COMMENTS ON THE ALI CORPORATE GOVERNANCE PROJECT

JAMES W. WALKER, JR.*

I wish to consider with you three broad areas. First, the response from the business community to the ALI corporate governance project to date. Second, some views on the topic of changes in corporate control, which I understand will be the subject of Part VI of the ALI project. Finally, I would like to consider briefly some of the principal influences on boards of directors and senior officers of large public corporations.

I. BUSINESS RESPONSE TO ALI PROJECT

It would not be an overstatement to say that the ALI's corporate governance project has become highly controversial and in many ways is viewed as unacceptable in the business community.

A principal reason, I believe, is that much of the underlying rationale of the ALI project is now questionable. The perspective of many in the business community is that the ALI project originated in response to now discredited theories. Those theories include a belief that the ideal solution to any problem in corporate management or corporate governance is based on increased government regulation designed to serve political and social ends. Thus, the project is viewed as something of a throw-back to the 1960's and 70's.

I suspect that many in the business community see the project, in its efforts to promote nationally uniform corporate law, as a stepping stone to a federal code, reminiscent in content to the prescriptions with which Mr. Nader and Senator Metzenbaum were associated during the 1970's. It should come as no surprise that the proposals are unwelcome in the 1980's when national attention is turned to deregulation, to promoting the economic recovery and to problems engendered by competition from foreign products.

Such perceptions are not entirely unfair. No one can question the integrity or wisdom of the ALI's original decision to undertake the project. Many of us strongly supported it as a means of averting efforts at federal corporate regulation along lines suggested by Mr. Nader and Senator Metzenbaum. However, many of the reasons for that support have eroded in the last few years. First, the nation has come

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to realize that regulation and a superabundance of legal prescriptions have tended to cause, rather than to cure, many of our economic and social ills. Second, our nation's corporate leadership has done much to correct the potential for abuse in corporate transactions on its own initiative by developing new standards of governance. And third, the courts have demonstrated a basic restraint in dealing with corporate law matters and should be given the opportunity to continue the development of a corporate common law.

The proposal of the ALI's reporters probably viewed as most hard to accept relates to the standards of liability and the accompanying risks of litigation. Generally, the number of rules directors must follow is expanded; a strict standard of care is enunciated; and the business judgment rule has been substantially narrowed in project drafts. There are also rules about directors' and officers' obligations to make reasonable inquiry. Meanwhile, the proposal seems virtually to beg for an increase in litigation, and the various drafts toy with maximum and minimum levels of liability of directors for their negligence, disregard or indifference to their duties. Taken together, there should be little wonder why the business community has responded so vocally.

Of course, there are also other objections:

For example, there is opposition to the so-called "monitoring" or "overseeing" role for corporate structure. The point is made that this is only one of a number of viable choices for boards.

There also are objections to mandatory standards and "good corporate practice" with respect to the boards and their committees. The argument is made that the project will discourage flexibility and innovation, and that developments in corporate governance itself will be inhibited.

Generally, there is the objection that the proposal simply constitutes, in effect, more regulation on top of existing regulation, without an adequate analysis of the harm to be prevented or the implicit costs of these new regulations.

On the procedural side, the argument is made that the Restatement format is unsuitable for a work of this kind, and that it is an inappropriate departure from past ALI projects.

II. CHANGES IN CORPORATE CONTROL

Turning for a moment to the subject of changes in corporate control, a subject which I understand is to be included in Part VI of the ALI project, I submit that the ALI should not subject this topic to a "prestatement" of the law.

Generally the courts have sought to follow a policy of neutrality toward takeovers. On the whole, they have permitted wide discretion by the boards of both target and bidder companies under the business judgment rule.[1]

This neutrality has been criticized by some academics who generally display a bias for approaches favoring the bidder companies. I am not suggesting that unfriendly takeovers are inherently bad or good; I do suggest that legal policy should remain neutral on the subject. Perhaps efficient markets in corporate control would be promoted by favoring bidders, but there are significant policy reasons why target companies should be allowed to defend their institutional lives. Here are a few:

Many successful tender offers are likely to be disadvantageous to those investors who are inclined to hold their investments for long periods. For such long-term investors, the offer may have all the characteristics of an economic "squeeze-out." This has become increasingly evident as tender offers are adapted to force the sale of operating properties of the target,[2] and as devices such as the "front-end loaded" offer are developed.

Successful director resistance to takeovers often provides the time and the incentive for the target company to obtain a higher bid from a white knight, thus increasing the price paid to shareholders. Often, the increase is quite substantial.

The public has a significant interest in the encouragement of long-term planning and investment, and in protection of the continuity necessary to promote these objectives. Advocates of the theory that achievement of successful tender offers should be facilitated by compelling director passivity to these offers, in my view, place the development of a market for corporate control ahead of these public interests.

Even a serious threat of a tender offer can hurt corporate interests since it often forces management to sacrifice long-range benefits for short-term results.[3] The orientation to short-term objectives discourages effective planning and innovation, which in turn hurts both shareholders

1. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Berman v. Gerber Products Co., 454 F. Supp. 1310 (W.D. Mich. 1978); Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969). *See also* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979).

2. *E.g.*, Dome's tender offer for the stock of Conoco's Canadian properties.

3. *See* Speech by Harold Williams before the Seventh Annual Securities Regulation Institute (Jan. 17, 1980), *reprinted in* [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,445, at 82,875. *See generally* Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978).

and the general public. Similarly, the potential for a tender offer may also discourage transactions which could significantly increase future liquidity.[4]

When abuses do occur in the process of resisting changes in corporate control, it seems to me, the courts are exceptionally appropriate bodies to make judgments, one at a time. These kinds of problems, I suspect, lend themselves more to judicial resolution than legislative solutions. Also, case-by-case resolution permits the law to evolve naturally, without deterring innovation in this important area.

The courts have permitted and thus, in a sense, encourage development in the area of takeovers by exercising caution regarding limitations and restrictions. In part, this may reflect the courts' respect for business people managing their own affairs as they think best. More importantly, it reflects an appreciation of the law's inherent limitations in these situations.

With respect to defensive tactics in particular, in my view, the continued ability of incumbent directors and officers to resist takeovers in the exercise of their business judgment is necessary to protect both the interests of shareholders and the public.

As you probably know, the SEC Advisory Committee on Tender Offers recently submitted its report of recommendations to Mr. John Shad, Chairman of the Securities and Exchange Commission. Although the Advisory Committee presented fifty recommendations, these changes on the whole were more a fine tuning than a dramatic overhaul of the takeover rules. Without attempting to comment on particular recommendations, I would say that, generally, this approach strikes me as correct.

When the SEC Committee's report of recommendations was sent to John Shad, a cover letter was included from the Chairman of the Committee summarizing the Committee's work. I would like to call attention to a portion of this letter from Committee Chairman Dean LaBaron because, in my view, it is right on point. Mr. LaBaron wrote:

> The Committee respects the free market forces in the operation of the U.S. securities markets. Academic evidence is widespread that the takeover process is at least not demonstrably harmful to shareholders and some evidence points to its systematic benefits. We would be reluctant to restrict a process which seems to work reasonably well with the

4. *E.g.*, Congoleum became a prime target as a result of its recovery of a significant treble damage award in an antitrust suit.

possibility that we might incur some unintended harm. The Committee is humble in its ability to anticipate all of the takeover innovations that are likely to occur: good and bad. Our instincts led us to rely upon competitive markets as the ultimate regulator for the unforeseen specifics that may affect security holders. Our recommendations should promote private investment systems rather than hamper capital flows by heavy reliance upon rule making. We are attracted to solutions which are characterized by flexibility, simplicity and lower costs.

III. CONSTITUENCIES AND MARKET FORCES

Finally, I would like to offer some observations about the influences and forces upon senior officers and boards of directors of American business corporations. For those of you more familiar with other types of large organizations, such as universities, I suspect you will find these comments generally applicable.

Large companies constantly face a host of problems and decisions. At the risk of stating the obvious, I would note that these judgments are not made in a vacuum. In reaching their decisions, managements and boards of large companies must always be mindful of their many constituencies.

By constituencies, I am referring to shareholders, of course, but also to employees, vendors, distribution systems, bankers, investment analysts, local communities, and others.

I submit that constituencies are very powerful forces which serve, in a way, as regulatory substitutes for companies. No management or board of directors can afford to disregard them for any extended period of time. The reason is simply that constituencies have clout. They have ways of penalizing companies for making bad judgments. If necessary, they have the capacity to mobilize public opinion against the company, its management, its products, even its good name. Indeed, it is clout of this type which qualifies them as constituencies. In my view the larger the company, the more sensitive it is to these constituencies.

Additionally, for all but the very largest of companies, there is also the risk of takeover. In our American free market system there are always those potential investors searching relentlessly for assets not properly employed. It is hard to imagine more effective regulatory control.

With respect to boards of directors of large companies, I do not

see how new rigid rules of conduct, standards of diligence or the risk of additional litigation will serve any better than the present forces at work. On the contrary, such changes may make boards more guarded and less innovative in their actions.

It seems to me that more than ever before, boards need wide latitude to exercise their own best business judgment and should not be exposed to the risk of litigation at every turn. Boards need some privacy in their deliberations, and they should be free to make the difficult choices regarding when and where to concentrate their efforts without undue concern about liability.

In conclusion, I suggest that the ALI has discovered a kind of "constituency" in the business community. And the Institute is to be commended for its sensitivity to the concerns expressed by that community. I am sure that the recognition by the ALI of the concern of the business community regarding the corporate governance project will ultimately lead to a very constructive and useful result.

MISCONCEPTIONS ABOUT THE ALI CORPORATE GOVERNANCE PROJECT AND THE ROLE OF CRITICISM

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The American Law Institute is an interesting institution in many ways. Its processes for coming to any conclusions are slow, deliberative and cautious, sometimes to the distraction of someone as impatient as I am in pushing ahead. I serve as chief reporter of the Corporate Governance Project with four reporters working with me, each of whom has been assigned the task of preparing first drafts on the segment assigned to him. After we discuss these drafts collegially, we move on to the consideration of a group of consultants, whom I do not personally appoint, but who are appointed by the Institute. The ten consultants whom I have are a very distinguished and fairly diverse group. Two of them are here today, Professor J. Robert Mundheim and Donald Schwartz. The others include George Coombe, general counsel of The Bank of America; Lloyd Cutler, Bayless Manning; Irving Shapiro of Du Pont; and others of similar expertise and distinction. After we run that particular gamut, we present our revised documents to a group of advisors, who are again persons whom I do not appoint. One of the advisors, and someone with whom I have worked extensively, is James Lorie, who happens to be an economist of a school which an earlier speaker incorrectly said was unrepresented in our deliberations. Among the total of about forty advisors are one other economist, Oliver Williamson, from Yale; a few professional directors; a very distinguished group of corporate practitioners; some academics; and a number of prominent judges. I give you this background so that you will understand the character and deliberateness of the process by which the ALI works, and of which most people are unaware. After the reporters' drafts run through all these stages, i.e., meeting with the consultants three or four times a year, and with the advisors once or twice a year, we present revised drafts to the Council. The Council of the ALI consists of about fifty members of a highly diverse and distinguished character. They do not focus precisely on or become as technically involved in corporate law as advisors and consultants, but they are persons of extraordinary ability. They are sufficiently generalists so that one never knows from what direction

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a matter will be challenged, considered, or examined. The Council is made up of people such as former Solicitor General Erwin Griswold, Judge Henry Friendly, former Attorneys General Edward Levi and Nicholas Katzenbach, Judges Walter Schaeffer, Charles Breitel, and Edward Gignoux, in addition to a group of very distinguished practioners and academics. I am describing this process so that it will be clear that the preparation of an ALI document will never be accomplished in an off-hand or casual manner, and so that it will be apparent that any such document largely represents a consensus. Our documents have been, and will continue to be, debated at length.

I agree with our luncheon speaker, Mr. Vincent, that the reaction to the ALI corporate governance proposals has been extraordinary. I enjoyed his remark about Wagner but I will not begin my remarks by singing anything from Tannhauser, which I would think would be just about as relevant as the remark quoted earlier this morning to the effect that we were telling a banker how to run his business. There's not a word in our document about how to make or collect a loan or how to conduct any other kind of banking transaction. We would not want to infringe upon the conducting of business activities, and we haven't. Similarly, I want to say that I think a very large portion of the criticisms and characterizations that have been made concerning the ALI corporate governance document has been in the realm of metaphor, and misleading metaphor at that. I do like poesy and I find flights of fancy quite charming at proper times and places; in general, however, when used as a substitute for solid specific legal comment on the merits, they are inaccurate, unhelpful, and unfortunate. Moreover, I think loose comment seriously interferes with productive legal discussion, and I would ask you all to be a little more receptive toward our efforts and to focus directly upon the merits of what we actually say.

Before proceeding further, I want to challenge you, Professor Manne, directly and personally, on something you said about the project. I was sent a copy of a document which was a solicitation of funds which you made in December 1982 on behalf of your Institute. You ask in your letter for money, "to avert a new threat to the corporate free enterprise system" from the ALI Corporate Governance Project. I do not think that's a fair observation or fair comment. We at the ALI are trying to do a lawyerlike and serious job of analyzing the field of corporate governance in order to clarify and simplify it in some respects. I do not believe we have been radical in our proposed changes. Indeed, we may not have been even suitably innovative. I say that with a certain amount of embarrassment, but we have to achieve con-

sensus in large measure, as you can gather from the kind of process I have described. The pejorative remark in your solicitation letter and its innuendo constitute, in my opinion, an unfair, unwarranted, and unproductive form of attack. I hope we are not going to hear any more such statements. I invite specific criticism on the merits; however, generalized invective such as your letter contains is seldom helpful.

Now let me focus on the remarks that were made by the preceding speaker just a few moments ago. We were told, among other things, by Mr. Wagner, that the ALI reporters should not involve themselves in the field of corporate control. Control comprises a broad and difficult field, and it involves many different approaches to things. It involves the question of purchases at a premium; buy-backs for self-perpetuation; sales of blocks by individuals; sales of blocks by corporations; as in *Condec v. Ludenheimer*;[1] purchases to protect, as in *Cheff v. Mathes*;[2] purchases for what was conceived to be an improper purpose, as in *Perlman v. Feldmann*,[3] plus a mass of matters that are now, I think, less than clear. One can, of course, take the position that was stated openly at a meeting by someone (whom I will not identify, but who was present this morning), that the law in this area is murky and confused, but he'd rather have it stay that way. He doesn't think, he said, that anybody is going to get too seriously hurt by virtue of that uncertainty, and he doesn't want the law changed in any way, at any time or in any respect. I do not share that view. I have had a good deal of experience in practicing law and I have served on a large company's board of directors for over twenty years. I have chaired an audit committee, served on other committees and, from long experience, have learned some of the practical things. I know very well that there are many areas where I and my fellow directors are confused or uncertain. I, as a lawyer, insist on protecting myself by special kinds of inquiry and activity which I don't always see others pursue.

I have heard prominent businessmen say that the state of the law in this area is so confused that they, as directors, have to seek advice too frequently from their counsel, who can't give them definitive assurance or even very helpful advice. Against that kind of a background, it seems to me that one should look at the ALI proposals in a different manner than they have been approached here so far today. This is a document which is designed to avoid confusion, to achieve some clarification, and to attain some simplification. This is

1. 43 Del. Ch. 353, 230 A.2d 769 (1967).
2. 41 Del. Ch. 494, A.2d 548 (1964).
3. 219 F.2d 173 (2d Cir. 1955).

not a litigation document. It is a document for counseling purposes. It is a document which seeks to minimize litigation by reducing uncertainty and misapprehension.

Now let me turn to some specifics of the document. Most of the comments so far today have been addressed to the requirement of a majority of nonaffiliated directors found in the beginning of Part III. Parts I and II are statements of objectives and definitions. Part III speaks of the structure of the board. A great deal of fury has been exhibited over the initial requirement in Part III that there should be a majority of directors not affiliated with management. Bear in mind that the document does not call for directors who are independent and that, for our purposes, a shareholder is not affiliated with management. The theory was that there should be a majority on the board who are not too closely tied to, or under the thumb of, management. Independence in the sense of a lack of interested involvement is a different concept. It was believed that the management should have a group of persons on the board who can perform their functions without bias. The revised draft will eliminate the mandatory character of that particular requirement for a nonaffiliated majority, even though that requirement only applied to the large companies listed on the New York Stock Exchange. This draft still recommends such a board composition on a voluntary basis. I think this is probably, over the long term, an unwise change, but the ALI Council has directed it.

The only committee now required by Part III will be the audit committee. It would really be strange not to require that because it is required by the New York Stock Exchange; therefore all the companies listed on the Exchange are presumably already observing that requirement.

A few moments ago, Mr. Wagner referred to the fact that we did the outrageous thing of proposing a ceiling on liability of directors for negligence. I concurred in that recommendation with some degree of hesitance. Professor Eisenberg, who is here, can testify to the numerous discussions that we had among ourselves on that subject. The underlying theory was that it was unfair to subject directors to astronomical liability for negligence. For the moment, the details of how one defines negligence should be put aside. The purpose of the ceiling is to provide fairness through limitation. I have had some very interesting discussions on that subject. Mr. Block, a partner in the firm of Weil, Gotshal & Manges, who represents the Business Roundtable, and several members of the advisory board of lawyers to the Business Roundtable, have taken the position that by reducing the liability of directors for negligence, we are depriving directors of the

protection they now get from damages that are so outrageously high as to be relatively unacceptable to the courts. Therefore, it is said that if we drop the rule of damages down to a level of proper fairness, by way of the proposed ceiling, the courts will start imposing the proper liability. Therefore, instead of having reasonable rules to limit damages for due care violations, we should, it is said, keep the damage rules outrageous in character so that the courts will be reluctant to apply them. The last time I saw that argument seriously advanced was while Alice was quarreling with the Red Queen near a psychedelic mushroom.

Mr. Wagner also said that the ALI document seriously diminished the protection of the business judgment rule, or narrowed the rule. I don't believe for one moment that this is correct. I think that our discussion of the business judgment rule is, by and large, a statement of the rule as I understand it presently exists under court decisions. I strongly believe in the business judgment rule. I don't think directors' innovation should be inhibited. I will tell you that I have been astonished at the significantly different and inconsistent interpretations of this rule by various members of the bar. It is said that few lawyers concur as to the actual content of the business judgment rule. I am not talking about the question of whether or not our statement of it is accurate; I'm just noting that the views of the business judgment rule held by the bar around the country and, even worse, by the businessmen with whom I've spoken, are so diverse, so heterogeneous and so variegated, that misunderstanding is inevitable. Our project has restated the business judgment rule as applied by the courts and has caused the bar to focus carefully on the actual content and meaning of the rule.

Our project is also inaccurately accused of fomenting litigation. As a matter of fact, one document that was sent around the country indicated our project had an anti-management bias because twenty-six and a half pages dealt with plaintiffs, or plaintiffs' attorneys' fees, in derivative actions. That is true. However, the pages were included at the insistence of one of our consultants in order to discourage the institution of derivative litigation which has, as its primary motive, obtaining fees for plaintiff's counsel. If you are sincere, he challenged us, you must try to deal fairly with the phenomenon of extortionate fees. So I command you to read those twenty-six and a half pages because they represent an effort to minimize exorbitant fees for plaintiff's counsel in improper instances. I do not know of any other place where that has been attempted. Members of the plaintiff's bar have, of course, objected. But our project has also been gratuitously de-

nounced from the other side by management representatives, who have no basis for so doing. As Andrew Carnegie once said, "No good deed goes unpunished."

I really do not want to begin talking about control questions now. I probably have already spoken past my permitted time. But I thought it would be more interesting to you if I were to confront and correct a few of the erroneous statements that were made about our project at this meeting.

I looked upon this meeting, frankly, as a learning experience. Our project needs to deal with the problem of control, and control means many things beyond tender offers. Tender offers are significant and serious matters. But, for example, the recent SEC recommendation reaches the flat statement that control is a corporate asset. That is a lovely phrase. When I first heard it in law school, I didn't know what it meant; I don't believe I know what it means now, and if it means what I think it does, I doubt if I agree with it.

In my understanding, the matters addressed by Mr. Wagner concerning the notions behind the ALI project had nothing to do with what we were trying to achieve. One of our goals is taking a concept such as control, examining it, and focusing the attention of the bar on it. We try to analyze it; we try to deal with its ramifications; we run it through this extraordinarily slow and meticulous filtering process which the ALI utilizes; and we subject it to the scrutiny of the bar in general. I'm sure it will be widely examined, and in close detail. My successor in teaching corporation law at the University of Chicago, my former student, Professor Frank Easterbrook, who spoke here this morning, will, I am sure, attempt to educate me on anything I say that is wrong, as I hope all of you will. One of the things that the ALI project will do is center the attention of the bar on such a question as the meaning of control as a corporate asset. I would hate to have that kind of a concept running around loose and accepted widely without careful analysis and examination of what it really does or ought to mean.

Now let me say something which may, at first, seem contradictory to what I have said previously. Part of the bar will focus on this kind of question and will do a professional job and a public service. To some members of the bar, including many who have written to me and evidently have not read the document they criticize, I fear that a witticism about annual reports will apply. Someone once said that the annual report is one of the great unread literary forms of the twentieth century. I fear that our project's drafts may be similarly unread and may be more often criticized than perused. I would urge

you all to read the document. You may conclude that we do something erroneously, or that we are not dealing with anything relevant enough to be important, or that there's no emergency to justify our work. We do not try to deal with emergencies. We try to deal with our subject in depth after careful thought. But I urge you all to read the document itself objectively, and I further urge you to give me your specific suggestions so that we may benefit from them.

TOWARD A MORE PERFECT MARKET FOR CORPORATE CONTROL

WILLIAM J. CARNEY*

I. INTRODUCTION

I am here to speak about a portion of the Restatement that has not been written yet.[1] In one sense I think that is just as well since nothing has yet been engraved in stone, and there is no need for views to get polarized.

Since the Restatement Project intends to deal with control transactions, I intend to speak broadly about the area, including federal law. You cannot discuss control transactions without discussing federal law, since it plays such an important role in the market for corporate control. Furthermore, since the Restatement has gone beyond the usual statement of the law to suggest law reforms, I assume that process will continue in the part dealing with control transactions.

Before discussing legal reform, it is critical to have a clear idea about how the market for corporate control operates.[2] It is also critical to understand whether control transactions benefit investors and society. You have all heard the adage, "if it ain't broke, don't fix it." We can't make intelligent choices about whether to regulate control transactions without a clear understanding of how they operate. I'm going

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1. As of the date of final revisions of these remarks for publication, the situation remains unchanged. References to the "Restatement" in this paper were appropriate at the time it was delivered. The published version at that time was Principles of Corporate Governance and Structure: Restatement and Recommendations (Tent. Draft No. 1, Apr. 1, 1982) [hereinafter cited as Restatement or First Tentative Draft]. The title of the document has been changed to Principles of Corporate Governance: Analysis and Recommendations, to reflect the reform nature of the document, and its departure from a traditional Restatement approach. Tentative Drafts 2 and 3 [hereinafter cited as Second Tentative Draft and Third Tentative Draft] were published in 1984. Tentative Draft No. 4, Discussion Draft No. 1, and Reporters' Study No. 1: Transactions in Control, were published in 1985. The Reporters' Study accomplishes what I predicted in the following paragraph was impossible: it discusses control transactions without discussing federal law.

2. The phrase "market for corporate control" originated with Henry G. Manne in *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965).

to take a brief look at that problem this afternoon. My conclusion will be, "it ain't broke; don't regulate it."

I believe the Restatement ought to recommend deregulation of the market for corporate control. That means repeal of the Williams Act,[3] and, incidentally of any state takeover statutes that may remain after *Edgar v. MITE Corp.*[4] I will also recommend eliminating both the veto power now held by corporate boards over mergers, and the treatment of defensive tactics as self-dealing transactions which warrant the closest scrutiny by the courts.

Before undertaking what may sound like a radical agenda, I should explain why it is in the interest of American management, as well as investors, to promote such deregulation.

There is a long tradition of accusing American management of being unaccountable, which goes back at least to Brandeis and Berle and Means.[5] All of these critics have seen the large corporation as somehow being free of normal market constraints. Some of that theme also appears in the First Draft of the Restatement, as part of the justification for the increased regulation of corporate management that has been proposed.[6] I believe the Restatement drafters understand the relationship between effectively functioning markets and the justification for regulation. Only if they argue that markets do not operate to make corporate managers accountable can they press for greater regulation.[7]

3. Act of July 29, 1968, Pub. L. No. 90439, 82 Stat. 455, adding 15 U.S.C. §§ 78m(d), (e) & 78 n(d)-(f). Rather than enact repeal, Congress, with at least partial support from the SEC, seems likely to expand the scope of the Williams Act. *See, e.g.*, H.R. 5693, 98th Cong., 2d Sess. (1984); H.R. REP. No. 1028, 98th Cong., 2d Sess. (1984) (Tender Offer Reform Act of 1984). While many of the same proposals to expand the Williams Act reappeared in 1985, ultimately the SEC withdrew its support for any expansion except to require the filing of Schedule 13D immediately upon acquisition of 5% of a company's shares, before any more could be acquired. *SEC Abandons Bulk of '84 Tender Offer Package*, 17 SEC. REG. & L. REP. (BNA) 926 (1985). Lack of SEC support has not deterred others from proposing expansion of the Williams Act, however. The most recent legislative proposals would require increased tender offer disclosure of the impact of a takeover on communities, and would require offers to remain open for at least 60 days (H.R. 1480, S. 631, and S. 706, 99th Cong., 1st Sess.). *Wirth Committee Hears Testimony on Community Impact of Tender Offers*, 17 SEC. REG. & L. REP. (BNA) 1055 (1985).

4. 457 U.S. 624 (1982).

5. *See, e.g.*, L. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT (1914) and A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

6. Restatement, *supra* note 1, § 3.02, Comment, at 60-62.

7. A large body of literature critical of regulation has developed. *See, e.g.*, Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); *see also* Hilton, *The Basic Behavior of Regulation Commissions*, 62 AM. ECON. REV. PAPERS & PROC. 2 (1972); Jordan, *Producer Protection, Prior Market Structure and the Effects of Government Regulation*, 15 J. L. & ECON. 151 (1972); Peltzman, *Pricing in Public and Private Enterprises: Electric Utilities in the United States*, 14 J.L. & ECON. 109 (1971); Posner, *Taxation*

The best defense against increased judicial regulation of management is increased market regulation. The choice is clear: either management will be held accountable through rational market forces or through a system of tighter and tighter regulatory controls. Management will either be governed by product markets and the market for corporate control, or by judges. My own strong preference is for markets.

If you share my belief that markets create more economic wealth than courts do, then the proper role for the Restatement is to free market forces to do their job.

II. THE RESTATEMENT VIEW OF THE MARKET

Let me turn now to the remarks in the First Draft of the Restatement on the nature of the market for corporate control. It is clear the drafters understood that they could not justify a proposal for more corporate regulation unless they could dismiss markets as ineffective constraints. The commentary to section 3.02 is enlightening. After the reporters dismiss shareholders as effective monitors of management, and product markets as constraints on inefficient firms, they turn to the market for corporate control.[8] Now let me quote from the passage where they dismiss the effectiveness of that market:

> The takeover mechanism, however, also provides excessive leeway for managerial inefficiency, because of the high transaction costs imposed by the inherent mechanics of takeover bids, the requirements of relevant statutes, the wide array of defensive tactics available to incumbent management, the incentives to take over well-run rather than poorly run com-

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by Regulation, 2 BELL J. ECON. & MGMT. SCI. 22 (1971); Posner, *Theories of Economic Regulation*, 5 BELL. J. ECON. & MGMT. SCI. 335 (1974); Stigler & Friedland, *What Can Regulators Regulate? The Case of Electricity*, 5 J.L. & ECON. 1 (1962). For recent efforts to justify securities regulation, at least in a limited context, see Carney, *Defining a Security: The Addition of a Market-Oriented Contextual Approach to Investment Contract Analysis*, 33 EMORY L.J. 311 (1984) [hereinafter cited as *Defining Security*]; Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984); and Coffee, *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984) [hereinafter cited as *Market Failure*]. All of these papers use economic analysis, with its theories of human behavior, to construct models of market reactions in various situations that might suggest efficiency improvements possible through regulation. Other examples of the application of economic analysis to criticize the justifications for securities regulation use empirical techniques to test specific hypotheses about the benefits of regulation. *See, e.g.*, Stigler, *Public Regulation of the Securities Markets*, 19 BUS. LAW. 721 (1964), and Benston, *The Effectiveness and Effects of the S.E.C.'s Accounting Disclosure Requirements* in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES (H. Manne ed. 1969).

8. Restatement, *supra* note 1, § 3.02, Comment, at 62.

panies, and the time-lag often experienced by the public in ascertaining managerial inefficiency.[9]

They are correct, of course, that this market does not work perfectly. No market that I know of does. Information is not free, so we can expect time lags in identifying poorly managed firms.[10] Takeovers are costly, and we cannot expect to see one every time there is the slightest lag in the productivity of a management team.

The real question is what are we going to do about this? Should we deregulate the market for corporate control, so it will make corporate managers more accountable, or should we provide a new layer of regulation to remedy the problems created by the present system of regulation? Sometimes this is called "fine-tuning" the system, but I prefer to think of it as using one regulatory mess to justify creating another.

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9. *Id.* The Second Tentative Draft has been revised to include a more explicit recognition of the "agency cost" literature. *Id.* § 3.02, Reporter's Note at 74-76. That discussion contains no express reference to transaction costs and inefficiencies in the market for corporate control, but does attempt to reject the general efficacy of markets:

> However, it is extremely unlikely that market forces acting alone will produce an optimal solution of the agency-cost problems in the context of the publicly held corporation, partly as a result of potential conflicts of interest [unidentified] concerning the installation of monitoring institutions, and partly because some monitoring institutions and incentive mechanisms that seem theoretically desirable in a frictionless model entail substantial transaction costs, such as the costs of acquiring information and the cost of contracting, in the real world.

Id.

The note goes on to cite as examples of questionable assumptions the notion that lower-level managers will continually monitor those who supervise them, in the hope that they can step over shirking or less competent managers by reporting to their superiors; the notion that the board seeks information from these lower level managers about the performance of top managers; that outside directors serve primarily as arbiters to resolve internal disputes among managers, or as referees to stimulate competition among managers, and that outside directors are disciplined by the market for their services. The Reporter's Note concludes that "the theories argued in this special portion of the agency cost literature, while suggestive, are based on assertions that appear either unrealistic or too limited to serve as an exclusive basis for policy concerning the administrative structure of the publicly held corporation." *Id.* The commentary is thus no longer addressed to the efficacy of the market for corporate control, but attempts to refute the economic literature by simple references to assumptions of a frictionless model and the "unrealistic" nature of some of its assumptions. It presents no counter model of human behavior, no empirical evidence that refutes the hypotheses suggested by the model, nor evidence suggesting market failure that can be remedied in a Pareto superior manner by regulation.

10. For a discussion of the problems of identifying potential targets, see Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J.L. & ECON. 371 (1981) [hereinafter cited as *Economic Effects*].

III. THE COSTS AND BENEFITS OF REGULATION

What I propose to do now is to examine briefly the costs and benefits of regulation and management defensive tactics.

Let me start with the Williams Act. The benefits of the Williams Act are almost never analyzed. There is a good reason for that; there is almost nothing to analyze. Once we get beyond some general praise for the virtues of full disclosure and equality of treatment for shareholders, and take a close look at these issues, the benefits start to evaporate.[11]

A. The Dubious Benefits of Disclosures

Under the Williams Act, a bidder must make rather full disclosures about its own background, sources of financing for the bid, and plans if the takeover is successful.[12] The results of this disclosure can be perverse, in terms of getting the most efficient management team in control of the target. If no takeouts[13] were possible, for example, shareholders who believed that the bidder would do a better job of managing the target would be tempted to hold on to their shares, since they would expect the post-acquisition value of their stock to be higher than the bid price.[14] This makes perfect sense, since they would not expect the bidder to pay a premium price in the tender offer unless the bidder thought the shares would be worth more later on. Target shareholders would be tempted to free ride on the bidder's efforts.[15]

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11. The House report on the original act is typical:

> Without knowledge of who the bidder is and what he plans to do, the shareholder cannot reach an informed decision. He is forced to take a chance. For no matter what he does, he does it without adequate information to enable him to decide rationally what is the best possible course of action. This is precisely the kind of dilemma which our Federal securities laws are designed to prevent.

H. R. REP. No. 1711, 90th Cong., 2d Sess., 3 (1968).

12. Section 14(d) requires a tender offeror to file Schedule 13D, 17 C.F.R. § 240.13d-101, as modified by SEC regulations, at the time a tender offer begins. Schedule 14D-1, 17 C.F.R. § 240.14d-101 (1984), Item 4, requires the bidder to disclose any plans or proposals which the bidder has which relate to such activities as mergers, reorganizations, liquidations, asset sales, management changes and other material changes involving the target.

13. A takeout merger is one in which a dominant shareholder votes its shares in favor of a merger in which the minority shareholders will not receive an equity interest in the surviving firm.

14. *See* Grossman & Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL. J. ECON. & MGMT. SCI. 42 (1980).

15. The outcome of this situation is indeterminate. The problem can be illustrated with a game theory matrix using a two-person game. Assume a stock currently trading at $30 per share, with a tender offer at $35 for any or all of the shares of the firm, with an expected post-bid value of $40 for the firm's shares, because

The very act of retaining their shares would defeat the bid, if all shareholders acted in this manner.

On the other hand, if target company shareholders believe the bidder would be an inferior manager from the Williams Act disclosures, they would expect the success of the bid to mean the value of target shares not tendered would be lower. They could avoid this by tendering to the inefficient bidder. Thus a disclosure that demonstrated the inferiority of the bidder as a manager could lead to the success of the bid, if enough shareholders believed the bid might be successful.[16] That is also a perverse result.

In the real world, of course, we do not have this problem. Bid-

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of the expectation of improved management. We can diagram the outcomes available for shareholders A and B as follows:

	B's Strategies: Tender	Don't Tender
A's Strategies: Tender	$35 for A $35 for B	$35 for A $40 for B
Don't Tender	$40 for A $35 for B	$30 for A $30 for B

Each shareholder's choices may lead collectively to a suboptimal result, where no one tenders. Thus, for A, if B tenders A will receive more by not tendering. Thus, if all shareholders share a belief in the bidder's superior management abilities, none will tender. If, on the other hand, A believes B will not tender, he can maximize his own position by tendering.

16. Given a pre-bid market price of $30, a tender offer at $35 for any or all of the shares of the firm, and an expected post-bid market price of $25, because of expected inferior management (which might take the form of looting the target corporation for the benefit of a parent), the situation would be as follows:

	B's Strategies: Tender	Don't Tender
A's Strategies: Tender	$35 for A $35 for B	$35 for A $25 for B
Don't Tender	$25 for A $35 for B	$30 for A $30 for B

Thus, if A assumes B will tender, A will prefer to tender, while if A assumes B will not tender, A will also prefer to tender. Since B faces the same situation, the success of the bid is guaranteed. This perverse result was recognized in the perspicacious opinion of Judge Tjoflat in Liberty Nat'l Ins. Holding Co. v. Charter Co., 734 F.2d 545, 569 n.47 (11th Cir. 1984), which concluded: "Therefore, non-tendering shareholders will be damaged by control moving to, or staying in, those hands less likely to increase the value of the firm. This is a curious result for a piece of legislation that is intended to help shareholders."

ders do their best to make all of the Williams Act disclosures irrelevant by threatening a takeout merger at a price below the cash tender offer price.[17] The effect of the two-tier bid is to persuade shareholders to tender now rather than run the risk of getting the lower takeout price.[18] The bidder tells target shareholders in advance of the prices at which shares will be purchased in the takeout. By doing this the

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17. Two-tier bids are a relatively recent phenomenon. *SEC Advisory Committee on Tender Offers: Report of Recommendations* 24, *reprinted in* Special Rep. No. 1028 FED. SEC. L. REP. (CCH) (1983) [hereinafter cited as Advisory Report]. The SEC has not accepted the recommendations of the Advisory Committee that two-tier bids be penalized by being kept open for a longer period, at least at this point. SEC Exchange Act Rel. No. 21079, FED. SEC. L. REP. (CCH) ¶ 83,637 (1984). The Commission questioned whether two-tier bids were uniquely coercive, when compared to any bid over current market prices, and cited the study of the Office of the Chief Economist ("OCE") that indicated that weighted premiums in two-tier bids were higher than those in any-or-all bids. *Id.* at 86,916. *See also* Hearings of the House Subcommittee on Telecommunications, Consumer Protection and Finance Concerning the Recommendations of the SEC Advisory Committee on Tender Offers, [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,511 (March 28, 1984) (statement of John S.R. Shad, Chairman, SEC) [hereinafter cited as Shad Statement]. The use of the pressures implicit in two-tier bids is a bit older, however. Formerly tender offer materials in partial bids would indicate that the bidder, if successful, would consider "other means" to acquire the remaining shares. The disclosure process encouraged explaining the pressures to target firm shareholders. *See, e.g.*, Halle & Stieglitz v. Empress Int'l, Inc. [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,249 (D.C. Del. 1977) and A. A. Sommer, Jr., *"Going Private": A Lesson in Corporate Responsibility*, [1975-75 Decisions] FED. SEC. L. REP. (CCH) ¶ 80,010, at 84,696 (1974). In some cases the SEC has charged bidders with excessive gloom (or candor) in these disclosures. SEC v. Westinghouse Elec. Corp., [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,262 (S.D.N.Y. 1975) (SEC Complaint). The SEC has issued a release expressing its concerns about the coercive pressures of two-tier bids:

> While the decision to tender appears to be a voluntary act by the individual investor, there are pressures to accept the offer because if enough security-holders tender their shares, non-tendering security-holders may find that whatever liquidity existed in the trading market for the issuer's securities has been severely undermined or has disappeared entirely. Moreover, nontendering security holders may lose the protections of the Exchange Act if the issuer becomes eligible for and seeks termination of registration under Section 12 or if the duty of the issuer to file periodic reports under Section 15(d) is suspended.

SEC Exchange Act Release No. 14,185 [1977-78 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,366 at 88,737 n.12 (1977).

18. This is the coercion imposed by a non-communication game, the "prisoner's dilemma." *See, e.g.*, Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. BAR FOUND. RES. J. 341, 349 n.39 [hereinafter cited as Carney]. The problems of a target company shareholder are illustrated *id.* at 351-52 n.47. Two-tier bids are coercive only if the second stage, the takeout merger, carries with it a price below the current market price. The OCE study, *supra* note 17, indicates that the average takeout premium over the pre-bid market

bidder assumes all of the risk of management of the target.[19] Target company shareholders then have no interest in information about the quality of the various management teams.[20] Two-tier bids thus cure all of the incentive problems that the Williams Act disclosures might create.

B. Equal Treatment Under the Williams Act

The other major goal of the Williams Act is to protect investors from missing out on the best offer.[21] They can miss out in any market if they don't respond promptly before offers are withdrawn. But we regulate tender offers and leave other markets alone, for reasons that are not obvious.[22] The method used to protect target shareholders is to create incentives not to sell or to tender. In doing so the rules again alter investor incentives in a perverse manner.

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price is 47.1%. Release No. 21,079, *supra* note 17, at 86,916 n.7. Further, "shark repellent" amendments that impose supermajority requirements for shareholder votes on takeout mergers, or impose "fair price" conditions on such mergers protect target shareholders against this form of coercion. Carney, *supra*. Thus the only coercion generally appears to be that target shareholders will miss out on the first stage of the bid, which carries an average first-tier premium of 63.5%. *Id.*

19. While a two-tier bid may be "coercive" in one sense, it shifts to the bidder, as sole owner of the firm after a successful takeover all risks associated with the future performance of the target firm.

20. This analysis assumes that successful bidders that are clever traders but poor managers cannot profit from stock market gains from a takeover where no real economic gains are involved. (For purposes of this analysis I exclude gains from correcting stock prices for undervalued firms, since this correction would lower the cost of capital for unappreciated firms, and thus improve economic efficiency.) The analysis depends on at least a weak form of the efficient market hypothesis, which requires "that information be available to a 'sufficient' number of investors, that transaction costs be 'reasonable,' and that, in the absence of agreement about the implications of current information and expectations regarding price movements, there be no evidence of consistent superiority by significant participants in the markets." J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 80 (1973). Support for this view of markets is found in Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); Friend, *The Economic Consequences of the Stock Market*, 62 AM. ECON. REV. PAPERS & PROC. 212 (1972); Grossman, *On the Efficiency of Competitive Stock Markets Where Traders Have Diverse Information*, 31 J. Fin. 573 (1976) and Comment, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977).

21. As the Advisory Report, *supra* note 17, at xxii, stated: "A fundamental premise of the Committee's recommendation is that all target company shareholders should have an equal opportunity to participate in a tender offer."

22. The range of market failure arguments that might support securities regulation generally are explored in Defining Security, *supra* note 7. None of them apply to securities traded in efficient markets. The most elaborate arguments in favor of

Market traders are persuaded to hold out once a bidder acquires five percent of a target's shares and files its schedule 13D. They will now wait for the expected tender offer at a premium, which raises the bidder's costs.[23] Next, the SEC has done its best to make sure that once a bid has begun, everyone gets the same amount. Bidders are forbidden by the statute to make a "first-come, first-served" offer, with its incentives to respond quickly. Instead, shareholders who tender within a fixed period of time can all participate in the proration pool.[24] This creates an incentive to hold out until the last day to see if something better comes along. The SEC has extended the tender offer period from the statutory minimum of seven to ten days to twenty days, apparently on the theory that anything less is fraudulent and manipulative.[25]Under Rule 14d-8, the proration pool for a partial bid is extended for the entire period of the tender offer.[26] The SEC Ad-

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some form of regulation argue that market failures do exist in what most economists consider efficient securities markets. *See, e.g.*, Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983) [hereinafter cited as Lowenstein]. Lowenstein argues that bidders are able to take advantage of market imperfections that undervalue some securities, because markets operate on the "greater fool" theory, that stock prices are set only on the basis of what investors expect other investors will pay for them, which is somehow unrelated to expected earnings. *Id.* at 275-81. This argument assumes there are no rational investors who will purchase on the basis of expected earnings except bidders, and that correcting stock prices by bidding up the stock prices of undervalued firms has no economic or efficiency implications, while in fact it reduces the cost of capital for such firms. For a discussion of some of the anomalies that trouble observers of efficient markets, see *Market Failure, supra* note 7, at 719 n.10.

23. Since the schedule 13D requires disclosure of a bidder's plans and proposals with respect to a target, it necessarily discloses valuable new information that will have an impact on the target's stock prices. This, in turn, may raise the reservation price of existing shareholders, force the bidder to share the results of its research with them, and dissipate the profits for the bidder that otherwise would be generated by its research. *Economic Effects, supra* note 10.

24. Exchange Act, § 14(d)(6), 15 U.S.C. § 78n(d)(6) requires the bidder to prorate all shares tendered within the first ten days of a tender offer. *But see* Rule 14d-8, *infra* note 26.

25. The Williams Act did not specify a minimum offering period, but periods of seven days for "any or all" bids and 10 days for partial bids were implicit in the requirements that target shareholders be given withdrawal rights for seven days and proration rights for 10 days under § 14(d)(5) and (6), respectively. The minimum 20 day offering period only appeared explicitly in Exchange Act Rule 14e-1, 17 C.F.R. § 240.14e-1 (1984). Since this rule was adopted under the authority of the antifraud provisions of Section 14(e) of the Exchange Act, the SEC must have concluded that short two-tier bids were inherently fraudulent. *C.f.*, SEC Exchange Act Release No. 16384, Special Bulletin No. 835, Part II, FED. SEC. L. REP. (CCH), 60-64 (Nov. 29, 1979). *But see* Radol v. Thomas, 534 F. Supp. 1302 (S. D. Ohio 1982).

26. Exchange Act Rule 14d-8, 17 C.F.R. § 240.14d-8 (1984).

visory Committee on Tender Offers would push the equal treatment rule even further, penalizing partial bids through a requirement that they must stay open two weeks longer than bids for all of the shares of the firm.[27]

Finally, the SEC Advisory Committee would push the equality notion to its logical extreme by effectively preventing the sale of large blocks. They would do this by prohibiting the acquisition of more than twenty percent of the shares of a target without a pro rata tender offer.[28] Since a large block holder could not be assured of being able to sell out entirely in a tender offer, it would be faced with giving up control and assuming a minority position, if it tendered to a partial bid. If such large holders fail to tender, this may defeat the transfer of control. This is not justified on the basis that these transfers hurt smaller shareholders; it is only justified on the basis that someone else is getting a higher price which they are not sharing in. Defeating beneficial transfers of control in the name of equal treatment can leave all shareholders worse off.

The reason I have catalogued all of these moves toward equal treatment is two-fold. First, the securities laws have traditionally been about disclosure, and have let investors take their own risks about the prices at which they are able to buy or sell shares.[29] Similarly, state laws have not imposed any restrictions on these markets.[30] There is no reason why we should start now.

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27. Advisory Report, *supra* note 17, at 26. *But see* SEC Exchange Act Release No. 21079, *supra* note 17, which raises doubts about the reasoning of the Advisory Report. H.R. 5693, *supra* note 3, would have amended § 14(b) of the Williams Act so a new § 14(b)(3) would have required all tender offers to remain open for at least 40 days. The SEC opposed this provision. H.R. REP. No. 1028, *supra* note 3, at 33, 37-39.

28. Advisory Report, *supra* note 17, at 23 (Recommendation 14). This recommendation is based on the argument that control is a corporate asset, *id.* at 22-23, which appears to have originated in Berle & Means, *supra* note 5. That argument has not yet been accepted by the courts. *See, e.g.*, Honigman v. Green Giant, 208 F. Supp. 754 (D. Minn. 1961), *aff'd*, 309 F.2d 667 (8th Cir. 1962), *cert. denied* 372 U.S. 941 (1963); and Tyron v. Smith, 191 Or. 172, 229 P.2d 251 (1951). There is contemporary support for this rule in holdings that shareholders are under no fiduciary obligation to share control premiums with others. Doleman v. MEIJI Mutual L. Ins. Co., 727 F.2d 1480, 1483 (9th Cir. 1984); Wellman v. Dickinson, 682 F.2d 355, 367-68 (2d Cir. 1982); Claggett v. Hutchinson, 583 F.2d 1259, 1263-64 (4th Cir. 1978); McDaniel v. Painter, 418 F.2d 545, 548 (10th Cir. 1969) and Zetlin v. Hanson Holdings, Inc., 48 N.Y.2d 684, 421 N.Y.S.2d 877, 397 N.E.2d 387 (1979).

29. As Professor Loss stated: "Congress did not take away from the citizen 'his inalienable right to make a fool of himself.' It simply attempted to prevent others from making a fool of him." 1 L. LOSS, SECURITIES REGULATION 128 (2d ed. 1961).

30. While state blue sky laws have imposed substantive regulation on offerings of new issues, until the late 1960's they did not provide substantive regulation of

The other reason I am upset by these pressures is that all of these rules serve to make efficient and wealth-producing control transfers less likely. They generally reduce incentives to tender.[31] Some of them raise bidders' costs. Bidders need some mechanism to overcome the inertia of investors and some of the perverse incentives I have described.[32] The critical mechanism now is the ability to convince shareholders that the tender offer price is the best price they are likely to see. Bidders used to do this by first-come, first-served tactics or short proration periods.[33] Since these devices are no longer available, bidders have turned to two-tier offers. Now the SEC and its Advisory Committee are attempting to reduce the ability of bidders to provide this pressure. They have concluded, apparently, that any inequality of outcome for shareholders is an "abuse."

The fact is that if investors consider the matter in advance, when they don't know who the winners and losers will be, they will choose a system of inequality if it produces greater total wealth for them.[34]

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tender offers. Most state takeover statutes were of a disclosure type, but some provided for administrative hearings on the fairness of tender offers. These statutes were largely invalidated by Edgar v. MITE Corp., 457 U.S. 624 (1982). Recently some states have adopted takeover statutes that provide some regulation of a kind formerly provided by private contractual arrangements, in the form of so-called "shark repellent" amendments to corporate charters. *See, e.g.*, Md. Gen. Corp. L. § 3-602 (providing 80% supermajority voting for takeout mergers) and § 3-603(b) (excusing such voting requirements if fair price conditions are met); and Ohio Gen. Corp. L. Ch. 1707 (requiring shareholder approval for the acquisition of more than 20% of the shares of a firm).

31. One witness expressed concern that the disclosure requirements of the Williams Act tipped the balance in favor of management. He was Professor Stanley Kaplan, later Chief Reporter of the Restatement project. *Full Disclosure of Corporate Equity Ownership and In Corporate Takeover Bids: Hearings on S.510 Before the Subcomm. on Securities of the Senate Comm. on Banking & Currency*, 90th Cong., 1st Sess. 120 (1967).

32. *See* text at footnotes 12-16, *supra*.

33. *See generally* E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL: A TREATISE ON THE LEGAL AND PRACTICAL PROBLEMS OF THE OFFEROR, THE OFFEREE, AND THE MANAGEMENT OF THE TARGET COMPANY IN CASH TENDERS AND EXCHANGE OFFERS (1973).

34. Behind such a "veil of ignorance", investors will choose the highest "expected value" available to them. To the extent that higher expected value carries with it higher risk, in terms of greater variance of possible outcomes, investors can diversify their portfolios to provide some protection against such a risk. The balance of the risk is compensated by the bid premium. Cf., Easterbrook & Fischel, *Corporate Control Transactions*, 91 Yale L.J. 698, 711-15 (1982). It has recently been pointed out that diversification alone is not a complete solution to the squeeze-out problem, since it requires ownership in the bidder corporation proportionate to the investor's percentage ownership of the minority shares in the target for the wealth transfers to equalize. Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 749-51 (1984). The incomplete nature of the diversification solution to squeeze-outs is also an explanation of the growth of supermajority and fair price amendments. *See infra* text accompanying notes 35-39.

Private solutions are now in use, through supermajority and fair price amendments.[35] Shareholders can now choose a system of total equality by contract and it is interesting that they have not all done so.[36] Shark repellent amendments that provide that the only "fair" price for a takeout merger is the tender offer price can accomplish this result. The fact that not every corporation in America has chosen to offer this kind of "protection" against "abuse" to its shareholders is evidence that equality isn't desired by investors at any price. If the price of such equality is a reduction in the number of attractive bids that are made, most investors will not be willing to pay it.[37] The fact is there are private solutions to any problems that may exist here, and there certainly is no need for additional regulation. If private solutions are valued by investors, firms will adopt them. Regulation adds unnecessary delay to achieve the same result, and very likely provides overkill.

One can imagine a case where the two-tier bid was used to coerce target shareholders to tender where they were not better off than before. If the cash portion of the bid was above the pre-bid price and the takeout price was below the pre-bid price, the average price received by target shareholders might be no higher than the pre-bid price, and

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35. *See, e.g.*, Carney, *supra* note 18.

36. Surveys of the terms of shark repellents appear in DeAngelo & Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329, 346 (1983) [hereinafter cited as DeAngelo & Rice] (fair price amendments were proposed in only 14 of 100 cases surveyed); Linn & McConnell, *An Empirical Investigation of the Impact of "Antitakeover" Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361, 370 (1983) [hereinafter cited as Linn & McConnell] (fair price amendments or redemption provisions achieving same purpose only proposed in 24 proxy statements surveyed, compared to 280 proposals of supermajority shareholder voting (Table 2A). A survey of the results of the 1983 proxy season appears in 2 FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING 615 (1983). That study indicates that of 57 shark repellant proposals, 40 contained a form of fair price provision. In many of the cases meeting the fair price conditions excused compliance with the supermajority voting requirement. Thus a bidder able to obtain the required vote often did not have to offer the formula's "fair price" in a takeout merger.

37. This is particularly true when the potential opposition of institutional investors is considered. For a description of their positions on some of these proposals, see HEARD, VOTING POLICIES OF INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE ISSUES (Investor Responsibility Research Center, 1981). The high approval rates shown for shark repellents in the studies in *supra* note 36 (over 90%) may reflect a skewed sample, since managers of firms with many institutional holders of their stock may undertake a preliminary survey of institutional resistance, and decline to put shark repellent amendments to a shareholder vote where it appears there is little chance of passage. A recent SEC study is reported to indicate that stock prices decline upon adoption of shark repellent amendments, reflecting a negative investor response. *SEC to Release Study on Effects of Shark Repellents on Stock Prices*, 16 SEC. REG. & L. REP. (BNA) 1527 (1984). *Contra* DeAngelo & Rice, *supra* note 36 and Linn & McConnell, *supra* note 36. Thus far the studies have failed to examine whether investors differentiate among various types and relative strengths of shark repellents.

they might feel forced to tender. This scenario assumes that the successful bidders can get away with a takeout below the pre-bid market price, which is highly unlikely, but assume for the moment that it is possible.[38] I have described elsewhere how shark repellent amendments are being used to respond to this problem.[39] If these amendments require takeouts to be approved by a supermajority vote, the bidder either has to pay the higher cash price for a larger amount of shares or make a better offer at the takeout to obtain the consent of some of the remaining shareholders. If ratification by the holders of a majority of the remaining shares is required, the second stage price has to be more attractive. If a fair price approach is used, the bidder can only complete the takeout on terms the target shareholders have approved in advance. If target management hasn't given this kind of protection to its shareholders, perhaps that is a good reason to replace it.

C. *Management Veto Power Over Mergers*

Mergers at arms' length have generated little controversy. The fact that all shareholders are treated identically in such mergers must go far to explain this. If equality of treatment is a goal, we can encourage this by lowering the barriers to mergers. The principal barrier is the veto power retained by boards of directors which can prevent any merger proposal from coming to a shareholder vote.[40] If that power were eliminated, and directors were obligated to present such proposals to shareholders in all cases, this would encourage the use of mergers rather than hostile tender offers. It might well be that this would go far toward eliminating two-tier bids. I do not mean directors should not make recommendations to their shareholders about how to vote; of course they should. But there is little reason to allow boards of directors to prevent shareholders from making their own decision about an offer.

38. For bidders to be able to engage in such a "theft of control" requires no competition in the market for corporate control for the particular target, and a lack of ability of arbitragers to withhold their shares in the face of a low-ball bid. Nevertheless, there are reported cases of "negative premiums", where the cash bid was below the market price of the target's shares two weeks before the successful bid. Austin & Jackson, *Tender Offer Update: 1984*, 19 MERGERS & ACQUISITIONS 63, 65 (1984). This phenomenon suggests that blended premiums (weighted averages of bid prices and takeout prices) might also be below the pre-bid market price.

39. *See* Carney, *supra* note 18.

40. DEL. CODE ANN. tit. 8, § 251(b) (1974 & replacement vol. 1983) is typical, requiring a vote of the board of directors of each merging corporation before the approved agreement is submitted to the shareholders. *See also* MODEL BUSINESS CORP. ACT § 71 (1981). One writer has observed that this veto power may create a power in incumbent management to insist on receipt of some compensation from a pro-

D. *The Costs of Regulatory Delays*

Let me turn now from the benefits of regulation to its costs. I am turning to the delays imposed by the Williams Act and the problems created by second bids and target management defensive tactics.

The standard argument in favor of delay and for allowing target managers to defend and to seek second bidders is that this may produce a higher price for target shareholders. All of this is true.[41] Under current law, I believe it is target management's duty to seek the highest price for their shareholders, whether they do so by defeating a "lowball" bid or by finding a white knight to make a higher offer.[42]

One problem is to separate good faith attempts by target managers to do this from self-serving attempts to protect their own positions. I am less concerned about this distinction than many observers, for several reasons.

There is a natural tension between target management and its own shareholders in the context of a hostile tender offer. That is just one aspect of the agency costs of any large firm.[43] Managers may have legitimate fears that their careers with the company may be cut short

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spective merger partner for its consent to the merger. Manne, *Some Theoretical Aspects of Share Voting*, 64 COLUM. L. REV. 1427, 1433 (1964).

41. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Bebchuck, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defenses*, 35 STAN. L. REV. 51 (1982); and Lowenstein, *supra* note 22. The original justification for the Williams Act was to fill a "regulatory gap" in the Federal securities laws, to protect investors from making uninformed investment decisions, and to encourage investment by increasing public confidence in the securities markets. S. REP. No. 550, 90th Cong., 1st Sess. 1 (1967). *See also* H.R. REP. No. 1711, 90th Cong., 2d Sess. (1968). Arguments about the avoidance of hasty, ill-considered decisions rarely appear in the modern academic defenses of the Williams Act, perhaps because the widespread acceptance of the efficient market hypothesis, has sapped their vitality. *See supra* note 20.

42. Technically, of course, management owes no duties to shareholders who are simply dealing with outsiders who make an offer for their shares. Broffe v. Horton, 172 F.2d 489, 494 (2d Cir. 1949); Mairs v. Madded, 307 Mass. 378, 30 N.E.2d 242, 245 (1940); Mundheim, *Corporate Acquisition by Tender Offer*, 115 U. PA. L. REV. 317, 353 (1967); 3 FLETCHER, CYCLOPEDIA CORPORATIONS § 848, at 168 (1975 Rev. Vol.); *but* c.f. Jewel Cos. v. Pay Less Drug Stores Nw., 510 F. Supp. 1006, 1011-12 (N.D. Cal. 1981) (refusing to issue injunction against competing bidder where target management recommended the second bid). The argument elevates the interests of the corporate entity over those of the shareholders, in a triumph of form over substance. Recently the Delaware Supreme Court has included shareholders in its description of the board's "fundamental duty and obligation to protect the corporate enterprise, which includes stockholders, from harm reasonably perceived. . . ." This means that "When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders." Unocal Corp. v. Mesa Petroleum Co., 493 A. 2d 946, 954 (Del. 1985).

43. Agency costs may be defined as those benefits that agents can divert from owners of assets without contractual authorization, plus the costs of minimizing such

by a takeover. Many managers have invested much of their human capital in knowledge and skills that are most valuable only with their present employer, and it is understandable that they would want to protect that investment.[44] More and more corporate boards have recognized this concern, and have attempted to deal with the issue by providing "golden parachutes."[45] These contracts make good sense both for managers and for investors. If they are correctly structured, in essence they provide management with an insurance policy against special career risks from takeovers. Providing this insurance eliminates many of the incentives to engage in obstructive defensive tactics.[46] It aligns the interests of managers and investors. Since these agreements are becoming more common, we can expect to see fewer questionable moves by target managers in the future than we have in the past.[47] For that reason, I expect that abusive tactics should be less of a judicial concern in the future. That is just one example of how creatively market

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diversions. They are described in Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs & Ownership Structure*, 3 J. FIN. ECON. 305 (1976) [hereinafter cited as Jensen & Meckling].

44. *See* Carney, *Pols Poking Holes in Golden Parachutes*, The Wall St. Journal, Apr. 16, 1984, at 32. For a more general study of the problems of protecting specific assets by contract, see Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. LAW & ECON. 297 (1978).

45. A recent survey of 560 of the Fortune 1000 firms showed 48% have executive employment contracts, of which 49% have change in control provisions, while 29% of the employment agreements are pure "golden parachutes" that merely specify severance payments in the event of termination of employment following a change of control. WARD HOWELL INTERNATIONAL, INC. SURVEY OF EMPLOYMENT CONTRACTS AND "GOLDEN PARACHUTES" AMONG THE FORTUNE 1000 (1983). Another recent study shows that 180 of 485 companies in the Standard & Poor's 500 have severance benefit arrangements with executives that are contingent on a change in control. Investor Responsibility Research Center, Antitakover Charter Amendments: A Directory of Major American Corporations (1985). "The term 'golden parachute' has been used to describe [these severance] agreements because of their more generous payments and other benefits; they assure the executive a 'safe landing' if he leaves the corporation." R. WINTER, M. STUMPF & E. HAWKINS, SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER 425 (1983).

46. A recent study found positive stock price movements on the announcement of adoption of golden parachute agreements by firms. Lambert & Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, 7 J. ACCT. & ECON. 179 (1985). For those firms with a positive response, the authors found that the larger the size of the golden parachute payments, the more positive the market response where the firm was subject to a relatively high probability of a takeover bid, as measured by industry activity or prior bids for the firm. For another defense of golden parachutes, see Comment, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909 (1985).

47. Golden parachutes have been subjected to punitive taxation in § 67 of the Tax Reform Act of 1984, which amended § 280G of the Internal Revenue Code of 1954 to disallow employers' deductions for "excess parachute payments", which includes any payment contingent upon a change in ownership or control of the corporation, where the aggregate present value of the payments is in excess of 300% of

participants can respond to problems.

Now assume that future target management tactics will generally be directed toward maximizing value for their shareholders once a bid is made. What could possibly be wrong with that?

For the particular firm, there is nothing wrong with it at all, once a bid has been made. But for the markets at large there is a lot wrong with it. Defensive tactics and attempts to create auction markets have two impacts. First, they raise the cost of a bid for prospective bidders. Second, they reduce the chances of success, and lower the expected gains from a takeover bid. Raising the price of the product while lowering its quality, in terms of expected benefits, normally leads to fewer purchases. The prospect of higher prices and lower expected returns will inevitably lead to fewer takeover bids.[48] That seems so fundamentally obvious to me that I do not intend to elaborate on it. The evidence on this is very strong, at least in one respect. Where a second bid is made, the success rate of first bidders is about twenty-five percent

the average compensation received by the executive in the preceding five years. Employees are subjected to an excise tax of 20% of the amount of such excess payments under Code section 4999. While these provisions make such payments more costly, they may not eliminate them, or even reduce their size in all cases. Indeed, if firms increase the size of payments to compensate managers for additional taxes, such payments in the aggregate may rise rather than fall. Tax planners have already suggested the use of longer payout periods to reduce the present value of the payment, or use of non-qualified stock options designed to give the executive a gain equal to the desired payment. 24 TAX NOTES 608-09 (Aug. 6, 1984). Further, the negative impact of such payments on earnings will affect the income statement only after a takeover. This negative impact, to the extent it deters bids, may be viewed as a "good" by some target managers who prefer job preservation to shareholder wealth maximization. One would also expect a market for insurance to develop to cover risks that can no longer be covered with direct contracts. Some forms of such insurance are already offered by Lloyd's of London. *Takeover Insurance Emerges*, N.Y. Times, Aug. 23, 1984, at 36. Moral hazard problems with such insurance may slow the growth of this market; too generous a policy may stimulate attempts to sell the firm.

48. The argument is made by Easterbrook & Fischel, *The Proper Role of A Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); *see also* Easterbrook & Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981) and Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982). Whether Bebchuk, *supra* note 41, and Lowenstein, *supra* note 22, or Easterbrook & Fischel have the better of the argument about the wealth effects of defensive tactics depends entirely on the slope and elasticity of the demand curve for shares of target firms. The demand curve for shares generally is highly elastic. Scholes, *The Market for Securities: Substitution versus Price Pressure and the Effects of Information on Share Prices*, 45 J. BUS. 179 (1972). Professor Coffee takes the position that there does not currently appear to be any reliable data on demand elasticities for target firms. Coffee, *Regulating the Market For Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1180 (1984). Coffee's position may be correct if targets are somehow unique from investors' and bidders' perspectives, and thus distinguishable from the firms in Scholes' study, *supra*, but there is currently no evidence on this question, other than a study showing a decline in bids over time as regulation increased. *Economic Effects*, *supra* note 10. A

according to the latest studies.[49] That contrasts with earlier studies that showed success rates of eighty percent for bidders.[50]

There are several theories on why regulatory delay raises bidders' costs. Delay allows other potential bidders to examine the information disclosed by the first bidder, who is forced to share the results of its own research with others, at no charge.[51] Obviously long delay creates the opportunity for costly defensive tactics, including litigation. Some proponents of more regulatory delay tend to dismiss these costs as minor, but they have no empirical support for their positions.[52]

But even if research costs and transaction costs associated with a bid were minor, there is another reason why bidders are deterred by regulatory delay. Delay allows the White Knight to enter, and reduce the first bidder's chances of success. If the prospects of success for a first bidder have been reduced from eighty percent to twenty-five percent, the expected value of the bid has been dramatically reduced. First takeover bids have become much more of a gamble. Since repeated losses in takeover bids may harm the reputation and careers of a bidder's management team, they may seek safer investments in other markets.[53]

IV. RECOMMENDATIONS

Repeal of the Williams Act would preclude many defensive tactics, since there simply would not be the extended time period now available.

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recent study contributes something to our knowledge, at least implicitly, about the elasticity of demand for targets. A study of targets that defend against bids found that 75% of these firms are ultimately acquired, at a premium 17% above the first bid, and that these gains compensate target shareholders for the losses in defeated bids, on average. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & ECON. 151, 174 (1985).

49. Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. FIN. ECON. 141, 147 (1983).

50. Austin, *Tender Offer Statistics: New Strategies Are Paying Off*, 10 MERGERS & ACQUISITIONS 9, 12-13 (1975). This study showed a generally increasing success rate for cash tender offers, with rates of 60.7% in the 1968-72 period and 82% for 1972-75. This success rate continued during 1978 and 1979. Austin, *Tender Offer Update: 1978-79*, 15 MERGERS & ACQUISITIONS 13, 16 (1980).

51. *Economic Effects*, *supra* note 10.

52. One study of the transaction costs of making a tender offer indicated these costs represented 13% of the post-market price of the shares tendered. Smiley, *Tender Offers, Transactions Costs and the Theory of the Firm*, 58 REV. ECON. & STAT. 22 (1976). Several authors dismiss the costs of delay as insignificant. *See* Bebchuk, *The Case For Facilitating Competing Tender Offers*, *supra* note 41, at 1035-38 and Lowenstein, *supra* note 22, at 324-26.

53. Anecdotal support for this statement appeared in a report that several major risk arbitrageurs are diversifying into other fields, in the face of higher risks associated with a greater number of successful takeover defenses. *Business Bulletin: Takeover Speculators Diversify As the Game Grows Riskier*, Wall Street Journal, Oct. 11, 1984, at 1, col. 5.

A tender offer is a license to litigate under the Williams Act.[54] Obviously any such licenses that may still be available under state law should also be eliminated.

Even without these artificial delays, state courts will still face questions about the validity of some defensive tactics. Golden parachute contracts should eliminate many incentives to act contrary to shareholder interests, but there will still be some problem areas for the courts to deal with.

The great debate in the courts about defensive tactics concerns whether they should be judged by the business judgment rule or under some more stringent standard as self-dealing.[55] Professors Frank Easterbrook and Daniel Fischel have written a series of articles in which

54. At least one court has expressly addressed this problem, and has held that implying private actions would be contrary to the third part of the test enunciated in Cort v. Ash, 422 U.S. 66, 78 (1975), that the private remedy sought must be consistent with the legislative scheme. In *Liberty Nat'l Ins. Holding Co.*, 734 F.2d at 566, the court held that allowing target management to sue "would tip the balance towards management, thereby injuring the existing investors", the very group Congress wished to protect. Other cases denying private actions under the Williams Act include Equity Oil Co. v. Consol. Oil & Gas Co., [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,425 (D. Utah 1983); Leff v. CIP Corp., 540 F. Supp. 857 (S.D. Ohio 1982); First Alabama Bancshares, Inc. v. Lowder, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,015 (N.D. Ala. 1981); Berman v. Metzger, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,857 (D.C.D.C. 1981); American Bakeries Co. v. Pro-Met Trading Co. [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,925 (N.D. Ill. 1981); Sta-Rite Indus., Inc. v. Nortek, Inc., 494 F. Supp. 358 (E.D. Wis. 1980) and Gateway Indus., Inc. v. Agency Rent A Car, Inc., 495 F. Supp. 92 (N.D. Ill. 1980); *contra*. Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707 (5th Cir. 1984); Indiana Nat'l Corp. v. Rich, 712 F.2d 1180 (7th Cir. 1983); Seilon, Inc. v. Lamb, [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,448 (N.D. Ohio 1983); K-N Energy, Inc. v. Gulf Interstate Co., [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,423 (D. Colo. 1983); Rorer Group, Inc. v. Oppenheimer & Co., Inc., [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,256 (S.D.N.Y. 1983); Jacobs v. Pabst Brewing Co., 549 F. Supp. 1050 (D. Del. 1982). Earlier decisions are of less interest because, as Judge Tjoflat noted in *Liberty Nat'l Ins. Holding Co.*, 734 F.2d at 562 n.35, prior to 1977 all courts implied private causes of action, a situation that was altered by a series of Supreme Court decisions in the area. *See, e.g.*, Herman & MacLean v. Huddleston, 459 U.S. 375 (1983); Merrill Lynch, Pierce, Fenner & Smith v. Curran, 456 U.S. 353 (1982); Transamerica Mtge Advisers v. Lewis, 444 U.S. 11 (1979); Touche Ross & Co. v. Redington, 442 U.S. 560 (1979); Cannon v. Univ. of Chicago, 441 U.S. 667 (1979); and Cort v. Ash, 422 U.S. 66 (1975). Schreiber v. Burlington N., Inc., 105 S. Ct. 2458 (1985), held that section 14(e) of the Williams Act did not cover acts that artifically affect the price of securities without deception, in a suit brought by a target shareholder. The decisions of the lower courts, dismissing for failure to state a claim, were affirmed without discussion of whether a private right of action lies under the Williams Act.

55. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (disagreement between majority and dissenting judge over the applicability of the business judgment test); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (applying business judgment test); Ministar Acquiring Corp. v. AMF Inc., FED. SEC. L. REP. (CCH) ¶ 92,066 (S.D.N.Y. 1985) (declining to apply business judgment test under New Jersey law); and Norlin Corp. v.

they argue very effectively that all defensive tactics are costly, and reduce the number of bids that will be made, to the detriment of all shareholders.[56] They would simply prohibit all such tactics.

One way to approach the issue more conventionally is to recognize that courts have applied the business judgment rule to keep their hands off most management decisions because they realized that managers were accountable in other arenas—mostly in product markets and in the market for corporate control. Where defensive tactics frustrate the operations of the latter market, there really isn't any alternate system for the courts to rely on.[57] And where markets are frustrated, there really is justification for a very close judicial review to determine if these tactics are in the interest of investors.[58] The very least the Restatement could do would be to impose a very heavy burden of proof on target management to show that these moves benefit their shareholders.[59] The obvious way to do this was suggested by the dissenting judge in *Panter v. Marshall Field*, who characterized defensive tactics a self-dealing.[60]

Rooney, Pace, Inc., [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,564 (2d Cir. 1984) (declining to apply business judgment test under Panamanian and New York law). The SEC Advisory Report, *supra* note 17, at Recommendation 9.b, recommended that the business judgment rule should apply, while the SEC "believes that shareholders would be better served if the courts gave greater recognition to potential conflicts of interest." Shad Statement, *supra* note 17, at 86,678.

56. Easterbrook & Fischel, *supra* note 48.

57. In *Mobil Corp. v. Marathon Oil Co.*, 669 F.2d 366, 374 (6th Cir. 1981), the court stated that lock-up options on target company shares given to "white knights" "for all practical purposes completely block normal, healthy market activity and, in fact, could be construed as expressly designed solely for that purpose."

58. *C.f., Donohue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975), where the court imposed special rules on close corporations largely because of the lack of a market for their securities. That principle was recognized in Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch. 1985), where the court held that a restructuring of authority in the corporation, which transfers power to determine the response to a bid from shareholders to directors shifts the burden to the Board to present evidence that the plan was not primarily motivated by a desire to retain control, but by a reasonable belief that the plan was necessary to protect the corporation. *Id.* at 1076.

59. Federal legislation could have achieved such a result H.R. 5695, 98th Cong., 2d Sess. (1984) was introduced by Rep. Timothy Wirth, Chairman of the House Subcommittee on Telecommunications, Consumer Protection and Finance. It would have added a new section 14(h) to the Williams Act, providing:

> (h)(1) No issuer whose securities are registered under this title, or any affiliate of such issuer, shall engage in any transaction in contemplation of effecting, or of defending against, a change in control of such issuer that is not prudent for the issuer and fair to the issuer's shareholders. The Commission or any shareholder of that issuer may bring a suit in the proper district court of the United States or of the District of Columbia to enjoin any such transaction and for such other equitable relief as may be appropriate. In any such suit the burden shall be upon such issuer or such affiliate to prove by a preponderance of the evidence that the transaction complained of is both prudent for the issuer and fair to the issuer's shareholders. A

V. CONCLUSION

What I have attempted to do today is to demonstrate that the failure of markets for control to function perfectly results largely from current regulations that caused them to malfunction. There is a danger in evaluating the need for regulation in the face of some imperfections in markets, to fall into what Harold Demsetz has called the "Nirvana fallacy" of comparing the real world, with all of its imperfections, with an ideal world.[61] If we do this, we can readily conclude that all markets are imperfect and in need of regulation. What we ought to compare are the costs and benefits of regulation with the costs and benefits of deregulated markets. Proponents of regulation generally have it easy in talking about costs, because one of the principal costs of regulation is lost opportunities for target shareholders to sell at a premium. Because we cannot easily see those losses, they too often tend to be ignored.

The cost of regulation of markets for control includes not only lost takeovers, but the system of heavier judicial regulation that the Restatement would impose on firms. Corporate managers can either face the risks of an unregulated marketplace, or the risk of a random system of judicial review and shareholder litigation. The results of the market are far more predictable. Rewards and punishments are rational, and they move assets in the right directions. Litigation, on the other hand, tends to paralyze management, to delay action, and to impose inordinately high costs on the decision-making process. That, from my perspective, is a lot less socially beneficial than the free operation of the market for corporate control.

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court may award attorneys' fees to a shareholder in such a case.

This proposal did not survive the committee's review of bills relating to the Williams Act. *See* H.R. REP. No. 1028, *supra* note 3. SEC Chairman Shad is reported to have indicated the SEC's opposition to the proposal, on the basis that it would be a "far-reaching preemption of fundamental state corporate law." [Bulletin No. 1093] FED. SEC. L. REP. (CCH) 6, 7 (1984). Closer judicial scrutiny of defensive tactics is not the approach suggested in Reporters' Study No. 1: Transactions in Control (1985), which argues that it is impossible to distinguish valid from invalid responses to bids on the basis of motivation. It suggests, in the alternative, procedural changes for adoption of shark repellents (supermajority shareholder approval); issuance of new shares (shareholder votes) and for lockup agreements for either shares or assets (shareholder approval). In other instances the study provides even more draconian solutions: targeted share repurchases (invalidation where the seller has not held for a substantial period of time); standstill agreements that require shareholders to vote as directed by the board (invalidation); and golden parachutes that allow the manager to resign and collect benefits (should almost invariably be deemed waste). These solutions differ radically from the approach of current law, and deny the possibility that any of these actions could be wealth-producing for investor.

60. *Panter*, 646 F. Supp. at 299-300 (Cudahy, J., dissenting).

61. For a discussion of the nirvana fallacy, see Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J. L. & ECON. 1 (1964).

AN ECONOMIC VIEW OF THE MARKET FOR CORPORATE CONTROL

RICHARD S. RUBACK*

I. INTRODUCTION

There is a rapidly growing body of scientific evidence about the effects of various aspects of the market for corporate control on the wealth of shareholders. This scientific evidence does not resolve all of the empirical issues that lie behind the debate about the structure of the market for corporate control. But the evidence does provide an important factual framework for such a debate. In particular, the evidence indicates that:

> Target shareholders substantially benefit from successful takeovers;
>
> Shareholders of bidding firms do not, on average, suffer from successful takeovers;
>
> Completed takeovers increase the combined value of the firms involved and most of these gains accrue to shareholders of the target firms;
>
> The benefits of takeovers are realized only when control of the target firm's assets are transferred to a bidding firm;
>
> Anti-takeover corporate charter amendments do not reduce stockholder wealth;
>
> Opposition to takeovers which eliminates a takeover bid reduces the wealth of target shareholders.

Before expanding on this scientific evidence and its implications for public policy, I would like to discuss the economic framework in which the evidence is interpreted. The market for corporate control is the arena in which management teams compete for the right to manage

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resources.[1] In this managerial competition model of the market for corporate control, management teams are the activists and, when the market for corporate control functions well, stockholders are relatively passive.

The passivity of stockholders in the market for corporate control evolves from their role in the modern corporation. Jensen and Meckling define the corporation as a 'nexus of contracts' between independent agents.[2] Fama and Jensen emphasize that stockholders in the modern corporation are the agents that specialize in risk bearing.[3]

Efficient specialization in risk bearing precludes the active participation of stockholders in the management of the corporation. Modern portfolio theory shows that investors can minimize their risk (for a given level of expected returns) by holding well-diversified portfolios in which only a small fraction of their wealth is invested in an individual firm. This diversification virtually eliminates the incentive for stockholders to monitor the firm. Shareholders have a small percentage of their wealth invested in the firm so that the expected rewards from monitoring the firm are likely to be smaller than the costs. Also, since stockholders hold securities of many firms, they do not have the information or expertise to monitor any single firm. Thus efficient risk bearing results in passive stockholders.

Competition among management teams is most apparent in proxy contests. In such contests an insurgent management team proposes an alternative operating strategy for the corporation and shareholders choose among the competing management teams. Proxy contests are not, however, the most frequent device used to transfer corporate control. This lack of popularity occurs because proxy contests inherently conflict with the passivity of stockholders. In a proxy contest stockholders are required to evaluate the plans of the competing management teams. Shareholders vote for the team whose plan is expected to result in the highest stock price. But passive stockholders do not have the information or expertise required to estimate the effects of competing management teams on the equity value of the firm. In other words, efficient risk bearing by stockholders in the modern corporation tends to preclude their careful evaluation of alternative management teams upon which proxy contests depend.

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1. This definition of the market for corporate control is presented in Jensen & Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 FIN. ECON. 1 (1983) [hereinafter cited as Jensen & Ruback].

2. Jensen & Meckling, *Theory of the Firm: Management Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

3. Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. ECON. 301 (1983).

Competing management teams could provide stockholders with forecasts of the future stock prices of the firm under their plans. However, the competing teams have ample incentives to overstate the benefits of their plans. Furthermore, these forecasts are not amenable to third party verification because they often involve different assumptions about the future. Thus, stockholders in proxy contests would have to verify the forecasts. This verification process, of course, conflicts with the passive role of stockholders.

Management teams can compete and the passive role of stockholders can be preserved if the competing teams offer to purchase the target's stock. Stockholders can thereby avoid expending resources to verify the claims of the competing management teams. Stockholders only have to compare the offer prices of the alternative proposals to a forecast of the stock price of the firm without a change in the management team. This form of competition between management teams occurs in the most frequent corporate control transactions: mergers and tender offers.

Mergers and tender offers are more efficient than proxy fights because they preserve the passivity of stockholders. However, mergers and tender offers require that the insurgent management team has resources to purchase the shares of the target firm. This suggests that proxy contests are likely to occur when the insurgent management team lacks such resources.[4] Consistent with this implication, Dodd and Warner find that 85% of proxy contests for firms listed on the New York and American Stock Exchanges that occurred between 1962 and 1978 were led by individuals.[5]

The managerial competition model suggests that tender offers are less informationally efficient than mergers. In a tender offer, the bidder offers to purchase the target's common stock at a fixed price. The target shareholders cannot, however, remain completely passive. The decision to tender is determined by comparing the offer price with the shareholder's assessment of the future price of the target firm. Such an assessment is likely to be complex since it involves evaluating the potential for higher competing bids and any new information released during the offer which would alter behavior or profitability of the incumbent management team. The costs of this assessment are mitigated

4. There are, of course, other reasons why mergers and tender offers occur. For example, some forms of synergy such as realization of economies of scale, are likely to require the formal combination of the bidding and target firms.

5. Dodd & Warner, *On Corporate Governance: A Study of Proxy Contexts*, 11 J. FIN. ECON. 401 (1983).

by the fact that target shareholders can sell their stock in the market during a tender offer to anonymous arbitrageurs.

The arbitrageurs perform an important role by specializing in valuing competing offers and providing a market that allows investors to delegate both the valuation and the risk bearing function during a tender offer. This specialization reduces the costs and increases the rewards from evaluating the competing management teams. Nevertheless, for the arbitrageurs to survive, their gross profits (on average) must at least equal the costs of evaluating the competing management teams. Thus, the arbitrageurs reduce, but do not eliminate, the costs of evaluating the competing management teams in a tender offer.

Merger proposals are negotiated and approved by the target's incumbent management team. Ignoring conflict of interest problems, the evaluation by the incumbent management team is most efficient since they are likely to have the best information set. Since the incumbent management team typically wants to retain its position, it is unlikely that it would approve a merger at less than the full value of the target firm. Target stockholders can therefore rely on the incumbent management's appraisal of merger proposals that are forwarded to them and remain completely passive.

The evaluation of competing management teams by the incumbent management team does present a potentially serious conflict of interest. The incumbent managers may oppose competing bids when they anticipate higher competing offers or when they possess other information that indicates that the compensation offered by the competing management team is inadequate. However, the desire to retain their positions, as well as the natural belief that they are the best management team for the firm, will cause the incumbent management team to reject some value increasing takeover proposals. In such cases the competing management team can make a hostile tender offer.

II. THE SCIENTIFIC EVIDENCE

The effect of takeovers on the stock prices of participating firms has been studied extensively. Each of the empirical studies focuses on a different aspect of the takeover market, and uses slightly different techniques and data. A synthesis of the results of these studies, which was recently compiled by Michael C. Jensen and me, is presented in table 1 for successful takeovers and in table 2 for unsuccessful takeovers.[6]

6. See Jensen & Ruback, *supra* note 1, at 7-9, for a review of the evidence on the market for corporate control.

Table 1 shows that the stockholders of target firms realize substantial and statistically significant stock price gains for 30% in tender offers and 20% in mergers. Successful bidders realize abnormal returns of 4% in tender offers and zero in mergers. This data indicates that target shareholders are not harmed by takeovers. Instead, target shareholders appear, on average, to capture most of the percentage gains in tender offers and all of the gains in mergers.

The data in Table 1 indicates that there are no abnormal returns to bidding firms in successful mergers. This suggests, in the language of financial economics, that mergers are zero net present value investments from the perspective of the bidding firm. However, the summary table masks the substantial variation across studies in the estimated abnormal returns for successful bidders in mergers. For example, Dodd[7] reports an abnormal return of -7% whereas Asquith, Brunner, and Mullins report an abnormal return of 3.5%.[8] Thus, while zero is my best estimate of abnormal returns for bidding firms in mergers, I have less confidence in this estimate than in any other of the empirical results reported in this paper. There are several reasons for the difficulties in measuring the abnormal returns for bidders. First, bidders tend to be much larger than targets. This tends to reduce the estimated percentage of abnormal returns for bidders and their statistical significance. Second, the acquisition may have been anticipated. This anticipation could occur through the announcement of an acquisition program. Also, some of the gains associated with acquisitions may have been impounded into the stock price of the bidding firm when it invested in a "toehold" position in the target prior to announcing the merger.

The stock price changes associated with unsuccessful takeover attempts are presented in table 2. Both targets and bidders in unsuccessful mergers and tender offers suffer small negative returns, although only the -5% return for unsuccessful bidders is statistically significant. Stockholders in firms that experience proxy contests realize statistically significant abnormal returns of about 8%. Somewhat surprisingly, these returns are about the same whether the insurgent group wins or loses the contest.

The contrast between the large stock price increases for successful targets and the insignificant stock price changes for unsuccessful targets indicates that the benefits of mergers and tender offers are realized

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7. Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105 (1980).

8. Asquith, Brunner & Mullins, *The Gains to Bidding Firms from Mergers*, 11 J. FIN. ECON. 121 (1983).

TABLE 1

ABNORMAL PERCENTAGE STOCK PRICE CHANGES ASSOCIATED WITH SUCCESSFUL CORPORATE TAKEOVERS*[9]

Takeover Technique	Targets	Bidders
	%	%
Tender Offers	30	4
Mergers	20	0
Proxy Contests	8	na

*Abnormal price changes are price changes adjusted to eliminate the effects of marketwide price changes.

na: Not applicable

TABLE 2

ABNORMAL PERCENTAGE STOCK PRICE CHANGES ASSOCIATED WITH UNSUCCESSFUL CORPORATE TAKEOVER BIDS*[10]

Takeover Technique	Targets	Bidders
	%	%
Tender Offers	-3	-1
Mergers	-3	-5
Proxy Contests	8	na

*Abnormal price changes are price changes adjusted to eliminate the effects of marketwide price changes.

na: Not applicable

9. Jensen & Ruback, *supra* note 1, at 7.
10. *Id.* at 8.

only when control of the target firm's assets are transferred to a bidding firm. This suggests that stockholders of target firms are harmed when target management teams oppose takeover bids or take other actions that reduce the probability of a successful acquisition. However, opposition by the incumbent management team to a takeover proposal may benefit stockholders if it leads to a higher takeover offer or otherwise increased stock price. Also, since the incumbent management team typically has more detailed inside information about the firm, their evaluation and active opposition may provide stockholders with important information that they could not otherwise obtain. I now turn to a more detailed examination of the issue on managerial opposition to takeovers.

III. MANAGERIAL OPPOSITION TO TAKEOVERS

The incumbent management team of the target firm can take a variety of actions to increase the costs and to reduce the probability of success for competing management teams. The incumbent management team can oppose potential competing management teams prior to the actual takeover bid by instituting anti-takeover charter amendments, by repurchasing large blocks of its common stock held by potential bidders, and by entering into standstill agreements with potential bidders. The target's management team can oppose actual takeover bids by rejecting merger proposals. If the bidder elects to take a tender offer, the incumbent management team can continue to oppose the competing management team by filing antitrust suits, by initiating delaying tactics, by divesting key assets, or by soliciting a competing bid from a "white knight."

Resistance to takeovers may benefit target stockholders by raising the offer price. Resistance that eliminates bidders may also benefit target shareholders. For example, the incumbent management team may have reliable inside information that its equity is underpriced and that the takeover proposal does not adequately compensate shareholders. If this information cannot be made public without reducing the value of the target, the management team will, in the best interest of its stockholders, attempt to defeat the takeover. If such resistance successfully blocks the competing management team, stockholders benefit through higher expected future prices. Furthermore, even if the managerial resistance does not eliminate the competing management team, such resistance will provide stockholders with information about managements' assessment of the takeover bid. While this information is clouded by the possibility that the opposition is due to self

interest by the incumbent management team, it nevertheless provides important information to target shareholders that would not be available in the absence of managerial resistance.

Since there are both costs and benefits associated with resistance to takeover bids, the net impact of this resistance is an empirical question. I now turn to the evidence on this issue.

The summary of the abnormal stock price changes indicates that stockholders of completed mergers realize gains of about 20% and stockholders of successful tender offers realize larger gains of about 30%. While these percentage stock prices changes are not directly comparable and the difference may not be statistically significant, it is nevertheless tempting to conclude that hostile tender offers are more rewarding to target shareholders than friendly, negotiated mergers.[11] This suggests that instead of being costly, the opposition of the incumbent management team to the takeover benefits the shareholders of the target firm by raising premiums. However, the data also indicates that bidders in tender offers realize abnormal returns of 4%, whereas bidders in mergers realize zero abnormal returns. The larger gains by both bidding and target firms suggest the total gains are larger in tender offers than in mergers. Furthermore, assuming that bidders in tender offers and mergers are about equal in size, target firms seem to realize, on average, a smaller fraction of the total gains in tender offers.

Interpreted within the framework of the managerial competition model, these results suggest that the opposition to takeovers by the incumbent management team does not benefit target shareholders. Tender offers occur when resistance by the target's incumbent management team precludes a merger. But not all rejected merger proposals become tender offers. The required assessment of alternatives in a tender offer and the signal implicit in the incumbent managers' rejection of the merger proposal means that premiums will, on average, be higher in tender offers. Therefore, some rejected mergers will not become tender offers because the gains from shifting corporate control are insufficient. Thus the higher average total gains in tender offers may result from the truncation of less profitable offers; that is, the average gain in tender offers are higher because the low premium rejected mergers are eliminated from the population and this raises the average

11. Of course, not all mergers are friendly and not all tender offers are hostile. Also, there are other systematic differences between mergers and tender offers; for example, tender offers typically involve cash compensation for target shareholders whereas mergers typically involve the exchange of securities.

measured premium. The evidence, interpreted in this way, indicates that the rejection of merger proposals does not necessarily benefit target shareholders.

Opposition to takeover bids by the incumbent target management team may also reduce the welfare of target stockholders by reducing the frequency of takeover bids. Easterbrook and Fischel argue that such opposition raises the costs of hostile takeovers and thus reduces the rewards since competing bidders share the benefits of the first bidder's identification of the target as a takeover candidate.[12] The opposition to takeover bids, therefore, reduces the incentives of bidders to search for potential targets. The costs of the reduced frequency of takeovers are difficult to quantify. Nevertheless, the larger gains in tender offers are consistent with a reduction in the frequency of takeover proposals when opposition is likely. Further, my study of 48 competing tender offers indicates that the first bidder was successful in only 25% of the offers.[13]

Some information about the costs of the reduced frequency of takeover proposals can be obtained by examining the effect on stock prices of anti-takeover, or "shark repellent" corporate charter amendments. The effects of the adoption of anti-takeover amendments on stock prices is examined in DeAngelo and Rice[14] and Linn and McConnell.[15] Neither study provides any evidence that stockholders are harmed by the adoption of anti-takeover amendments. This suggests that general opposition to takeover proposals does not reduce the wealth of stockholders.

Currently available evidence suggests that managerial opposition to takeovers does reduce stockholder wealth if the resistance eliminates takeover bids by competing management teams. Dodd[16] provides some direct evidence which indicates that managerial opposition to takeovers harms target stockholders. He examines 25 mergers that appear to be terminated by targets. The average abnormal percentage stock price change on the day before and day of termination announcement is

12. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter cited as Easterbrook & Fischel].

13. Ruback, *Assessing Competition in the Market for Corporate Acquisitions*, 11 J. FIN. ECON. 141 (1983).

14. DeAngelo & Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329 (1983).

15. Linn & McConnel, *An Empirical Investigation of the Impact of "Antitakeover" Amendments on Common Stock Prices*, 11 J. FIN. ECON. 361 (1983).

16. Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105 (1980).

about -6% for cancellations by targets. These negative returns suggest that incumbent management teams that cancel such mergers are not acting in the stockholders' best interest.

Resistance to takeover proposals can occur prior to the public announcement of a takeover. The incumbent management team can eliminate a potential competing management team by repurchasing a block of its common stock held by the potential bidder. Generally, such targeted repurchases occur at a premium which can be interpreted as payment to potential bidders to cease takeover activity. The evidence indicates that repurchases that occur at a premium are associated with significant negative abnormal returns for the repurchasing firm. Dann and DeAngelo[17] and Bradley and Wakeman[18] report that a significant average abnormal return of about -2½% is associated with targeted repurchases that involved a premium.

The evidence therefore suggests that targeted repurchases which eliminate potential takeover bidders reduce stockholder wealth. Bradley and Wakeman[19] reinforce this interpretation by examining twenty-one firms whose targeted repurchases were associated with takeover cancellations. For these firms, the average abnormal return associated with the repurchase is -5.5%. In contrast, the abnormal returns for the forty firms whose targeted repurchases were not associated with takeover cancellations is -1.4%. Thus, targeted repurchases are more costly to non-participating shareholders when they are used to thwart takeover attempts.[20]

Standstill agreements are voluntary agreements in which a firm agrees to limit its holdings in another firm. Dann and DeAngelo[21] report that significant abnormal returns of -4.5% are associated with standstill agreements. Since standstill agreements may terminate the takeover plans of a competing management team, this evidence further supports the hypothesis that actions by incumbent target management that eliminate potential or actual bidders reduces the wealth of target stockholders.

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17. Dann & DeAngelo, *Standstill Agreements, Privately Negotiated Stock Repurchases and the Market for Corporate Control*, 11 J. FIN. ECON. 275 (1983) [hereinafter cited as Dunn & DeAngelo].

18. Bradley & Wakeman, *The Wealth Effects of Targeted Share Repurchases*, 11 J. FIN. ECON. 301 (1983).

19. *Id.* at 310-21.

20. Recent evidence suggests that the larger stock price losses for targeted repurchases that thwart takeover bids are offset by gains prior to the targeted repurchase. *See* Mikkelson & Ruback, Targeted Repurchases and Common Stock Returns, Sloan School Working Paper #1707-85 (September 1985).

21. Dann & DeAngelo, *supra* note 17.

The evidence on managerial opposition to takeover bids indicates that such actions which eliminate competition from insurgent management teams reduce stockholder welfare. However, the data focuses entirely on the adverse effects of managerial opposition. They do not examine the favorable consequences of managerial opposition, such as solicitation of higher bids, or the signal that inside information warrants a higher offer price. Unfortunately, these data are not yet available. Nevertheless, there is a sound logical basis for the hypothesis that managerial opposition can be consistent with the interests of stockholders. However, the assessment of the net impact of managerial opposition to takeovers must await a systematic study of such behavior which measures both the costs and benefits of managerial resistance to competing management teams.

IV. PUBLIC POLICY IMPLICATIONS

As an economist, I am hesitant to recommend changes to a system that works fairly well. The market for corporate control is complex. It involves the interactions between the internal control system of corporations, which are embodied in the managerial labor market and the structure of corporate governance, and the external control system, which occurs through competition between managerial teams. Changes in any aspect of the institutional framework may have unexpected effects through their interactions with other elements of the market.

The scientific evidence indicates that target firms capture a large share of the total gains in takeovers. There is no basis, therefore, to add constraints on bidding firms that are designed to "protect" target shareholders from competing management teams. Such protection is not required because there is no evidence that the shareholders of target firms are exploited in any manner.

There is some scientific evidence and a logical basis for adapting the institutional and legal framework to protect target shareholders from the incumbent management team. The logical basis is that the incumbent management has incentives to oppose some takeover bids that would increase the value of their stockholders' claims. The current institutional and legal framework allows managers to pursue their self interest by using corporate resources to oppose takeover bids. This raises the costs and reduces the probability that competing management teams will be able to successfully acquire control of the target resources. In addition to defeating actual bids, potential opposition by the incumbent management team reduces the frequency of hostile takeover bids.

The analysis, therefore, suggests that hostile takeover attempts should not be made more costly. Such changes to the institutional framework, for example, lengthening the time tender offers are outstanding, have been advanced to protect target shareholders from bidding firms. However, no such protection is required. Raising the costs of hostile takeovers would increase the veto power of incumbent target managers and further isolate them from the competition with other management teams.

Easterbrook and Fischel[22] and Gilson[23] have recommended changes to the institutional framework which would reduce the ability of the incumbent management team to oppose takeovers. Easterbrook and Fischel propose a passivity rule which prohibits all opposition by incumbent managers.[24] Gilson argues that incumbent management should be allowed to solicit higher competing bids, but in all cases the proposals by the competing management teams should be forwarded to stockholders.[25] While I am somewhat sympathetic to these proposals, I suspect that they would not improve the efficiency of the market for corporate control. Both proposals force stockholders to evaluate the competing management teams. This shifts too much responsibility to shareholders. The role of stockholders in a modern corporation is one of passive risk bearing. By forcing shareholders to evaluate competing managerial teams, the proposals conflict with the stockholders' passivity. Furthermore, while some of the evaluation will occur by takeover specialists such as arbitrageurs, the incumbent management is likely to have the best information to make such an evaluation.

The evaluation of competing management teams by the incumbent managers will be affected by their desire to retain their positions. However, the effects of this conflict of interest can be mitigated by compensation agreements which guarantee that the top managers of the target firm do not suffer financially from a change in corporate control. Such compensation agreements, often called "Golden Parachutes," are a private and relatively inexpensive solution to the conflict of interest problem that arises in takeovers. Golden parachutes make it less likely that incumbent managers would oppose takeovers because of their self interest. I believe that private solutions to the

22. Easterbrook & Fischel, *supra* note 12, at 1199-1204.

23. Gilson, *A Structural Approach to Corporations: The Case Against Defense Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) [hereinafter cited as Gilson].

24. Easterbrook & Fischel, *supra* note 12, at 1194-1204.

25. Gilson, *supra* note 23, at 831-48.

conflict of interest problem, such as golden parachutes, dominate the proposals to eliminate managerial opposition to takeovers because the proposals require shareholders to become active and denies shareholders the information contained in the incumbent management's appraisal of the takeover bid. However, no costless solution to the conflict of interest problem inherent in the market for corporate control exists.

SHORTCOMINGS OF THE ARGUMENTS AGAINST MODERNIZING CORPORATE LAW

MELVIN A. EISENBERG*

Various kinds of arguments have been made against proposals to modernize corporate law, including the ALI Project. One argument consists of offering up the adage, "If it ain't broke, don't fix it." It is hard to know what is meant by the adage in this context. It seems to mean, don't make any changes in a legal rule, even by way of modernization, unless the relevant portion of the legal system has broken down. If that is the meaning, the argument reflects great imprudence. The adage is a caution that is well to keep in mind. There is, however, another concept of caution that is also well to keep in mind: If it isn't well maintained, it will break.

Interestingly, many of the same people who put forward the adage simultaneously urge that the Williams Act be dropped, and all tender-offer defensive tactics be precluded, although there is no indication that the market for corporate control has broken down.

A second argument sometimes made against proposals to modernize corporate law is that the need for modernization has not been empirically demonstrated. The meaning of this argument is also elusive. It seems to mean that the need for a given proposal is not empirically demonstrated unless the evidence supporting the proposal consists of quantitative economic data that is significant at the 95% level of confidence. If that is the meaning of the argument, it is wrong. With very few exceptions, those areas of life governed by law are much too complex to be adequately captured by quantitative data that is significant at the 95% level of confidence. To the extent this argument means that a law is not justified unless it is supported by such data, it would require wiping off the books almost every law that has ever been adopted.

Interestingly, many of the people who make this argument simultaneously press for abolition of the Williams Act, although there is no quantitative evidence that is significant at the 95% level of confidence to show that corporate efficiency has been reduced by that Act.

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A variant of this second argument is that the only support given for a proposal to modernize corporate law is "anecdotal evidence." People who make this argument are seriously distorting the language, by characterizing all empirical evidence, except quantitative data that is significant at the 95% level of confidence, as "anecdotal." That is nice political rhetoric but bad English. Virtually all the empirical evidence for law, including corporate law, consists of data and experience that does not rise to the 95% level of confidence, but is much more than "anecdotal."

A third argument sometimes made against proposals to modernize corporate law is that such proposals are inspired by Berle and Means, who are said to claim the managers want to line their own pockets. This is a serious mischaracterization. Most managers, like most other people, try to do their moral best, and most proposals for modernizing corporate law, including the proposals in the Corporate Governance Project, are based on that premise. (Of course, this does not mean that attention need not be paid to conflict-of-interest situations when they do arise.)

Interestingly, many of the people who make this third argument simultaneously advocate the so-called "agency theory," which does claim that managers want to line their own pockets and will do so unless repressed by some sort of formal institution.

Still another argument sometimes made against proposals to modernize corporate law is that the markets take care of most corporate law problems. It is foolish to think that the market will take care of, for example, conflict-of-interest transactions, because usually too little money is involved. If a corporation has $50 million in earnings, and somebody engages in a conflict transaction that at most is going to line his pockets with $50,000, there will be no market effect. Of course, if a corporation is operating exclusively in product markets that meet the classical requirements for perfect competition, then unfair self-dealing would theoretically result in insolvency, because there would be no margin for any inefficiency. However, few publicly held corporations conduct all of their operations in such markets. Similarly, the argument, sometimes made, that there is a market in corporate charters that has desirable effects, is not supported by reliable evidence.

Interestingly, many of those who argue that markets work perfectly, or at least very well, simultaneously argue that the Williams Act needs to be amended or dropped, and that defensive tactics need to be curtailed or eliminated, because the Act and such tactics seriously in-

terfere with the workings of the market. If the Williams Act and defensive tactics seriously interfere with the workings of the market, then the market isn't working very well. If they don't seriously interfere with the working of the market, why drop them?

Another argument sometimes made against proposals to modernize corporate law is the ad hominem argument that people who want to modernize corporate law are antibusiness. Like most ad hominem arguments, this one is both intellectually improverished and factually wrong. Modernization of corporate law, as embodied in the Corporate Governance Project, is intended to preserve the corporate system. In the long run, if you want to preserve that system, which the Reporters do, you've got to keep its legal aspects up-to-date and in good repair. That's what the Corporate Governance Project is about.

A CRITIQUE OF THE AMERICAN LAW INSTITUTE DRAFT PROPOSALS*

NICHOLAS WOLFSON**

On April 1, 1982, The American Law Institute (ALI) distributed Tentative Draft No. 1 of the Principles of Corporate Governance. Many of the ALI Draft published proposals are now in the process of change.[1] In a sense, we are discussing a moving target. The drafting variations to date, although interesting in themselves as intellectual exercises, are in a basic sense illusory. The fundamental premises of the project are as immutable and immovable as the Rock of Gilbraltar. They are, simply stated, as follows: First, senior management, including the general counsel, cannot be trusted without tough rules of law, second, the present extensive panoply of criminal and civil corporate regulation, such as SEC oversight, does not adequately police senior management; third, the forces of the free market do not adequately discipline senior management; and fourth, statutory and judicial law must be drastically expanded and toughened to curb that same management.

The fundamental purpose of the ALI project is to establish a new regulatory non-market system for the governance of the large publicly held corporation. The purpose would be achieved by establishing, as a good standard of corporate practice, that a majority of the directors of such corporations be free of any significant relations, as defined, with the corporations' senior executives. Next, the ALI would recommend that every such corporation, with certain exceptions, have a powerful nominating committee composed exclusively of directors who are not officers, and which includes at least a majority of directors who have no significant relationships with the senior brass. This nominating group would, to a significant extent, take from senior management the power to nominate next year's board. Other powerful committees, such as the audit and compensation committees, would be required or strongly recommended as additional tools to curb the supposed excesses of management. Finally, the ALI project would dramatically toughen the legal duty of care and would, in addition, facilitate derivative suits against corporate fiduciaries.

The philosophical concept underlying all of these changes is

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1. This paper was presented at a conference held on September 23, 1983.

embodied in Section 3.02, which embraces the notion that the only proper role of the board of directors is that of a monitor or overseer of management. Tentative Draft No. One even forbids the board from ever regularly exercising a management function. Advisory Group Draft No. Three gingerly tiptoes a centimeter or so back from that rigid rule. Still, it insists that performance of a management role by the board on a regular basis "would not be good corporate practice."[2]

As the recent statement of the Business Roundtable on the ALI proposals pointed out, research has identified five kinds of boards: legitimating, advisory, participating (monitoring), judicial, and dominating. Unfortunately, the Reporters have chosen one of these types, monitoring, and asserted that it is the kind of board preferred for all large corporations. As the Business Roundtable statement aptly questions, must we etch "in stone, for all time, the monitoring or overseeing model of the board . . . ?"[3]

It is no surprise or accident that the ALI project sinks or swims with the monitoring board philosophy. That approach is absolutely required, given the premises of the ALI Draft. I have already spelled them out but I can, I believe, reduce them all to one single assumption. It is that the management cannot be trusted. It harks back to the 1930's thesis of Adolph Berle that the modern public corporation is afflicted with the original corporate sin of the separation of control from ownership. Ownership is in the hands of thousands of helpless and hapless shareholders. Control is in the hands of management. That control is supposedly self-interested and frequently hostile to the shareholders and the public interest. From that premise grew naturally the creation of the Securities and Exchange Commission. From that premise came the radical proposals of Nader groups for even more government control. And now from the respectable non-barn burners of the ALI come proposals for increased regulation of the corporation.

The ALI Reporters are not engaged in a modest restatement of technical corporate law. If you will read or reread the Professor Melvin Eisenberg book on *The Structure the Corporation*, you will see in 1976 the philosophical foundations for the ALI projects. It is there that the rigid notion of a monitoring board is laid out. It is there that the

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Since then the ALI Reporters have drafted numerous changes and a new Reporter has been added to the drafting group. None of the changes in the aggregate answer the principal arguments of this paper. The author of this paper is preparing a number of articles on the ALI project, as presently constituted, which should be published in the near future.

2. Advisory Group Draft No. 3, Appendix B., at 10.

3. Statement of the Business Roundtable on the proposed *Principles of Corporate Governance and Structure: Restatement and Recommendations* 25 (Feb. 1983) [hereinafter cited as Business Roundtable Statement].

necessity for domination by independent directors and nominating committees is set forth. Finally, it is there that Professor Eisenberg lays down the precept, implicitly adopted by the ALI Reporters, that the modern publicly held corporation is basically not a dynamic competitive economic entity but is rather a mini-government or polity that must be therefore subject to the same legal restraints and fetters as any powerful government.

Professor Eisenberg's book forcefully represents the popular suspicion of the large corporation that has always prevailed in American political and cultural thought. Everyone in this audience, however, should be aware that Professor Eisenberg and the other ALI Reporters are skeptical of the modern economic scholarship regarding the true nature of the corporation and the efficacy of market forces in curbing the excesses of senior management. And it is here that I make perhaps the most serious of my charges against this project. The casual reader working his way through the Commentary and Reporters' notes would gain the impression that the suggested new restraints on senior management including corporate general counsel flow naturally from legal scholarship. The short answer is that they do not. They flow naturally from the legal scholarship of Adolph Berle's time, the 1930s. The new economic scholarship which has already been described to you in other speeches, reaches a different reading than the ALI materials would suggest.

To begin with, Berle's criticism of the split between control and ownership as a corporate original sin requiring regulatory grace has been exploded. Modern efficient market theory and empirical studies of control demonstrate, instead, that the separation, *where it exists*, is a natural and beneficial result of the needs and desires of shareholders. These individuals and institutions cannot spend time managing and operating the corporations in which they invest. They must rely on the expertise of managers, namely, the senior management of the large corporation. They invest in corporations that are run soundly and disinvest in those that are run poorly. This is the so-called "Wall Street Rule" and it works well. When investors sell out the price of the stock drops and acts as a signal for takeover efforts. Takeover activity acts as the great enforcer of management efficiency and effort. Modern economic empirical research demonstrates that the takeover activity, or the market for control as it is called, is working well to benefit shareholders of the target corporation. In turn, it is working well to discipline incumbent management.

It is not only the market for control which operates to discipline senior management. There is also the market for management. Managers know that their record for performance will influence their

rate of success within the corporation. Furthermore, they know that a record of performance increases their value to other corporations that may bid for their services. The gain to be obtained from such a reputation for efficiency far exceeds the gain to be derived from slacking off or leading the easy life at the office watercooler. Finally, product competition also operates to force management to work hard and diligently to survive and prosper.

These competitive forces have been researched and analyzed by modern economists using the latest statistical and research methods. A number of law professors have joined in that research, sometimes working in tandem with economists. Yet none of this modern research effectively works its way into the ALI project. If it did, and if many of the reporters had been selected to reflect the scholars in that field, the ALI project would never have taken the regulatory mode it has reached.

The unfortunate truth is that most law professors are notoriously unskilled in empirical research as it is normally practiced in other scholarly disciplines. It is therefore no surprise that there is no organized empirical support for the major premises and conclusions of the ALI project. I must emphasize that point. Virtually all of you in this audience are active practitioners of law or active in management. You may, perhaps, be persuaded that the ALI project is based upon objective scholarship to which you, as hardnosed practitioners of law and management must defer. Do not be misled. The ALI project reflects fine legal skills of draftsmanship, but its major assumptions and conclusions are divorced from any modern empirical support or scholarship. In that regard, consider the key ALI recommendations on corporate structure, namely, the various proposals for independent dominated committees and independent boards. As a theoretical matter, a strong case can be made against independently dominated boards. I have written extensively on this, and therefore, plead indulgence in quoting myself briefly on this issue:

> The bottom line assumption has been made by many of the corporate community that independent directors are better capable of assuring management success and honesty than is senior management itself. Yet this is an empirical proposition that has absolutely no conclusive basis in empirical research. In fact there are plausible reasons for believing the opposite. Independent directors will tend to be more conservative than management. That is, they will be less entrepreneurial since they are not tied to the corporation by compensation packages rewarding them for successful management. Second, they will tend to be more receptive to pressure

> from regulators. They will get their "brownie points" not from profits but from the approbation of government regulators like the SEC and special interest "do-good" groups. Therefore, they will tend to pay more attention to the demands of outside interests than to the desires of shareholders. Third, they will be inept disciplinarians of inefficient managers. . . . As part-timers without time or incentive to closely evaluate performance, it is only disaster which is likely to move them to replace senior management.[4]

Not only is there no theoretical basis for independent dominated boards, there is no scientific basis for them either. When the ALI project got underway, and throughout its preparation, there was absolutely no organized *empirical* support for the efficacy of independent dominated boards or committees. Further, there was no empirical justification for the monitoring role of the board. Finally, there was and is no empirical justification for toughening or strengthening the duty of care obligation, as is recommended by the ALI reporters.

To this fact, one that the Reporters will concede, the usual rebuttal is that empirical research takes time, too much time, and until then men and women of the world must act on hunch and informed guesswork; otherwise no change will be accomplished. Hence we must draft new laws and adopt more regulation of the corporation. Note that corporate reformers never conclude that lack of empirical support should lead to caution and no action. Well, I subscribe to the notion that, "if it ain't broke don't fix it." The present regulatory structure "ain't broke." Indeed, it is already too extensive. Due to the lack of empirical support for the ALI proposals, the burden of proof is on the Reporters to justify change and not on the corporate community to justify restraint from further regulation.

Since the preparation of Tentative Draft No. 1 however, organized economic research has been performed. Professor Paul MacAvoy tested the Reporters' hypotheses and found them wanting. He found, as you no doubt have already heard, that, in the words of the recent Business Roundtable report, "there was no basis for concluding—in light of the available empirical data—that the objectives sought to be achieved by the Reporters would be attained by the structural model they propose."[5] This failure is true with respect to economic performance, law compliance and corporate social responsibility.

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4. Wolfson, *SEC Thinking About Corporate Governance and Accountability: Lessons in Bureaucratizing the Entrepreneurial Corporation*, in CORPORATE GOVERNANCE: PAST AND FUTURE 9-10 (1982) (citations omitted).

5. Business Roundtable Statement, *supra* note 3, at 26.

Since there is neither theoretical nor empirical support for the ALI recommendations, and no breakdown in corporate morality and behavior, why go forward with the ALI project? There are plenty of non-coercive voluntaristic kinds of guidance in the literature now. Take, for example, the *Corporate Directors' Guidebook*. If there are significant technical problems the new Model Business Corporate Act can take care of such issues.

The answer is that the ALI project is an effort to recast the nature of the large publicly held corporation. Make no mistake about it. If the intent were to make little or no change why gear up such an effort? The Reporters, through the medium of independent nominating committees and independent boards, more derivative suits, and tougher duties of care are attempting to wrest control of the large corporation from management and place it in the hands of the courts and independent directors.

Mr. Roswell B. Perkins, President of the ALI, has eloquently denied this charge in his remarks of March 14, 1983 on the Corporate Governance project at a Forum at The Association of the Bar of the City of New York. He emphasized that the ALI Council voted on February 25 to delete the language of Section 3.03 mandating an outside dominated board. This will now be put on a good corporate practice basis. Next, the Council has asked the Reporters to change the type color of good corporate practice statements from black letter type. Perhaps they will now be "in 'gray letter' or some different typographical form."[6] Third, the Council has asked the Reporters to "consider a new phraseology [instead of "good corporate practice"], such as 'recommended' or 'suggested' corporate practice in order to avoid any connotation of an existing normative principle which could carry any liability-creating implications."[7] In addition, Mr. Perkins has "conceived of our project as providing an umbrella for every conceivable kind of a board other than the unacceptably inattentive board."[8] He also suggests, at page 14, that change will be made in the current narrowly formulated version of the business judgment rule of the Tentative Draft No. 1.

To begin with, the revised language in Advisory Group Draft No. 3 does not bear out his statement about a flexible notion of board function. The independent director monitoring role is still clearly

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6. R. Perkins, Remarks at a Forum on the Corporate Governance Project at the Association of the Bar of the City of New York at 13 (Mar. 14, 1983).

7. *Id.*

8. *Id.* at 15-16.

preferred in the ALI Draft materials. For example, the Draft comment states that the board normally will not manage the business because assumption by the board of the ongoing management function would compromise the board's performance of the monitoring function.

On a more fundamental level, Mr. Perkins' defense of the ALI Draft proves rather too much. If he means what he says literally, most of the rationale for much of the project collapses. To draft a new statute that says that all board concepts except the grossly inattentive board are permitted is hardly a job for the impressive expertise of the ALI.

Next, the use of "good corporate practice" or "suggested" or "recommended" phraseology cannot get the ALI project out of the business of lobbying for its own restrictive versions of corporate structure. If flexible corporate structure within the confines of present law is the goal, why "recommend" a particular structure? Furthermore, how can the ALI guarantee that its recommendations, which carry great weight, will not be adopted by the states or, worse yet, some future Congress? In addition, what of the burden on general counsel and responsible senior management who disagree with such versions of good corporate practice? They will now bear the burden of public persuasion on these matters.

At page 22 of Mr. Perkins' remarks, he asserts that the new changes will allow a participating board as well as an overseeing board. Hence, the criticisms of Professor MacAvoy and Business Roundtable are now moot. Again, if you will read the statutory material and commentary in Part III, you will see that if that is literally to be accomplished, the entire body and soul of that crucial section must be taken apart root and branch. The changes Mr. Perkins states will be made, if truly accomplished, will be, insofar as Professor Eisenberg is concerned, a change from statutory Dr. Jekyl to statutory Mr. Hyde. Article Three, through its language, word after word, concept after concept, is a monitoring model embracing the value of separating management from the board for purposes of hostile encounter.

Take section 3.01. It reads that corporate law should provide that management shall be conducted by or under the supervision of such senior management executives as may be designated by the board. However, if Mr. Perkins is to be taken literally, the section should now read that the business of the corporation *shall be managed by its board, or by or under the supervision of such senior executives, etc.* The first half of such a provision would, of course, harken back to older versions of state statutes. I could multiply such necessary changes by the bushel. In the end, if Mr. Perkins and the Council truly implement their defense

of the Code, the Code will say nothing that is not already clearly in the state statutes and the cases. Why bother?

The same objections to the ALI proposal on corporate structure may be made with reference to the ALI duty of care and derivative suit recommendations. The proponents of the ALI project ignore the various effective free market pressures on senior management to operate corporations in the best interests of the shareholders. Instead, they believe principally in the value of legal restraints and of a higher incidence of law suits. There are absolutely no empirical bases for such reliance. There is no evidence that this audience, or your colleagues not here, are engaged in some epidemic of fraud and crime that requires increased legal and regulatory surveillance over that already in existence. The business judgment rule, as flexibly and creatively developed by the state judiciary, reflects trust in management. It engages the superior ability of senior management, as advised by corporate counsel and other experts, to manage the business well. The doctrine attempts, therefore, to limit and restrict judicial second-guessing of management in the absence of proof of self-dealing or fraud. It respects the concept that free competitive market forces are to be more relied upon to discipline management than judicial oversight. For these reasons, shareholders would be harmed by the new ALI doctrines limiting the efficacy of the business judgment rule. For example, Tentative Draft No. One would protect the directors only if their decisions result from a so-called "deliberative" process. Changes on this issue in more recent drafts appear to be merely cosmetic, although it is difficult to judge until the black letter language is published. The ALI Draft doctrine would appear to expose directors to liability in a large array of cases where they bring their experience, insight and knowledge to bear on corporate matters in a manner that appears to a court in hindsight as too casual. This would place a premium on useless memos that may well choke the board process. Perhaps Mr. Perkins means to cure this by his reference at page 14 that, "I have had a fruitful dialogue with Prof. Goldschmid about how *preparation* for decision-making can encompass many preliminary business judgments, implicit or explicit. . . . He agreed with me. . . ." Change in that direction will be welcome but at best will merely bring the ALI into accord with the present state of judicial approaches. The same objections can be said for the Draft proposals to increase the inquiry obligation, to transmute the duty of care into simple ordinary negligence, to reject the reasonable *Allis-Chalmers*[9] test and to use a rational basis test what will allow plain-

9. Graham v. Allis Chalmers Manufacturing Co., 188 A.2d 125 (Del. 1963).

tiffs in many derivative suits to inquire into the merits of the directors' decision. In that list, I have not exhausted the litany of disturbing changes.

In the derivative suit area, there is no evidence that facilitating more litigation will help shareholders or the public. Yet the ALI Draft would make it more difficult for independent directors to have such suits against fiduciaries dismissed, and would in other ways facilitate such suits. In this regard the ALI Draft creates a superb irony. It supports the independent directors when they will curb management i.e., "the monitoring role", but not when they may protect directors from derivative suits. The ALI rejects the *Auerbach v. Bennett*[10] test and adopts, instead, a variant (i.e., tougher) version of the *Zapata Corp. v. Maldonado*[11] test. In other words, it requires court review of an independent director determination that the suit will be detrimental to the best interests of the shareholders. Unlike *Auerbach*, the ALI will not limit the court to a determination that the corporation's recommendation not to sue was made by truly independent directors.

In Part III, the ALI Draft project embraces the notion of a monitoring independent dominated board. Yet independent directors will not be permitted to police apparent conflicts of interest situations in derivative suits; the court will have to review their determination. According to Part III, independent director monitoring of complex business actions is permitted, but an independent director evaluation of the bona fides of derivative suits against fiduciaries is not.

It would seem that independent directors are better equipped to judge individual discrete conflict issues that arise in derivative suits rather than complex business plans devised by senior management. The latter requires overall knowledge and feel for the business that outside directors are seldom able to achieve to the extent of senior management. However, they do seem ideally situated to judge discrete individual derivative suits and to balance the harm of pursuing the suit against the value of discontinuing it. In any event, the ALI would step into this judicially evolving area and tilt the balance against the *Auerbach* result without any empirical evidence for its position.

In conclusion, the ALI project began as an effort to require the rigid monitoring role of the board. It was based upon distrust of senior management, a belief in the efficacy of independent directors and the increased frequency of plaintiff suits against corporations. If the ALI corporate governance project truly reverses itself on these premises, as I hope it does, it will have largely weakened the reasons for its birth.

10. 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979).
11. 430 A.2d 779 (Del. 1981).

AN ECONOMIST LOOKS AT THE ALI PROPOSALS

RICHARD R. WEST*

As Professor Henry Manne indicated in his introduction, the program for this conference bills my presentation as an economist's reaction to the ALI's proposed principles of corporate governance and structure. Having spent a number of years at the University of Chicago under the tutelage, if not the watchful eyes, of the likes of George Stiglert and Milton Friedman, I would like to think that I have the minimum qualifications to fulfill that mission. All the same, as a long time corporate director and even longer serving business school professor, I readily confess that much of what I will have to say probably reflects something other than a purely economic perspective.

Of course, as anyone who reads the funny papers knows, there is very little about which economists can agree. You probably have all heard the one to the effect that if you laid all of the economists in the world end to end they wouldn't reach a conclusion.

Stories such as this one not withstanding, however, economists do generally subscribe to the notion that when it comes to making public policy decisions, you ought to understand the problem you are trying to solve before you go about making prescriptions. Yesterday afternoon, Professor Carney mentioned the old saw to the effect that if it ain't broke, don't fix it. I would argue that this probably doesn't go quite far enough. It's not just a matter of knowing that something is broke; it's knowing why it's broke and what needs to be done to make it right.

In his forward to the ALI's Tentative draft #1, Mr. Herbert Wechsler, the Institute's Director, said that a 1975 conference sponsored by the American Bar Association convinced him that "there were important problems in the field of corporate structure and governance that the Institute could fruitfully address. . . ."[1] Mr. Wechsler, however, did not take the time to explain what those problems were.

In the past month or so, I've taken the time to read and reread the proceedings of that conference. And while I came away impressed with the keynote speaker's ability to raise the right questions, I also found that there was virtually no agreement as to what the answers

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1. Principles of Corporate Governance and Structure: Restatement and Recommendations (ALI Tent. Draft) No. 1, at vii (Apr. 1, 1982).

were. The Keynote Speaker, then SEC Commissioner, A.A. Sommer, Jr., began by telling the group,

> In assessing the extent to which federal and state law should establish standards of conduct for corporate management, we must, of course, have some notion of what the corporation is, what its roles have been historically in our society, what society expects—and has expected—of the corporation, the manner in which the corporation as not only an economic entity but a social one as well relates to other facets of American life—political, economic, and social.[2]

He went on to ask a series of questions which he believed the conference should try to answer. Once again quoting Mr. Sommer:

> The first issue we should confront, then, is whether indeed there is a need for strengthening the restraints on the prerogatives, the control, of management vis-a-vis the shareholders of the corporation. If, as Professor Hurst explains, the once expected restraint that shareholders might, because of their economic interests, place upon management, are not effective, and if "shareholder democracy" has not afforded an answer, and if the restraints of the market are not sufficient, then should the policy implicit in state corporation laws favoring largely unfettered management control be modified?[3]

While a few of the participants in the conference attempted to respond to the keynote speaker's queries, the vast majority did not, preferring instead to spell out their own versions of how to adjust or revise the law of corporations.

In his wrap up to the conference the distinguished Harvard law professor, Mr. Louis Loss, noted candidly, "Well, several people here have raised the question, not a bad question, why are we here at all?"[4] He then went on to offer several answers, all of which related primarily to issues of legal jurisdiction and clarification. In particular, he stated that he had assumed the "raison d'etre was to consider whether a house divided between a freewheeling federal development and a more tradi-

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2. Address by A.A. Sommer, Jr., before a 1975 American Bar Association Conference on Corporate Governance, *reprinted in A Keynote of Sorts*, 31 BUS. LAW. 871 (1976).

3. *Id.* at 876.

4. Address by Louis Loss before a 1975 American Bar Association Conference on Corporate Governance, *reprinted in, Wrap-Up*, 31 BUS. LAW. 1193 (1976).

tionally oriented body of state corporation law can long endure."[5] Nowhere, however, did he refer back to the kind of fundamental questions that Commissioner Sommer posed at the conference's outset.

Now in his forward to tentative draft #1, Mr. Wechsler also gave credit to a series of regional conferences held in 1977 and 1978, for providing a rationale for the ALI's project on corporate governance. My reading of the commentaries on these conferences, however, revealed virtually no commonly held view about what the problem was. And yet, as one commentator candidly observed, "We are probably committed to fixing it whether it is broke or not, and in order to do that with any intelligence, I think we ought to decide what it is we want to do and to whom."[6]

Professor Loss was also the wrap-up speaker for the regional conferences and he stated forcefully that he had reached some conclusions which, he sensed, "are not too far from the consensus of these groups." To quote Professor Loss:

> First, it seems to me axiomatic that the classic model of the corporation, in which shareholders elect directors, and directors appoint the chief executive officer and the other officers, is, for most publicly held companies, dead. We all know that in most of the large publicly held companies it is the president who in substance selects the board, and not the other way around. The second proposition that seems to be quite clear is that sooner or later, perhaps rather sooner than later, the public is going to demand that something be done about these huge power concentrations, something more than what the Delaware Legislature has chosen to do.[7]

In short, notwithstanding my conclusion that the commentators at the four conferences had shown precious little in the way of a consensus regarding the nature of the problems to be addressed, the wrap up speaker had, in effect, embraced the kinds of prospectives articulated by people who espouse managerialest views of the corporation—the same views espoused by the ALI's reporters.

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5. *Id.*

6. Marsh, *If It Ain't Broke, Don't Fix It, cited in* COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 293 (ALI) (D. Schwartz ed. 1979). In the introduction to the section of the proceedings containing Mr. Marsh's remarks, the editor commented as follows: "As a number of speakers and commentators throughout the symposiums observed, perhaps the prime need is to get a handle on the problem. This is not an easy task because there is no consensus on the problem." *Id.* at 288.

7. Loss, *Concluding Remarks, cited in* COMMENTARIES ON CORPORATE STRUCTURE AND GOVERNANCE 553 (ALI) (D. Schwartz ed. 1979).

After taking the time to read both the proceedings of the Airlie House conference and the commentaries from the four regional conferences, I was baffled by what Mr. Wechsler though these gatherings had concluded about what was broke and why it needed fixing. Indeed, I found myself becoming increasingly sympathetic with the view, articulated yesterday by Judge Winter, that the entire corporate governance movement constitutes a set of proposed solutions to a problem that simply does not exist, or at the very least, has not been shown to exist.

But enough about the lack of a clear statement of the problem which the proposed principles of corporate governance and structure are intended to solve. What of the principles themselves? Regardless of their motivation, what is likely to be their effect?

In the interest of time and in view of the backgrounds of those present, I will make no attempt to describe in any detail the substance of the tentative ALI proposals. Suffice to say that the contents of tentative draft #1 can usefully be viewed as falling into three general categories: (1) those concerned with the specifications of the structure and function of boards of directors; (2) those related to altering and refining criteria of "duty of care" and "business judgment"; and (3) those pertaining to derivative suits.

While I am personally opposed to the degree of rigidity that is embodied in the ALI proposals dealing with the function and structure of boards, I do not regard those proposals as being all that important in the first place, given where corporate practice is going. Certainly the monitoring model set out by the ALI is now so close to being universally accepted that including it in the proposed code constitutes little in the way of a radical departure from the status quo.

One might even say the same thing about the proposals concerning a majority of outsiders and the structure of board committees for large public companies. It is one thing, however, for the structure of boards to move in the directions proposed by the ALI in an evolutionary and gradual fashion and quite another for them to move in the same direction under pressure from regulation. My own strong preference is for the former, but I will not make too much of this point simply because it probably makes relatively little difference whether a board is structured one way or the other. Paul MacAvoy's analysis of the ALI proposals makes this point quite forcefully by demonstrating that it is not possible to identify any statistically significant differences in the behavior of firms on the basis of the structure of their boards.

It's interesting to note, by the way, that the ALI Council voted

in February of this year to delete the provision of the proposed principles that mandate a majority of outsiders. I'd like to think this represents an admission on the part of the council that the structural issues are really not that crucial. But I suspect, instead, it simply reflects their judgment that the tide is moving in the direction they desire anyway and that giving in on this point costs nothing and reveals a willingness to make compromises.

Thus far, however, the drafters and the council are "hanging tough" on the sections of the proposed principles that deal with duty of care, the business judgment rule and derivative suits. If they really want to have an impact on corporate behavior in the United States, they should continue to do so, for in contrast to the sections dealing with the function and structure of boards on directors, those related to duty of care, business judgment and derivative litigation have the *potential* to change significantly the way companies do business.

Even today, within an environment where the courts very rarely question business judgment and dismiss shareholders' derivative suits routinely, it is often difficult to attract qualified board members. If the proposed principles of duty of care and business judgment are adopted, more than a few currently serving directors might cease to do so and the task of finding their successors, let alone identifying candidates to cover the normal attrition that takes place, could become virtually impossible. The phrase, "who needs it?", which is already heard too often, could become even more commonplace.

Now those who support the proposed principles might respond by saying that all this is nonsense. Why should qualified people be put off by proposals that do nothing more than call on them to make decisions that are, in the words of the tentative principles (1) informed on the basis of reasonable inquiry; (2) made in good faith and without a disabling conflict of interest; and (3) made on a rational basis. The answer, of course, is that with hindsight—and hindsight, after all, goes with the turf in derivative suits—a decision that was made on a highly rational basis can look very bad. Indeed, it can look so bad that any reasonable man might wonder how a group of individuals, acting on the basis of reasonable inquiry and without disabling conflicts of interest, could possibly have made it in the first place. Recognizing this fact, it's not surprising that more than a few people of the calibre we would like to have on major corporate boards look at the proposed principles and say, "who needs it?"

But what about those who remain willing to serve? What impact could the proposed principles have on them? At a minimum, they will feel under even more pressure than now to protect their hind

quarters. Mr. Roswell G. Perkins, the ALI's president noted earlier this year that Advisory Group Draft No. 3 deleted the word "deliberative" in describing the kinds of decisions protected by the business judgment rule. Under the new formulation, he said, the rule would protect any decision "as to which judgment has in fact been exercised." While all of this may sound comforting, the fact remains that the only way for a board to demonstrate that judgment has in fact been exercised is to build a record; to hold meetings; write minutes; make studies; hire consultants, investment bankers, etc. A good bit of this activity already goes on. With the proposed principles in place, this activity would expand by an order of magnitude. And lest there be any misunderstanding, let me add that I am not talking about a desirable enhancement in the amount of care given to the process of decision-making, but rather about make work exercises whose only objective is to ward off second guessing and Monday morning quarterbacking.

But what is most disturbing about the proposed principles is that they could lead some companies to take less risk, and be less innovative. Mr. Kaplan's views of yesterday, notwithstanding all of the critiques of the ALI proposals presented in the Business Roundtable's analysis, reached this conclusion. This is not particularly surprising. Indeed, it is difficult to imagine that a business school professor or an economist, let alone a practicing businessperson, would come to any other conclusion.

There is also the prospect of more derivative suits, with all of the various costs attendant thereto. I have in mind, by the way, not merely the direct costs associated with defending against such suits, but also the very real indirect costs referred to yesterday by our keynote speaker.

There are, of course, differences of opinion, even among critics of the ALI proposals, about precisely how much impact they could have on the willingness of people to serve on boards, the amount of additional make work efforts that would be fostered and the extent to which derivative suits would multiply. All the same, it seems indisputable that the *net* effects would be in the directions I have described. If anyone has asserted any serious arguments to the effect that the ALI's proposals regarding duty of care, business judgment and derivative suits would encourage more good people to want to serve as directors, stimulate more risk-taking by corporations or discourage derivative suits, I would welcome learning of them.

Since the ALI's proposals on corporate control have not yet been published, it is probably premature, if not inappropriate for me to

make any comments at this time. I confess, however, that in my worst nightmares, I speculate on the possibility that the proposal may embody principles that would make it easier for the managements of target firms to resist takeovers. Such principles would, no doubt, be to the liking of many members of the corporate community, including more than a few who have thus far been opposed to what the ALI has proposed. Indeed, their inclusion in the ALI's final draft might even convert some of the code's critics into supporters, particularly now that the ALI has made a few cosmetic changes in its proposals on board structure.

Now I realize that some of you will view all of this as a terribly cynical view of the world. Perhaps it is. But a cynical view, the kind that public choice economists would simply regard as realistic, has proven to be highly accurate in the past. I would be pleasantly surprised if it did not prove to be equally accurate in this case. Until then, I will remain a cynic.

[The following is a summary of Professor Eisenberg's response to criticisms, by Professors Wolfson and West, of the ALI proposals.]

Professor Eisenberg criticized the call for empirical evidence to support the Restatement's proposals as a "side show." While empirical evidence is important, it is unrealistic to require it for all legal changes. He argued that there is no evidence that the *Auerbach* rule is inefficient. The duty of care, he pointed out, already exists; and there is little evidence that it has created paper trails.

In response to the criticism regarding the lack of empirical evidence to support the ALI proposals, Professor Eisenberg stated that everyone agrees that markets are not perfect and that takeovers have high transaction costs. In fact, he pointed out, the ALI proposals are based on considerable data about the functioning of board committees.

The problems to be addressed in the Restatement project are: (1) that corporate law now has ambiguous elements for which clarification and selection of a better rule is helpful, and (2) that corporations must be seen as accountable to society. If markets worked perfectly, he would agree with Professor Carney, that "if it ain't broke, don't fix it." In fact, markets are very imperfect.
