁴⁸ Delaware law says directors *can* “just say no” if they believe doing so is in the best interests of stockholders, but it does not say that they *should* “just say no” in every circumstance just because they can.⁴⁹ The decision remains in the hands of duty-bound directors. And if you trust directors to fulfill their duties, you want them to have the most powerful tools available. This is a critical point because if it is even close to correct, then before we take away or lessen the effectiveness of these tools for everybody, we ought to invest some effort to find a more focused solution that separates the users from the abusers.⁵⁰

48. This view is stated well in a passage from Bausch & Lomb’s 1997 annual meeting proxy statement and is quoted in the BC&S Study:

The staggered board does not preclude unsolicited acquisition proposals but, by eliminating the threat of imminent removal, puts the incumbent Board in a position to act to maximize value to all shareholders. In addition, the Board does not believe that directors elected for staggered terms are any less accountable to shareholders than they would be if elected annually, since the same standards of performance apply regardless of the term of service.

Bebchuk et al., *supra* note 1, at 901.

49. See, e.g., *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

50. Cf. Bebchuk et al., *supra* note 1, at 924 (“[W]e return to our initial objective, which is to assess the viability of the ballot box safety valve against *disloyal* target boards.” (emphasis added)). Again, the BC&S Study assumes the disloyalty of the boards in the sample, without analyzing whether this is a safe assumption to make.

BC&S would probably respond that ESBs do cause “bad” decisionmaking by protecting incumbents from removal for a longer period of time and thereby enabling directors to behave badly. This is only true, however, if we believe that unrestrained directors are, in fact, motivated to act other than in the best interests of stockholders, something BC&S presume to be true without proof. But is this true? The BC&S Study suggests the answer lies in the fact that the interests of managers and shareholders often diverge in the takeover context and that compensation and other arrangements cannot be relied upon to bring them back into alignment.⁵¹ The problem is, while this may be true for managers (meaning executives, whose job, compensation, reputation, prestige, perquisites, and benefits are often at risk in takeover transactions), it is hard to see how it is true for truly outside directors.⁵²

For this reason, at least one area we ought to examine with some care is board composition and independence. Experience suggests that boards that are truly independent of senior management and other insiders ultimately “do the right thing” and use the available takeover defenses to buy time and create leverage to find the best deal for stockholders.⁵³ Boards that do not “do the right thing,” on the other hand, tend to be those where the independence model is warped by one of any number of factors, such as domination by senior management (particularly where the CEO is also the founder or a member of the founding family), the presence of too many insiders, other business relationships or personal ties, or a history of personal animosity or business rivalry between the raider and the target. Virtually every one of the classic “horror” stories trotted out by opponents of takeover defenses falls into this category. A popular example, discussed in some detail in the BC&S Study,⁵⁴ is the case of Circon Corporation, which rebuffed U.S. Surgical’s \$18 premium cash offer for nearly two years before ultimately selling to Maxxim Medical in 1998 for \$15 per share. In that case, Circon’s CEO throughout the takeover battle was its original founder, who appeared to regard Circon as his own alter ego, and its fortunes as a reflection of his own performance and legacy. More importantly, a majority of the directors had been hand-picked by this CEO and

51. See the discussion in Bebchuk et al., *supra* note 1, at 909. For a more extensive discussion, though one that similarly often fails to distinguish between managers and directors, see Bebchuk, *The Case Against Board Veto*, *supra* note 3.

52. See e.g., *Unitrin*, 651 A.2d at 1380 (“[I]t cannot be presumed that the prestige and perquisites of holding a director’s office . . . prevails [sic] over a stockholder-director’s economic interest.”).

53. There is also at least some empirical evidence for this view. See James A. Brickley, Jeffrey L. Coles & Rory L. Terry, *Outside Directors and the Adoption of Poison Pills*, 35 J. FIN. ECON. 371 (1994) (finding that the proportion of outside directors increases the likelihood that a hostile bid target will be auctioned, and not remain independent, once a bid has been made), *cited in* Bebchuk et al., *supra* note 1, at 925 n.120.

54. Bebchuk et al., *supra* note 1, at 913-14.

had significant personal loyalty to him.⁵⁵ Indeed, after U.S. Surgical initiated its bid, Circon's CEO added to the board an old friend who later admitted that he believed his primary role was to help repel the U.S. Surgical bid.⁵⁶ Other good and well-known examples include Hasbro's rebuff of Mattel and Loewen Group's rebuff of Service Corporation International, both in 1996. In each of those cases, the chairman and chief executive was a member of the founding family, held a substantial but noncontrolling stake, and had bitter personal and business rivalries with the suitors.

You might be surprised to learn at this point that BC&S actually agree that the presence of a majority of truly independent directors could obviate the need for the reconsideration of law that they would propose.⁵⁷ "We agree," they write, "that the carrot of stock options and golden parachutes and the potential stick supplied by independent directors may sometimes sufficiently align *directors and managers* with shareholders. When this happens, we do not need a safety valve, because even absolute power to block bids would not be abused."⁵⁸ Through a tortured trick of logic—in which they appear to intentionally confuse the difference between "managers," whose professional careers and compensation arrangements are on the line, and directors, who do not share those interests if they are sufficiently independent—they conclude that it would be "unwise to rely solely on these incentives to align the interests of *managers* and shareholders."⁵⁹ Somehow, the reference to directors, and particularly outside directors, simply disappears from one sentence to the next.⁶⁰ This willful confusion of managers and directors is unfortunate because it leads BC&S to "proceed under the premise that a safety valve is necessary."⁶¹ In other words, they presume the need for the very remedy that they propose,⁶² but they never prove it.⁶³

55. See Brian Hall, Christopher J. Rose & Guhan Subramanian, Circon (A) (Harvard Business School Case Study N9-801-403), at 6 [hereinafter Circon (A) Case Study].

56. *Id.* at 9.

57. Bebchuk et al., *supra* note 1, at 908-09.

58. *Id.* at 909 (emphasis added).

59. *Id.* (emphasis added).

60. While BC&S may choose to ignore the manager versus outside director distinction, the Delaware courts appear to take this distinction quite seriously, as Professor Stephen M. Bainbridge notes in his companion response, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 STAN. L. REV. 791, 809-10 (2002). For example, there are a number of situations in which a board carries its burden of proof more easily, or shifts the burden of proof from itself to the plaintiff, when decisions are made by the independent directors. Similarly, the Delaware corporate code itself assumes in several places that directors who are disinterested with respect to a particular matter are able to act independently of those directors who have a greater interest in a particular matter. See, e.g., DEL. CODE ANN. tit. 8, § 144 (2001).

61. Bebchuk et al., *supra* note 1, at 909.

62. See also *id.* at 924 ("[W]e return to our initial objective, which is to assess the viability of the ballot box safety valve against *disloyal* target boards." (emphasis added)).

In light of these observations, it is imperative that BC&S examine whether the composition and independence of each of the ESB companies in their Study that elected to remain independent differ from that of those that agreed to be sold. Did the boards that elected to remain independent have greater entrenchment motivation than those that did not? While some of this would be difficult to determine objectively, the following factors certainly could be reviewed: (1) number of insiders on the board (including executives and other “managers,” as well as directors affiliated with the company’s lenders, investment bank, or regular outside law firm); (2) whether the CEO and/or chairman founded the company, took it public, or is related to the founding family; (3) other founders or founding family members on the board; (4) percentage of directors who were directors prior to the company’s initial public offering (this might be a useful approximation for whether the directors are “hand-picked,” as in the Circon case); (5) number of directors who have other business ties to the CEO or other senior company executives; (6) the number of directors who were nominated or identified for board service by the CEO or other senior company executives; and (7) whether the CEO or any directors have ever been associated with the raider, or vice versa. My suspicion is that we will find that any truly abusive behavior is closely associated with boards that are not truly independent and outside in the senses suggested by the foregoing (as well as under corporate law and stock exchange rules).

This is a suspicion worth confirming, because a focus on director independence brings the long-running takeover defense debate into alignment with current “post-Enron” efforts to improve board performance generally. For example, this past summer the New York Stock Exchange proposed new listing standards for companies seeking to be listed on the exchange.⁶⁴ Central features of the proposed revisions were: the requirement that boards of NYSE-listed companies have a majority of independent directors, that the definition of “independent directors” be significantly tightened, and that the role and authority of the independent directors be increased generally.⁶⁵ In particular, for a director to be deemed “independent,” the board must affirmatively

63. One interesting study, cited by Professor Bainbridge, suggests their presumption is wrong. Professor Bainbridge notes that management-sponsored leveraged buyouts, like unsolicited tender offers, inherently involve a strong risk of management self-dealing. If BC&S’s presumption that independent directors are unable to separate their duties to stockholders from their allegiance to management were correct, we would expect that stockholder premiums in management-sponsored leveraged buyouts would be smaller than in arms-length leveraged buyouts. However, as Professor Bainbridge notes, this is not the case; in fact, the premiums are “essentially identical.” Bainbridge, *supra* note 60, at 810.

64. New York Stock Exchange, Corporate Accountability and Listing Standards Committee, *Original Recommendations* (June 6, 2002), available at http://www.nyse.com/pdfs/corporation_govrept.pdf.

65. *Id.* at 6-9.

determine that the director has no material relationship with the company.⁶⁶ One of the committee members involved in developing the recommendations for the revised standards commented that “[w]hile the vast majority of companies in the United States act responsibly towards their investors, these new rules will ensure that all companies listed with the Exchange live up to that responsibility.”⁶⁷ The same is true for board decisionmaking in the takeover context.

Another reason it is worth looking at the composition and motivation of the boards in the few “horror story” cases is because they all turn out to be exceptional cases, whose facts should not be the premise for new or “reconsidered” law. Take again the example of Circon,⁶⁸ which is noteworthy both for the intensity of the battle and because it provides one of the very few examples in which the incumbent directors of a staggered board continued to hold out against the hostile bid even after the raider won an election contest to remove a class of incumbent directors and caused two of its own nominees to be elected to the board.⁶⁹ While this is undoubtedly a horror story (holding out through two years of a bull market only to sell for 17% less than the initial bid), it is also an example of the most extreme form of a runaway, nonindependent board, not to mention a perfect expression of the maxim that hard cases make bad law.

The difficulty of drawing conclusions from the hard cases is well demonstrated by the saga of Weyerhaeuser’s fourteen-month pursuit of Willamette.⁷⁰ In November 2000, Weyerhaeuser made an offer of \$48 per share for Willamette. In May 2001, after raising its bid to \$50 per share, Weyerhaeuser conducted a proxy contest to remove a third of Willamette’s staggered board, and was successful. The remaining Willamette directors continued to oppose the bid. Ultimately, in January 2002, Willamette agreed to be acquired for \$55.50 per share, a 16% increase over Weyerhaeuser’s initial bid fourteen months before.⁷¹ This case has been cited both as an abuse of the ESB defense (because the Willamette incumbent directors held out despite the preference clearly expressed by a majority of stockholders at the May 2001

66. *Id.* at 6.

67. Press Release, New York Stock Exchange, NYSE Board Releases Report of Corporate Accountability and Listing Standards Committee (June 6, 2002), *available at* <http://www.nyse.com/press/press>.

68. See *supra* text accompanying notes 54-56.

69. See Circon (A) Case Study, *supra* note 55.

70. Willamette is a “hard case” because it provides an example of a board for which the independence model had been significantly warped by a history of tremendous personal animosity and business rivalry between the raider and the target—most notably because Weyerhaeuser’s chairman and chief executive officer, Steven Rogel, had been president and chief executive officer of Willamette until he “switched sides” in 1997.

71. The foregoing description of the Weyerhaeuser/Willamette story is taken from Bebchuk, *The Case Against Board Veto*, *supra* note 3, at 1031.

election) and as a “shining example of how a staggered board and poison pill operate to the benefit of shareholders”⁷² (because the ultimate deal price was \$7.50 above Weyerhaeuser’s original bid and \$5.50 above the offer theoretically “approved” by stockholders at the May 2001 annual meeting). Professor Bebchuk has argued elsewhere that it is hard to see a 16% increase over a fourteen-month period as a “shining example,”⁷³ in particular because he doubts that the Willamette’s board’s actions were really part of a bargaining strategy, but were instead attempts to avoid a sale to Weyerhaeuser at all costs.⁷⁴ His shareholder return argument is weak because the 16% return is actually quite strong considering that during the same fourteen-month period the S&P 500 declined approximately 21%⁷⁵ and the S&P Paper & Forest Products Group, which both Weyerhaeuser and Willamette use to measure their performance,⁷⁶ increased just 6.6% during the same period (and actually declined from the time of Willamette’s 2001 annual meeting to the date Willamette agreed to be acquired in January 2002).⁷⁷ As to Professor Bebchuk’s second point—that the Willamette board displayed an intransigence that somehow went well beyond mere bargaining strategy—whether or not it is true in this particular case, it ignores the fact that it is obviously very difficult to distinguish between improper intransigence and good bargaining tactics; they tend to look very much alike until the very end. In other words, intransigence is not the same thing as bad board behavior, and it is a mistake to try to use one as a proxy for the other.

In any event, the *really* interesting feature of the Willamette saga was the willingness of stockholders to approve a transaction at a price that was at least 10% below what the board was ultimately able to extract from Weyerhaeuser using the leverage provided by the ESB.⁷⁸ This willingness indicates (1) that

72. Lipton, *Pills, Polls, and Professors Redux*, *supra* note 3, at 1057.

73. Bebchuk, *The Case Against Board Veto*, *supra* note 3, at 1031-32.

74. *Id.* at 1032-33 (“The facts appear to be at least consistent with a story of management seeking to remain independent, and to avoid a sale to Weyerhaeuser altogether, and agreeing to be acquired by Weyerhaeuser only under massive pressure from shareholders.”). That the board did indeed succumb to “massive pressure from shareholders” seems a quizzical admission in light of his strongly held view that legal reform is needed precisely because shareholder pressure does not provide an adequate disciplining force upon directors.

75. Yahoo! Finance, at <http://table.finance.yahoo.com/k?s=^gspc&g=d> (calculated using Yahoo! Finance historical price calculation for the S&P 500 from November 6, 2000, the date of Weyerhaeuser’s first offer letter to Willamette, and January 21, 2002, the date the two companies announced their negotiated \$55.50 per share deal) (last visited Oct. 16, 2002).

76. See Weyerhaeuser Proxy Statement 13 (Mar. 6, 2002).

77. S&P Paper and Forest Products Group Index closing prices, November 6, 2000 through January 21, 2002 (supplied to author by Amir Mirza, Associate, Investment Banking Division, Merrill Lynch & Co., Inc., from subscription data) (on file with author).

78. Indeed, in light of the relative size of the Weyerhaeuser/Willamette transaction

the stockholder vote is a highly crude instrument for the expression of stockholder will, and (2) that the “fix” to Delaware law that BC&S propose, which would essentially eliminate the board’s ability to act as a negotiating agent for the stockholders and would essentially require the board to accept a deal at whatever price the raider had put on the table at the time of the stockholder vote—does not appear to be particularly well designed to maximize returns to target stockholders, and may in fact be a significant step in the wrong direction.

In short, it is very hard, if not impossible, to conclude from the Willamette story that the benefit of a “ballot box safety valve” of the sort BC&S propose would have outweighed the value of the additional bargaining power afforded the Willamette board by the presence of an ESB. And if we cannot reach that conclusion in this and other cases, it is hard to see how BC&S have succeeded in proving that the benefit of ensuring the “ballot box safety valve” for a handful of bad boards (boards that should not even exist under a proper model for director independence) outweighs the potential harm to the delicate balance of power between acquirors and targets that—as the conventional wisdom suggests—works quite well for the multitude of companies that can and do wield the ESB tool in a responsible manner.

CONCLUSION

Near the end of the Study, BC&S note that their no-ESB-in-the-face-of-a-takeover-battle proposal is not merely a modest proposal intended to reduce the likelihood of Circon-like horror stories, but is in fact intended to have the “substantial consequence” of upsetting the “background” rules that influence the outcomes of all takeover contests.⁷⁹ This happens, they argue, because “the actions of bidders and targets in all takeover contests occur against the background of the ultimate powers and threats available to the parties.”⁸⁰ Conventional wisdom—as reflected in M&A practice and in judicial opinions over the past seventeen-plus years—suggests that these “ultimate powers and threats” available to bidders and targets seem to have reached a reasonable balance, if not by design, then in a rough justice sort of way. ESBs play an

relative to what I would expect to find the size of the hostile deals in the BC&S Study to be once their data is released, it is possible that on a dollar basis, the 10% benefit to Willamette stockholders of the ESB could all by itself outweigh the aggregate negative stockholder returns identified by BC&S for the 21 hostile bid targets in the BC&S Study that remained independent in the long run. For example, the aggregate transaction value of all six contested tender offers that were completed during 2000 or pending at December 31, 2000 other than Weyerhaeuser/Willamette was \$868.1 million, or just one-sixth of the \$5.24 billion value of Weyerhaeuser’s acquisition of Willamette alone. MERGERSTAT REVIEW 2001, at 41 figs.1-2.

79. Bebchuk et al., *supra* note 1, at 947-48.

80. *Id.* at 948.

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important role in that balance by solving a key vulnerability problem of the pill/EAT combination, thereby ensuring a balance of power that is not sensitive to the changes of season. BC&S have argued that the conventional wisdom is wrong—that ESBs tilt the balance of power too far toward targets. They make this argument in two ways. First, they purport to show that for hostile takeover bids, the costs associated with the increased likelihood of independence outweigh the benefits of any additional bargaining leverage that an ESB might bring. However, as explained above, they have not actually proven this, particularly when we move from considering the effect of the “background rules” solely on hostile takeover contests to looking at their effects on all merger and acquisition activity. Second, by arguing for a rule that would bind every board in every situation, they implicitly argue that no board can be trusted to use the ESB tool effectively.⁸¹ But they never prove this point, nor do they invest the effort to determine whether an alternative approach, one that would separate the users from the abusers, can be found.

In the end, all they have succeeded in proving is that ESBs can work. I have argued that this is a good thing because ESBs are needed to plug the important theoretical hole in the overall defensive scheme otherwise provided by a poison pill and EAT provisions. By plugging the hole, ESBs ensure that the balance of bargaining power between acquirors and targets does not ebb and flow based solely on the timing of the target’s annual meeting. Until someone provides more persuasive evidence that (1) the overall costs of ESBs really outweigh the overall benefits and (2) there is no better way to separate the users from the abusers, who’s to say that’s really such a bad thing?

81. For example, BC&S argue that “[r]efusing to concede after losing an informed shareholder referendum on a bid could fairly be considered ‘arbitrary.’” *Id.* at 945-46. This assumes that stockholders would never “leave money on the table” by approving a transaction at a price substantially below what the bidder was actually willing to offer. The Willamette story alone proves this is simply untrue. Stockholder votes are far too blunt an instrument through which to carry out price negotiations.