PUTTING DIRECTORS' MONEY WHERE THEIR MOUTHS ARE: A NEW APPROACH TO IMPROVING CORPORATE TAKEOVER DYNAMICS

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This paper aims to improve shareholder protection from underpriced bids in takeover situations. Target boards, as stewards of the corporation who typically possess superior information about the desirability of unsolicited bids, can be expected to protect their shareholders from such bids. Unfortunately, because they have a conflict of interest with their shareholders in takeover situations, they tend to reject hostile bids to an excessive degree. Moreover, the current Delaware doctrine is ineffective in monitoring boards' responses to takeovers, largely because boards might use selective inside information to which the courts lack access and because their judgments are backed by subjective, hard-to-attack legal and financial expert opinions which courts are ill-equipped to challenge.

To rectify the problems of courts' and shareholders' inferior information as well as boards' skewed incentives, I

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propose an arrangement in which target boards wishing to veto nonstructurally coercive takeover bids would be encouraged to demonstrate their opposition by committing to buy, if the bid fails, and hold for a specified period of time a certain amount of target stock at the bid price. The directors would be incentivized to follow the arrangement because it would require courts, in a potential fiduciary duties lawsuit, to give directors' commitments significant weight when evaluating their defense that they rejected the bid to protect their shareholders.

Adopting the proposed arrangement can significantly address important problems in corporate takeovers that have long claimed the attention of corporate law scholars and financial economists. In particular, inducing target boards to credibly transmit their genuine bottom-line understanding about the desirability of a bid would offset the courts' inability to review the directors' decision effectively. Imposing personal costs that the directors would uniquely incur if they wish to reject hostile bids would counteract the directors' ex-post incentive to reject hostile bids excessively. Increasing the directors' cost of a takeover attempt would improve market discipline and motivate the directors to increase firm value and reduce agency costs. Finally, favoring firms with high long-term value would protect them from myopic bidders and alleviate their unrelenting pressure to meet quarterly earnings expectations. For these reasons, the proposed arrangement could greatly improve corporate takeover dynamics.

I. Introduction 514
II. Why Shareholders Might Erroneously Accept Underpriced Bids 524
  A. Shareholder Inability to Assess the Target's Intrinsic Value 526
    1. Challenges in Distinguishing Between Market Value and Intrinsic Value 526
      a. Public Information 527
      b. Nonpublic Information 527

2. Challenges to Gathering Information Independently 529
3. Frictions That Limit Board Capacity to Convey Their Inside Understanding........ 531
B. Deviation of Shareholder Choice from Maximization of Long-Term Firm Value 532
III. Target Boards' Conflict of Interest 539
IV. Delaware Takeover Doctrine 542
A. Delaware Intermediate Standard of Review 543
B. The Substantive Coercion Threat 544
V. The Ineffectiveness of Adjudicating Substantive Coercion........ 547
A. Impediments to Judicial Review of Substantive Coercion 548
B. The Resulting "Just Say No" Response........ 551
C. Problems with the Resulting "Just Say No" Response 553
VI. A Proposed Remedy 553
A. Prerequisite: Allowing Outside Directors to Purchase Stock in Takeovers........ 554
B. The Proposed Arrangement........ 558
1. The Stock Commitment Should Be Made by Outside Directors 562
2. The Committed Stock Should Be Purchased from the Target 563
3. Stock Commitment Should Be Made Concurrently with Board Rejection of the Bid........ 564
4. Directors' Stock Commitment Should Be Made After Engagement with Major Long-Term Shareholders 565
5. Boards Should Recommend and Individual Directors Should Decide the Stock Commitment Amounts 568
6. Deciding Directors' Stock Commitments........ 569
a. A Model for Deciding Directors' Stock Commitment Amounts........ 569
b. Downward Adjustments 572

7. Special Cases That Justify Partial or No Applicability of the Arrangement 574
a. Multiple Offers 574
b. Nuisance and Opportunistic Bids 575
c. Directors Who Retire Soon After the Takeover Attempt 576
8. Integrating the Arrangement into Delaware's Takeover Doctrine 577
9. Enforceability 579
VII. The Potential Benefits of the Proposed Arrangement 580
A. Information Improvements................................. 580
B. Incentive Improvements 582
1. Ex-Post Benefits... 582
2. Ex-Ante Benefits 583
C. Increasing Long-Term Focus 584
D. Empowering Markets.. 586
VIII. Would the Proposed Arrangement Involve Any Significant Costs? 587
A. Directors' Professional Decisions Should Not Be Made on Their Own Dime 587
B. The Difficulty in Deciding the Credible Commitment Threshold...................................... 588
C. Decrease in Board Independence 589
D. The Arrangement Costs Might Be Rolled Over onto Shareholders 590
E. Panglossian Claims.. 592
IX. Conclusion 593

I. INTRODUCTION

The Delaware courts have developed a rich takeover doctrine to address the issue of target boards vetoing takeover bids, allegedly to protect their shareholders.[1]

[1] *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985); Grand Metro. Pub. Ltd. v. Pillsbury Co., 558

Target boards, assisted by armies of expensive lawyers and investment bankers, have used the rationale of protecting their shareholders to justify their adoption of various antitakeover tactics, such as the poison pill and the staggered board.[2] In response, shareholder activists, assisted by institutional investors, proxy advisory firms, and academics, have launched successful campaigns to indiscriminately dismantle antitakeover defenses in all Standard & Poor ("S&P") 500 companies.[3] This issue, which

A.2d 1049 (Del. Ch. 1988); City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988); Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1989); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995); Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011).

2 The term *poison pill* describes a family of "shareholder rights" that are triggered by an event such as a hostile tender offer or the accumulation of voting stock above a designated threshold (usually 15% of outstanding stock) by an unfriendly buyer. When triggered, poison pills provide target shareholders (other than the hostile bidder) with the right to purchase additional shares or to sell shares to the target on very attractive terms. These rights impose severe economic penalties on the hostile acquirer and usually also dilute the voting power of the acquirer's existing stake in the firm. A staggered board of directors, or a classified board, denotes a board in which only a fraction (often one-third) of the members is elected annually, typically for three-year terms, instead of en masse, with all directors having one-year terms. Each group of directors falls within a specified "class"—hence, the use of the term *classified* board. The array of takeover defenses is wider than just the poison pill and the staggered board. They also include the following: charter amendments that require supermajorities (i.e., votes of 70% or even 80% of shareholders) to approve a merger; dual-class restructurings that, by creating two classes of stock, concentrate voting control with management; litigation against the hostile suitor (usually alleging violations of antitrust and securities laws); and the purchase of the hostile bidder's foothold stock at a premium (so-called green-mail payments) to end the takeover threat. But although these particular defenses are often effective at delaying the hostile bidder, they are rarely enough to keep a target company independent.

3 Over the last ten years, shareholders have managed to push firms to do away almost entirely with the two most popular and effective defenses: the staggered board and the poison pill. *See* FactSet Research Systems Inc., Dataset, SHARKREPELLENT.NET, http://sharkrepellent.net. The Shareholder Rights Project, directed by Professor Lucian Bebchuk, has

has received much attention from legal scholars and financial economists,[4] has increased in importance. This is

succeeded in getting about a third of all S&P 500 companies with staggered boards to destagger them. *See* S'HOLDER RIGHTS PROJECT, THE SHAREHOLDER RIGHTS PROJECT 2012 REPORT (2012), http://www.srp.law.harvard.edu/releases/SRP-2012-Annual-Report.pdf [https://perma.cc/SH37-VHHM]. For the debate on the desirability of such campaign, see, e.g., Lucian Bebchuk, *Giving Shareholders a Voice*, N.Y. TIMES, Apr. 19, 2012, https://dealbook.nytimes.com/2012/04/19/giving-shareholders-a-voice/?_r=0 [https://perma.cc/H9MT-8A7R]. In response, see Martin Lipton & Theodore Mirvis, *Harvard's Shareholder Rights Project Is Wrong*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Mar. 23, 2012), https://corpgov.law.harvard.edu/2012/03/23/harvards-shareholder-rights-project-is-wrong/ [https://perma.cc/J8RQ-YDF4]; Lucian Bebchuk, *Wachtell Lipton Was Wrong About the Shareholder Rights Project*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Apr. 9, 2013), https://corpgov.law.harvard.edu/2013/04/09/wachtell-lipton-was-wrong-about-the-shareholder-rights-project/ [https://perma.cc/8BQE-SE5H]; Martin Lipton & Theodore Mirvis, *Harvard's Shareholder Rights Project Is Still Wrong*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Nov. 28, 2012), https://corpgov.law.harvard.edu/2012/11/30/harvards-shareholder-rights-project-is-still-wrong/ [https://perma.cc/ZQ37-GZL5]; Brad Hamilton, *Harvard Law School's Shareholder Rights Mistake*, L. BUS. (Apr. 6, 2012), https://bradhhamilton.wordpress.com/2012/04/06/harvard-law-schools-shareholder-rights-mistake/ [https://perma.cc/5C8U-9VDN]. For the recent debate on the desirability of staggered boards, see Alma Cohen & Charles C.Y. Wang, *How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment,* 110 J. FIN. ECON 627 (2013). In response, see Yakov Amihud & Stoyan Stoyanov, *Do Staggered Boards Harm Shareholders?*, 123 J. FIN. ECON. 432 (2017).

[4] Discussions of the issue start with William H. Steinbrink, *Management's Response to the Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978) and Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979) [hereinafter *Takeover Bids in the Target's Boardroom*]. Further discussion includes Leo Herzel et al., *Why Corporate Directors Have a Right to Resist Tender Offers*, 61 CHI. B. REC. 152 (1979); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter *The Proper Role*]; William J. Carney, *Shareholder Coordination Costs, Shark Repellents, and Takeout Mergers: The Case Against Fiduciary Duties*, AM. B. FOUND. RESEARCH J. 341 (1983); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM.

due to record levels of shareholder activism and hostile deal making, which has reached hundreds of billions of dollars annually worldwide.[5]

Boards of publicly traded companies often argue that their shareholders might accept value-destroying bids because of their ignorance of or mistaken belief about the intrinsic value of the corporation. At least in some subset of takeover situations, this can be a real concern, not only because shareholders have inferior access to material information, but also because some of them have short-term biases. Yet boards lack true independence and their directors have a personal interest in avoiding removal in a takeover. Hence, giving directors unfettered discretion to decide whether to accept a takeover can result in them rejecting too

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L. REV. 1145 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) [hereinafter *Corporate Control Transactions*]; Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983); James F. Cotter & Marc Zenner, *How Managerial Wealth Affects the Tender Offer Process*, 35 J. FIN. ECON. 63 (1994); Kenneth A. Borokhovich et al., *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495 (1997); Gerald T. Garvey & Gordon Hanka, *Capital Structure and Corporate Control: The Effect of Antitakeover Statutes on Firm Leverage*, 54 J. FIN. 519 (1999); Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002); Lucian Arye Bebchuk et al., *The Powerful Antitakeover Force of Classified Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. (2002); Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?,* 66 BUS. LAW. 1 (2010). Finally, the issue has been also discussed by economists. *See* Harry DeAngelo & Edward M. Rice, *Antitakeover Charter Amendments and Stockholder Wealth*, 11 J. FIN. ECON. 329 (1983); Gregg A. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merger?*, 28 J.L. & ECON. 151 (1985); Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983).

[5] *See* Maureen Farrell, *Deal-Making Has Never Been This Hostile*, WALL ST. J. (June 23, 2015), http://blogs.wsj.com/moneybeat/2015/06/23/deal-making-has-never-been-this-hostile/.

many bids. This problem is exacerbated by the fact that courts currently lack sufficient tools to exercise an effective judicial review over both the process and the substance of target boards' decision making in takeovers.

This Article argues that the systemic failure in protecting shareholders in takeover situations is not entirely due to the conflict of interest between target boards and their shareholders or to the lack of judicial tools to review board decisions effectively; it is also due to the legal rules prohibiting boards from showing their genuine opposition to the bid by committing to buy some shares of the target firms if the bid fails. Therefore, based on a well-established game theory model,[6] I propose a novel legal approach to the problem: a multistage, collaborative, decision-making procedure that boards would initiate and shareholders and courts would engage in and monitor. The procedure would work with the existing Delaware doctrine to induce the target's independent directors to prove their opposition to

6 Such game theory economic models demonstrate how the quality of goods traded in a market can degrade in the presence of information asymmetry between buyers and sellers, leaving only "lemons"—cars that are found to be defective only after they have been bought—behind. *See, e.g.*, George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970). It further demonstrates that when the party who possesses the private information credibly conveys it to the other party, the latter can reliably conclude the quality of the good. *See* Michael Spence, *Job Market Signaling,* 87 Q.J. ECON. 355 (1973). The asymmetric information problem manifests itself in this Article when courts, shareholders, and potential bidders do not know the intrinsic value of the target firm if it stays independent because they do not know important information held by the incumbent directors. Because they do not know the intrinsic value of the firm they do not know if the bid price exceeds it. The court's inferior information, especially when combined with the process-based lenient Delaware doctrine, results in target boards that exercise too many defensive tactics against unsolicited bidders, which, in turn, destroys shareholder value. The proposed arrangement credibly transmits the incumbents' private information to outsiders, and is expected to allow courts, shareholders, and potential bidders to distinguish between firms that should stay independent and those that should be taken over.

the bid by committing to buy and keep a certain amount of stock at the bid price should the bid fail—in essence, to "put their money where their mouths are." Adopting my proposal would address courts' and shareholders' lack of access to material information as well as boards' skewed incentives and thus would considerably improve corporate takeover dynamics.

Part II explains why shareholders might erroneously accept underpriced takeover bids. Shareholders face severe challenges in their efforts to receive, process, and evaluate the information necessary to assess the true intrinsic value of the target and, hence, to evaluate whether the bid price is adequate. In particular, they lack access to important nonpublic information. This, as well as market inefficiencies in pricing public information, often render shareholders unable to distinguish between the stock value and the true intrinsic value. In addition, because of restrictions imposed by federal laws and collective action problems among shareholders, investors do not gather important information independently. Moreover, even if investors were motivated to do so, frictions of various sorts currently prevent target boards from credibly transmitting their inside understanding about the desirability of a hostile bid to their shareholders.

Even if shareholders could accurately evaluate the intrinsic value of the target and, hence, the fairness of the bid price, the firm sometimes needs the board to protect it because shareholders might not make a choice that maximizes the firm's long-term value. There is a substantial risk that certain special interests would push shareholder response to a takeover away from maximizing the target's long-term value. Such interests include the short-term motivation of merger arbitrageurs, the financial interest that the target's institutional shareholders often have in the bidder due to their portfolio diversification strategies, the special concerns of shareholder groups such as public pension funds and labor union pension funds, and the entrenchment bias of inside shareholders (i.e., employees and directors). Importantly, solutions offered to counter distorted shareholder choice in corporate takeovers—in

particular, remedies to their pressure to tender and free-riding problem—often rely on the assumption that shareholders have full information about the desirability of the bid. The analysis in the beginning of this Part indicates that, unfortunately, this assumption is unwarranted.

Part III explains that target boards, while best situated to evaluate hostile bids, should not be relied upon to fix the problems identified in Part II. The analysis in Part III shows that because of their clear conflict of interest with their shareholders in takeover situations, target boards excessively misuse their power to reject unsolicited takeover attempts. Although virtually all boards have a majority composition of independent directors, these directors cannot be relied upon to exercise business judgment that is free from the target's executive officers' influence. Also, because a successful takeover will result in their involuntary removal, target boards have a personal interest in rejecting hostile bids. Furthermore, the design of their incentive compensation arrangements, which generally helps bond them with their long-term shareholders, functions in the opposite way in takeover situations. Finally, there is significant empirical evidence indicating that directors indeed overuse their power to insulate their firms from unsolicited acquisition offers.

Because of the perils identified in Parts II and III, the courts in Delaware, where most U.S. corporations are incorporated, have developed a rich takeover doctrine, which is described in Part IV. The doctrine[7] requires (1) the identification of a cognizable threat and (2) a showing that the response is proportional to the threat posed. The doctrine places the most demanding burden on demonstrating "substantive coercion." To support such an allegation, the board of directors must show that it has reasonably determined both that the bid is underpriced and that shareholders will mistakenly accept that offer because of

7 *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1989).

their "ignorance or mistaken belief" regarding the target's long-term value.[8] This doctrine essentially requires a process-based judicial review. The directors may satisfy this requirement by demonstrating good faith and reasonable investigation, which is commonly provided by the approval that comes from a legally independent board and is backed by opinions from outside financial and legal advisors.[9]

Part V discusses why judicial review of the substantive coercion doctrine is ineffective. It first examines the impediments to reviewing the target board's process. According to the analysis in Part III, even when a majority of the approving directors are determined by the courts to be legally independent, such directors tend to favor the interests of incumbent managers. It then notes that the financial and legal expert opinions that target boards rely on to justify their takeover decisions are extremely hard for courts to assess effectively because these experts tend to favor the interests of the managers who bought and paid for them, choosing their assumptions from among several widely disparate and justifiable estimates and using language that will almost assuredly justify the defensive tactics. That investment bankers' opinions are so lacking in credibility is underscored by the fact that the bankers have not been shy about changing their models' assumptions in response to changes in the bid price.

Part V shows how the inability of courts to effectively review target boards' allegations of substantive coercion has resulted in the directors' ability to "just say no" to unsolicited acquisition offers. Empirical studies indicate that this outcome is inefficient because, on average, board resistance to unsolicited bids results in both short-term and long-term shareholder value destruction.

Part VI proposes a novel arrangement to protect shareholders from underpriced bids by improving the judicial

8 *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1385 (Del. 1995).

9 *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 124–25 (Del. Ch. 2011).

review of substantive coercion and alleviating the managerial conflict of interest in takeover situations. The core purpose of this arrangement is to ensure that target boards communicate their genuine beliefs about the desirability of pending acquisition offers. Under the arrangement, which is based on well-established economic game theory models, directors who wish to reject a hostile bid are encouraged to show their genuine opposition to the bid by committing to purchase from the target if the bid fails, and hold for a specified period of time a certain amount of target's shares at the bid price. The directors would be incentivized to follow this arrangement because they know that, according to the arrangement, courts would give their aforementioned commitment significant weight in evaluating their substantive coercion defense in a potential fiduciary duties lawsuit.

Part VI further discusses the specifications of the arrangement. It provides that the directors' stock commitments be made only by the target's outside directors and that the committed stock should be purchased from the target rather than from the shareholders. It also explains that the commitments should be made simultaneously with the board's rejection of the bid and after engagement with the target's major long-term shareholders, who may be assisted by their proxy advisory firms. Despite the personal aspect of the costs that directors' stock commitments impose, to prevent free riding, the arrangement requires the board to recommend the amount of the directors' stock commitments. Part VI also introduces a formal and practical technique by which courts and shareholders can infer whether the commitment amounts are strong enough to show a genuine belief in opposing the bid, and it reviews special circumstances under which the arrangement should be adjusted. Finally, Part VI explains how the arrangement would be implemented and enforced within the existing Delaware takeover doctrine.

Part VII discusses the potential benefits of the proposed arrangement. Specifically, it shows that the arrangement would induce target boards to credibly transmit their

superior bottom-line inside understanding about the desirability of the bid to courts and shareholders. Because of this informational improvement, the arrangement would also empower markets and would likely shift a significant amount of current takeover action away from the courtroom. In addition, the arrangement is expected to correct directors' ex-post incentives to reject hostile bids excessively by imposing personal costs that they would have to incur if they wished to reject hostile bids. Ex-ante, by increasing target boards' incentives to reduce the likelihood that bidders will approach their firms, the arrangement is expected to motivate them to increase firm value and reduce agency costs.

Furthermore, the arrangement would significantly improve what is perhaps the biggest failure of corporate governance today: its emphasis on short-term performance. Boards are currently consumed by the fear that markets will not understand the positive, long-term effects of actions that sacrifice short-term profits. By making the directors' stock commitment cheap when the long-term intrinsic value of the firm is high, the arrangement protects firms with long-term focus from myopic bidders and alleviates their unrelenting pressure to meet quarterly earnings expectations.

Finally, Part VIII responds to concerns that the arrangement would involve significant costs. First, it shows that, practically, the arrangement does not expect the directors to use funds they already own and that it is in line with current director compensation arrangements. Second, it explains that the amount of directors' stock commitment that would render that commitment credible can practically be calculated and that the setting process of such amounts is well-monitored. Third, it shows that the arrangement's increase of director long-term stock holdings is in line with modern corporate governance and would not impair director independence. Fourth, it explains why the reality of corporate governance today ensures that the target's executives would not compensate the outside directors for their stock commitment costs and pass them to their shareholders. Finally, it argues that the fact that firms have

not adopted the arrangement already does not indicate its undesirability because U.S. federal laws have long prohibited directors from purchasing stock in the context of a takeover. Therefore, it details the specific regulatory barriers that should be removed.

Before proceeding, it should be noted that this paper is concerned only with takeover situations that potentially involve a substantive coercion threat. Unsolicited acquisition offers that involve structurally coercive schemes pose a special set of problems and require a separate analysis.

II. WHY SHAREHOLDERS MIGHT ERRONEOUSLY ACCEPT UNDERPRICED BIDS

Who should decide the outcome of a hostile bid? Two different groups have advanced polarized answers with equal vigor. One camp argues that boards should decide because responding to a takeover is a quintessential business decision that rests inherently in the professional expertise[10] and authority[11] of management. Moreover, only target boards have the necessary long-term focus to protect the corporation from opportunistic short-term driven bidders,[12] and only they owe fiduciary duties to the corporation to ensure its sustainable long-term growth.[13]

However, the other camp argues that giving target boards the power to block unsolicited takeovers allows incumbents

10 *See* Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983) (explaining that the separation of ownership and control is desirable because of the benefits of board specialization in management and shareholder specialization in risk bearing).

11 *See Takeover Bids in the Target's Boardroom*, *supra* note 4.

12 *Id.*

13 *See*, *e.g.*, William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 896–97 (1997) (stating that "the proper orientation of corporation law is the *protection of long-term value of capital* committed indefinitely to the firm"); *see* Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255 (2008).

to entrench themselves at the expense of shareholders.[14] Thus, only shareholders should decide the outcome of takeover bids because only shareholders will protect their own interests effectively.[15] The law should not be paternalistic toward shareholders in perhaps the most important investment decision they face. Because they are the residual claimants of the firm, shareholder primacy in takeover situations will also ensure the maximization of firm value. In this view, the market for corporate control serves as an important governance mechanism to displace inefficient managers,[16] especially those that produce large agency costs.[17]

This Article does not aim to take part in the general debate on who should decide unsolicited acquisition offers—that is, whether target boards should be allowed to block the bidder from taking over the corporation by approaching the shareholders directly. Instead, this Article focuses only on

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14 *See, e.g.*, *The Proper Role*, *supra* note 4; Bebchuk, *supra* note 4; Gilson, *supra* note 4.

15 *See, e.g.*, *The Proper Role*, *supra* note 4; Bebchuk, *supra* note 4; Gilson, *supra* note 4.

16 *See, e.g.*, *The Proper Role*, *supra* note 4, at 1164; Gilson, *supra* note 4, at 845–48.

17 Agency theory contends that shareholders-principals and managers-agents are parties to an *agency relationship,* under which the former engage the latter to manage the corporation on their behalf, which involves delegating some decision-making authority to the manager-agents. The agency relationship creates *agency costs,* which are the sum of (1) monitoring expenditures by the shareholder-principals, (2) bonding expenditures by the manager-agents, and (3) residual agency costs. Such *residual agency costs* may be triggered either by (1) managers diverting corporate resources to themselves, taking perquisites, and exerting too little effort in performing their jobs ("shirking"), or (2) managerial pursuit of non-value-maximizing objectives, such as making excessive acquisitions ("empire building"), encouraging excessive sales growth, and putting employee interests ahead of those of shareholders. In either case, corporate assets end up being abused to benefit managers at shareholder expense. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305, 308 (1976).

whether target boards should be allowed to block an underpriced bid, allegedly because the shareholders, if given the power, might accept it erroneously.

This Article first argues that shareholders face severe challenges in their efforts to receive, process, and evaluate the information necessary to assess the true intrinsic value of the target and, hence, to evaluate whether the bid price is too low. It then argues that even if shareholders could evaluate the fairness of the bid price correctly, the firm sometimes needs the board to protect it because shareholders might not make a choice that maximizes its long-term value.

A. Shareholder Inability to Assess the Target's Intrinsic Value

Target shareholders face major challenges in their efforts to assess the true intrinsic value of the company for three reasons. First, they are often unable to distinguish between stock value and intrinsic value. Second, they do not gather important information independently. Third, their boards are unable to credibly transmit such information to them.

1. Challenges in Distinguishing Between Market Value and Intrinsic Value

The Delaware courts have long recognized[18] that the divergence of true intrinsic value from market price can be extremely large.[19] In *Paramount Communications v. Time,* for example, the Delaware Supreme Court supported the Time directors' determination that the intrinsic value of the post-merger Time-Warner shares, which investors valued at

18 Such recognition came before the Delaware courts established their takeover doctrine. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 875–76 (Del. 1985) ("Using market price as a basis for concluding that the premium adequately reflected the true value of the Company was a clearly faulty, indeed fallacious, premise.").

19 Also, such intrinsic value can remain hidden for a long time. *See* Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value,* 96 NW. U.L. REV. 521, 529 (2002).

roughly $100, was more than the $200 per share in cash that Paramount had offered in the friendly merger (let alone the higher price that Paramount directors had signaled they were willing to pay).[20]

a. Public Information

Naturally, bidders launch takeover bids for targets with depressed stock prices.[21] Shareholders who wish to maximize firm value must be able to improve on the market's data, because absolute reliance on market pricing would result in an automatic acceptance of all takeover bids that offer a premium above stock price.[22] To that end, investors should be able to tell if all material information is well-reflected in the current stock price.

However, if shareholders must rely solely on the stock price to assess the desirability of the bid, they might get the wrong message. This is because stock markets not only lack access to inside information but also have difficulty fully capturing public information. This is evidenced by most financiers' belief that stock markets are not perfectly efficient,[23] so in reality, stock prices do not always fully reflect all the publicly available information about the target's intrinsic value.

b. Nonpublic Information

In addition to their inability to evaluate all public information related to the target's intrinsic value—and, hence, to the desirability of the bid—shareholders do not

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20 Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1140 (Del. 1989); *see, e.g.*, ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 93–94 (1991).

21 *See* Alex Edmans et al., *The Real Effects of Financial Markets: The Impact of Prices on Takeovers*, 67 J. FIN. 933 (2012) (reporting that a firm's discount to its potential value significantly attracts takeovers).

22 *See* Bebchuk et al., *supra* note 4.

23 *See, e.g.*, ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE 1–2 (2000).

have any access to material nonpublic information that might affect the target's intrinsic value. This occurs because U.S. securities laws do not require disclosure of all relevant, firm-specific information.[24] First, firms may hold back some information for competitive reasons.[25] Second, they do not have to share proprietary data, such as trade secrets or secret research and development efforts, even if such information is crucial to an understanding of the desirability of defensive measures. In fact, because keeping such information secret is often the subject of company codes of conduct and confidentiality policies, not only are directors under no obligation to disclose such information, but they are often under a duty *not* to do so.[26] Third, some important information is not disclosed because it is too speculative to be deemed completely credible.[27] If such information is communicated to shareholders, managers could subject themselves to the risk of fraud suits should certain events not come to pass.[28]

Undisclosed nonpublic information is significant. In a study of executive trading in over 1200 firms during a five-year period ending in January 2006, Alan Jagolinzer found that insiders regularly sell on inside information and

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24 Disclosure obligations are generally limited. *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS, 548–49 (6th ed. 2009).

25 *See, e.g.*, Instruction 4 to Item 402(b) of Regulation S-K, SEC Executive Compensation, 17 C.F.R. § 229.402 (2011) (permitting omission of performance-related factors involved in a pay-setting process if disclosure would result in "competitive harm"). Prospective events that remain uncertain may not need to be disclosed. *See* Basic Inc. v. Levinson, 485 U.S. 224, 237–38 (1988).

26 *See* Charles M. Nathan, *Maintaining Board Confidentiality,* HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Jan. 23, 2010), https://corpgov.law.harvard.edu/2010/01/23/maintaining-board-confidentiality/ [https://perma.cc/THF7-Z4VX].

27 *See* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977, 1002 (1992).

28 *See* Rule 10b-5, 17 C.F.R. § 240.10b-5 (2011) (prohibiting the employment of manipulative and deceptive devices).

generate above-market returns on such trades.[29] Take, for example, David Zucker, Midway Games Chief Executive Officer ("CEO"), who sold a total of 650,000 Midway Games shares for $12.9 million between December 19, 2006 and January 6, 2007; not coincidentally, between mid-December 2006 and late February 2007, Midway Games stock lost almost 60% of its value.[30] Also, the top five executives of Bear Stearns and Lehman Brothers derived cash flows of about $1.1 billion and $850 million, respectively, from stock sales during the eight years preceding their firms' colossal crashes in 2008.[31]

2. Challenges to Gathering Information Independently

Yet even if shareholders had the capacity to collect and process information about the desirability of the bid on their own, they would not be allowed or have the incentives to do so. In particular, individual shareholders may not collect such information directly from management because U.S. securities laws strictly prohibit the selective sharing of

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29 *See* Alan D. Jagolinzer, *SEC Rule 10b5-1 and Insiders' Strategic Trade*, 55 MGMT. SCI. 224 (2009).

30 Jane Sasseen, *A Closer Look at Trades by Top Brass; Some Execs May Be Abusing an SEC "Safe Harbor" Rule on Insider Stock Sales*, BUS. WK., Nov. 13, 2006, at 40.

31 *See* Lucian A. Bebchuk et al., *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000–2008*, 27 YALE J. REG. 257 (2010) (stating that the top five executive teams of Bear Sterns and Lehman Brothers cashed out large amounts of stock selling and cash bonus during 2000–08, the years that led to the credit crisis). In response, Fahlenbrach and Stulz suggest that bank CEOs did not reduce their holdings of shares in anticipation of the crisis or during the crisis. *See* Rüdiger Fahlenbrach & René M. Stulz, *Bank CEO Incentives and the Credit Crisis,* 99 J. FIN. ECON. 11 (2011) (stating that bank performance during the 2008–2009 credit crisis is not related to CEO incentives before the crisis). However, even Fahlenbrach and Stulz do not deny consistent and comprehensive selling by executives of their own firm equity. *Id.*

nonpublic information.[32] Also, individual shareholders are not motivated to collect such information because of their collective action problems.[33] All shareholders need the same information to evaluate the bid, so each individual shareholder is incentivized to "free ride" the efforts of her fellow shareholders to acquire it, thereby saving the costs associated with the effort. Further, because shares in large U.S. corporations tend to be widely held, coordinating such an accumulation of information is nearly impossible. Moreover, should an individual shareholder incur the expense entailed in such an effort, it would reduce his relative performance compared to that of his fellow shareholders, who are often, in today's highly institutional stock markets,[34] his competitors.

A possible way to solve this problem could be to have shareholders share the costs and benefits of extracting important information. However, current securities regulations hamper shareholders' ability to pull together the collective action needed for such cost sharing. In particular, a group of shareholders who act together and collectively own 5% of a company's shares must file a form 13D with the

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[32] *See* Regulation FD, 17 C.F.R. § 243.100 (2000) (stating the SEC promulgated Regulation FD in 2000 to curtail the ability of issuers to use the selective distribution of pertinent inside information to curry favor with analysts).

[33] For a discussion of shareholder collective action problems and how managers serve as a collective information-generating agency, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 67 (1991). For a more general discussion of collective action problems and the various mechanisms to mitigate it, see Marco Becht et al., *Corporate Governance and Control*, *in* HANDBOOK OF ECONOMICS OF FINANCE 1–109 (G.M. Constantinides et al. eds., 2003).

[34] On average, institutional investors own more than 70% of the shares of the largest 1000 U.S. public companies. *See* THE CONFERENCE BD., THE 2010 INSTITUTIONAL INVESTOR REPORT: TRENDS IN ASSET ALLOCATION AND PORTFOLIO COMPOSITION (2010). The percentage of UK equity markets held by institutional investors is comparable. *See* Simon CY Wong, *Why Stewardship Is Proving Elusive for Institutional Investors*, BUTTERWORTHS J. INT'L BANKING & FIN. L. 406 (2010).

Securities and Exchange Commission ("SEC") and risk a lawsuit by the company or by a shareholder claiming incomplete disclosure of their plans.[35]

3. Frictions That Limit Board Capacity to Convey Their Inside Understanding

Unlike shareholders, target boards do have access to all public and private information that might affect the intrinsic value of the firm and, hence, the desirability of the bid. In addition, they have the requisite expertise[36] to evaluate such information. Thus, they should be able to adequately assess whether the bid price is too low.

However, target boards are unable to credibly transmit their inside understanding about the desirability of a hostile bid to their shareholders. And even if they were motivated to communicate this understanding, their capacity to do so might be limited. For example, "soft" information—that is, information that cannot be directly verified by anyone other than the board—might be crucial in determining intrinsic value, but cannot be effectively conveyed to courts[37] because it cannot be adequately assessed. Consider, for instance, a raw set of data from geological studies about an oil-drilling project in a new location. These data do not squarely say what the project's dollar payoff will be; instead, they must be combined with the CEO's effort and expertise (e.g., knowledge of geology, experience and proficiency in assessing the costs of drilling and extraction, etc.) to generate a final judgment about dollar value. That final

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35 *See* Bernard S. Black, *Next Steps in Corporate Governance Reform: 13(d) Rules and Control Person Liability, in* MODERNIZING U.S. SECURITIES REGULATION: ECONOMIC AND LEGAL PERSPECTIVES 197–209 (Kenneth Lehn & Robert W. Kamphuis, Jr. eds., 1992).

36 *See* Fama & Jensen, *supra* note 10, at 319.

37 *See* Jeremy C. Stein, *Information Production and Capital Allocation: Decentralized versus Hierarchical Firms,* 57 J. FIN. 1891, 1892 (2002).

judgment is itself soft information that cannot be credibly communicated to outsiders.[38]

B. Deviation of Shareholder Choice from Maximization of Long-Term Firm Value

Even if shareholders could effortlessly obtain and process all relevant information needed to evaluate a hostile bid, firms would still need boards to protect them. This is because a shareholder decision to accept the bid might destroy the firm's long-term value. It is therefore worth exploring the entire universe of biases that would put the shareholders' agenda, in deciding takeovers, in conflict with the corporate good.

First, firms are vulnerable to short-term pressures by arbitrageurs, who typically purchase a significant amount of target shares at the onset of a takeover.[39] The arbitrageurs are motivated by the likelihood that the premium offer will be accepted and that they will be able to either tender their shares to the bidder or dispose of them as soon as possible after the bid fails. Therefore, they would be willing to tender to an offer even if it grossly undervalues the intrinsic value of the target.[40] Their interest in quick, short-term profits, together with their sophistication and large numbers, might significantly undercut long-term shareholder value. Even worse, such arbitrageurs—as well as shareholders in general—owe no fiduciary duties to their fellow shareholders or to the corporation generally,[41] so, unlike directors, they are under no obligation to advance the best interests of the firm.

Second, shareholders other than arbitrageurs might also suffer from short-term biases. Neither mutual funds nor

38 *Id.* at 1911.

39 *See* William J. Carney & Leonard A. Silverstein, *The Illusory Protections of the Poison Pill,* 79 NOTRE DAME L. REV. 179, 191–92 (2003).

40 *See Airgas*, 16 A.3d at 109.

41 *See* Paul K. Rowe et al., *Bebchuk's "Case for Increasing Shareholder Power": An Opposition*, 118 HARV. L. REV. F. 43 (2007).

hedge funds are typically concerned with the long-term success of the companies whose stocks they trade. The average turnover rate among equity mutual fund investors was 60% in 1980–2015,[42] while hedge funds trade their stockholdings nearly five times as often.[43] As one commentator has described them, such shareholders are largely financial engineers interested in making the largest possible profit in the shortest period of time.[44] An example of this can be seen in the aggressive efforts of hedge fund investors in MCI to urge the firm's board of directors to sell the company to Qwest despite the better long-term synergies offered by the rival Verizon.[45] Even institutional investors—shareholders who are perceived as having longer-term motivations—manifest short-term biases. For example, they prefer short-term earnings increases to long-term value creation,[46] and investment manager compensation incentives encourage short-term biases for institutions, just as they do for hedge funds.[47]

42 *See* INV. CO. INST., 2016 INVESTMENT COMPANY FACT BOOK 37 (2016), https://www.ici.org/pdf/2016_factbook.pdf [https://perma.cc/Z9Q6-RBLH].

43 *See* Charles Cao et al., *Hedge Fund Holdings and Stock Market Efficiency* 13 (May 2014) (unpublished manuscript), http://www.valuewalk.com/2016/06/hedge-fund-holdings-and-stock-market-efficiency/ [https://perma.cc/NFQ5-T4UA] (reporting that from January 2000 through December 2012, the annualized turnover ratio for shares held by hedge funds was 2.74).

44 *See* Robert Kirby, *Should a Director Think Like a Shareholder? (It Depends on Who the Shareholder Is)*, NACD DIRECTORSHIP, June 1996 (SIGNIFICANT ISSUE FACING DIRECTORS), at 6-1, 6-2.

45 *See* Almar Latour & Jesse Drucker, *Qwest, Revising Its Bid, Puts MCI Board on Spot*, WALL ST. J., Feb. 25, 2005, at C1.

46 *See* Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?,* 18 CONTEMP. ACCT. RES. 207 (2001) (discussing institutional short-term biases).

47 BEN W. HEINEMAN, JR. & STEPHEN DAVIS, COMM. FOR ECON. DEV., ARE INSTITUTIONAL INVESTORS PART OF THE PROBLEM OR PART OF THE SOLUTION? 17 (2011) (citing the 2011 World Economic Forum report for support that "'the goals and objective of the investment decision-maker might not be aligned with those of the beneficiaries of the investment fund' owing in part to skewed compensation schemes, risk measures that

Third, because of their substantial diversification strategy, most shareholders are in a structural conflict of interest when deciding takeovers. One reason for this conflict is that they often hold stock in both the target and bidding firm. Thus, the net effect of the takeover on their portfolio overall might conflict with the net effect of the takeover on their holdings in the target company alone.[48] Another reason has to do with their holdings in the target company's customers; these customers might be adversely affected by the takeover, which would thereby reduce the net effect of the transaction for diversified shareholders. As a case in point, Oracle's takeover of the business applications software company PeopleSoft left PeopleSoft's customers at risk that Oracle would stop supporting PeopleSoft's products,[49] an act that would have diminished the portfolio returns of a diversified shareholder who held the stock of both PeopleSoft and PeopleSoft's customers.

Fourth, shareholders are not a cohesive group of investors, and their differing special interests might be driven by concerns other than a desire to maximize the long-term value of the companies in which they invest.[50] The most influential shareholders in this category are public pension funds and labor union pension funds.[51] Public pension funds

penalize managers who favor long-term investments, and career considerations").

48 Takeovers generally produce gains for the target company but have a negative impact on the bidder's shares. *See* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 623–28 (1989). This might distort shareholder choice toward rejecting a value-increasing bid. Still, the direction of the distortion can change from one case to another.

49 *See* Steve Hamm & Andy Reinhardt, *Larry, You Picked a Nasty Fight; In Taking on Heavyweight SAP, Oracle Faces Very Long Odds*, BUS. WK., Apr. 4, 2005, at 42.

50 For a general discussion of this issue, see Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power,* 53 UCLA L. REV. 561 (2006).

51 *See* Randall S. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and*

are politically pressured to engage in "social investing"—making investments that foster in-state economic development[52]—whereas union pension funds are predisposed to furthering the special labor interests of their members. For example, a union pension fund might be seeking union recognition[53] or concessions in collective-bargaining negotiations. In 2004, following the strike by the United Food and Commercial Workers ("UFCW"), one of California's most powerful private sector unions, against Safeway, Inc., California Public Employees' Retirement System ("CalPERS"), which owned over $75 million in Safeway stock,[54] announced that it would withhold support for the board reelection of Safeway CEO Steven Burd. Many interpreted this move as a response to Burd's hard-line stance in his negotiations with the UFCW.[55] It is not impossible that union pension funds such as CalPERS would respond to management's hard-line stance to union demands by supporting a takeover that would promise to replace the incumbent managers—and that might be at odds with maximizing the long-term value of the firm.

Fifth, inside shareholders—firm employees and directors—have different objectives than outside shareholders. As explained in Part IV.B, directors and executives are motivated to frustrate some attractive acquisition offers that would increase shareholder value but possibly cost them their jobs. Like managers, rank-and-file employees make firm-specific investments in the firm and

Market Reaction, 13 J. CORP. FIN. 368, 384–85 (2007) (comparing levels of shareholder support according to type of shareholder proponent).

52 *See* Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 803 (1993).

53 *See* Marleen O'Connor, *Labor's Role in the American Corporate Governance Structure*, 22 COMP. LAB. L. & POL'Y J. 97, 114 (2000).

54 *See* Jonathan Weil & Joann S. Lublin, *Gadfly Activism at Calpers Leads to Possible Ouster of President*, WALL. ST. J., Dec. 1, 2004, at A1.

55 *See* Louis Lavelle, *CalPERS: Too Fierce? Why Its Good-Governance Crusade May Now Be Doing More Harm Than Good,* BUS. WK., June 7, 2004, at 114.

are often afraid to lose their jobs following a takeover. Therefore, like their managers, they have a private interest in maintaining the status quo and rejecting hostile bids.[56]

Following along these lines, insider shareholding has become increasingly significant and thus might be an important factor in the distortion of shareholder decision-making. Inside shareholders have never before had such clout in widely held firms because the majority of executive pay already includes stock compensation,[57] director pay increasingly includes stock,[58] and stock ownership policies ("SOPs") for directors and executives have become universal.[59]

As a result of insiders' tendency to reject takeovers, the employee stock ownership plan ("ESOP") became an important ally of management in efforts to defeat hostile takeover bids.[60] For example, in response to Shamrock's takeover attempt, Polaroid erected a "defensive" ESOP to

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56 *See* Michael J. Nassau et al., *ESOPs After Polaroid—Opportunities and Pitfalls*, 15 EMP. REL. L.J. 347, 348 (1989) (explaining that employees are "more concerned with the immediate benefits of job security than with the potential increase to the value of their future retirement benefits that will result from tendering their ESOP shares to a hostile acquirer.").

57 In 2015, stock-based compensation for S&P 500 CEOs amounted to more than seven times their base salary. *See* MERIDIAN COMP. PARTNERS, 2016 CEO PAY TRENDS 10 (June 2016), https://www.meridiancp.com/wp-content/uploads/Equilar-CEO-Pay-Trends-Report.pdf [https://perma.cc/JC27-A4YP].

58 60% of Fortune 500 outside directors receive restricted stock (stock with vesting periods), and 23% of all outside directors are granted with deferred stock and phantom stock (stock that will be given to them in the future but will not be subject to vesting periods). Moreover, 95% of total outside directors are paid with full-value stock. *See* Michael Bowie, *Equity Strikes Back: Larger Stock Values Drive Increases in Outside Director Pay*, TOWERS WATSON EXECUTIVE COMPENSATION BULLETIN (Sept. 24, 2014).

59 *See* Nitzan Shilon, *CEO Stock Ownership Policies—Rhetoric and Reality*, 90 IND. L.J. 353, 375 (2015) (reporting that as of 2013, SOPs have become virtually universal, with 95% prevalence among top 250 U.S. public firms).

60 *See, e.g.*, *Moran*, 500 A.2d at 1361; Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989).

purchase 14% of its shares.[61] Polaroid's resistance ultimately forced Shamrock to reach an accord with Polaroid and abandon its takeover bid.[62] Consequently, Polaroid stock plunged,[63] indicating that the markets perceived the interests of the inside shareholders who were entitled to the new ESOP stock as inconsistent with maximizing firm value. Given the growing prevalence of inside stock,[64] such distortions in shareholder decision-making are expected to become even more disturbing.

Sixth, even if shareholders have the right incentives to maximize long-term firm value, two major collective action problems would still distort their tender decision-making when faced with a takeover bid. The first problem is that individual shareholders might hold out for a value-increasing takeover bid in order to free ride on the bidder's improvement of the corporation should the bid be accepted.[65] This might happen because (1) any given shareholder will realize that his decision is unlikely to determine the bid's outcome, and (2) if the bid succeeds, the shareholder will be better off not tendering and thereby free riding on the increased firm value—value created by the improvements made by the bidder which may exceed the premium in the tender offer. If the bid is conditional on acceptance, the shareholder should consider taking action only if the bid

61 *See Shamrock Holdings*, 559 A.2d at 281.

62 Business Digest, N.Y. TIMES, Mar. 28, 1989.

63 *See* Robert J. Cole, *Polaroid Payout Plan Helps It Reach Shamrock Accord*, N.Y. TIMES, Mar. 28, 1989, at D1.

64 This is due to two facts. First, executive pay has climbed consistently and reached an all-time high of $10.8 million per year for S&P 500 CEOs. *See* EQUILAR/ASSOCIATED PRESS, S&P 500 CEO PAY STUDY 2016 (May 25, 2016), http://www.equilar.com/reports/37-associated-press-pay-study-2016.html [https://perma.cc/AN4V-QWWX]. Second, equity plays the primary role in executive pay, with an average of more than 60% of S&P 500 CEO pay received in stock or stock options. *See* EQUILAR INC., 2016 EQUITY COMPENSATION TRENDS (2016) (on file with author).

65 *See* Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 BELL J. ECON. 42, 53 (1980).

succeeds. Because it is rational for all shareholders to hold out for a value-increasing takeover bid, a conditional value-increasing bid is likely to fail.[66]

The second collective action problem is that shareholders might be pressured into tendering their shares to a value-decreasing bidder to avoid becoming a depressed minority.[67] This might happen because, again, any individual shareholder will realize that his tendering decision is unlikely to determine the bid's outcome, which makes tendering to a value-decreasing bidder the dominant strategy: the shareholder will receive the bid price, which is higher than the depressed per-share minority value should the bid be accepted.[68]

Proposed solutions to shareholder collective action problems in takeovers have relied on the assumption that shareholders have full information about the desirability of the bid. For example, Professor Lucian Bebchuk proposed to solve shareholders' distorted-choice problem by having them vote separately from their tendering decision about whether they wish the bid to be accepted.[69] But for such separate shareholder action to result in efficient outcomes, shareholders must have fully processed the information pertaining to the desirability of the bid. Unfortunately, as shown above, that assumption is not warranted.

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66 When the bid is unconditional, the shareholder must weigh, on the one hand, the chance that it will succeed and the benefits of holding out, and, on the other hand, the potential loss of the bid premium if he holds out. For the bidder, an unconditional tender offer might be too costly because if it fails, the bidder will have to acquire all the tendering shares without gaining control.

67 *See* Lucian Arye Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911, 911 (1987).

68 If the bid is unconditional, the shareholder might still rationally tender to the undesirable bidder, but it is not certain to happen. On the one hand, as explained, the bidder will gain if the bid succeeds, but if it fails, the bidder will lose the difference between the higher intrinsic value and the lower bid price. *See id.* at 924.

69 *See id.* at 931–41.

III. TARGET BOARDS' CONFLICT OF INTEREST

Shareholders' potential errors in accepting underpriced bids could be addressed by requiring target boards to protect them in such situations. In particular, target directors, as stewards of the corporation, could be expected to exercise their business judgment and professional expertise to identify and block underpriced acquisition attempts.

Because of their conflict of interest with their shareholders, target boards cannot be relied on to protect their shareholders from underpriced bids. First, although virtually all boards have a majority composition of independent directors,[70] they do not reliably exercise independent judgment that is free from the target's executive officers' influence. An empirical study from 2012 shows that boards appoint directors who—while technically independent according to regulatory definitions—may nonetheless be overly sympathetic to management.[71] In addition, for various financial, social, and psychological reasons, executives have power and influence over directors in publicly traded U.S. companies that make it personally costly and difficult for directors to act in ways that are unfavorable to executives.[72] These issues cast serious doubt on independent directors' ability to exercise objective business judgment.

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70 *See* SPENCER STUART, 2015 SPENCER STUART BOARD INDEX 12 (2015), https://www.spencerstuart.com/~/media/pdf%20files/research%20and%20insight%20pdfs/ssbi-2015_110215-web.pdf [https://perma.cc/NS8R-KGAT] (reporting that in 2014, independent directors made up 84% of all S&P 500 board members).

71 *See* Lauren Cohen, Andrea Frazzini & Christopher J. Malloy, *Hiring Cheerleaders: Board Appointments of "Independent" Directors*, 58 MAN. SCI. 1039 (2012).

72 *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 23–34 (2004) (describing sources of executives' influence over directors in public companies).

The directors in the *Airgas* case embodied some of these concerns.[73] There, the independent directors who were nominated by the insurgent voted for management and supported its defensive tactics *against* the insurgent. The *Airgas* directors had such a strong management-friendly mindset that they were compelled to support management even when doing so directly hurt the major interests of the shareholders who appointed them.

Second, a decision to accept a hostile takeover, unlike any other corporate decision, is followed by the involuntary removal of the entire board of directors and senior executive management, forcing them to relinquish their future compensation, perquisites, and intangible benefits of control.[74] As a result, managerial self-interest weighs more heavily in takeover situations than in nontakeover situations.

Third, whereas the design of their incentive compensation arrangements—and especially the vesting conditions of their restricted stock—help to bond directors with their long-term shareholders in nontakeover situations,[75] they misalign directors' long-term interests with those of shareholders in

[73] *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 48 (Del. Ch. 2011). The vote of Air Products' independent directors in *Airgas* can also be interpreted to support the opposing view, under which independent directors exercise strong independent judgment even if such judgment works against their appointees. However, the cohesive group dynamics of a defending target board can explain better the uniform board stance against the takeover than a deliberation involving each of the board members.

[74] *See* Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, 7 J. ACC. & ECON. 179, 184 (1985).

[75] *See* MERIDIAN COMP. PARTNERS, *supra* note 57, at 10. Also, in 2014, the average mix of pay for Fortune 500 outside directors was 44% cash and 56% stock. Also, 60% of such directors received restricted stock (stock with vesting periods), and 23% of all outside directors were granted deferred stock and phantom stock (stock that will be given to them in the future but will not be subject to vesting periods). Moreover, 95% of total outside directors were paid with full-value stock. *See* Bowie, *supra* note 58, at 1–2.

takeover situations. In particular, such granted but unvested[76] stock compensation, which might otherwise motivate the outside directors to maximize the long-term value of the firm, stands to be forfeited upon directors' termination in the takeover. This distorts directors' judgment away from maximizing long-term firm value and instead prompts their indiscriminate rejection of hostile bids, even if such action ultimately stands to destroy firm value. Golden parachutes, which could counter such an effect, do not apply to outside directors. Consequently, resisting a tender offer is clearly and significantly more desirable for directors than for shareholders.[77]

Fourth, empirical studies indicate that directors misuse their power to insulate their firms from takeover threats, probably because of their conflict of interest with their shareholders. Boards that place preemptive antitakeover defenses tend to generate suboptimal operating

[76] Vesting periods define when managers "earn" their stock options or restricted stock. In the United States, these periods are usually three to five years for executives but less for board members. Typically, each year the executive earns the prorated amount of his or her equity grant. Thus, if an executive is granted three hundred restricted stock units with a three-year vesting schedule, that CEO will own one hundred units after one year, another one hundred after two years, and the remaining one hundred after three years.

[77] *See* Cotter & Zenner, *supra* note 4, at 86 (reporting that shareholders do not necessarily gain due to resisting a tender offer while managers may gain from their resistance). Easterbrook and Fischel argue that resistance by a corporation's managers to premium tender offers, even if it triggers a bidding contest, ultimately decreases shareholder welfare. This is because the value of any stock can be understood as the sum of two components: the market price that will prevail if there is no successful offer (multiplied by the likelihood that there will be none) and the price that will be paid in a future tender offer (multiplied by the likelihood that some offer will succeed). Although board resistance might increase the price of a tender offer when the offer succeeds, it also decreases the likelihood that such an offer will actually go through. Overall, shareholders would be better off if board resistance were all but proscribed. *See The Proper Role*, *supra* note 4.

performance[78] and overconsume private benefits of control.[79] Furthermore, the insulation from takeover threats results in directors approving higher paychecks for their executives, allowing higher levels of managerial slack, and being more likely to support inefficient empire building.[80]

IV. DELAWARE TAKEOVER DOCTRINE

Thus far, this Article has shown that shareholders might erroneously accept underpriced bids and therefore should be protected from doing so. However, it has also shown that directors who could be expected to protect such shareholders, and who possess superior information and expertise to evaluate the desirability of takeover bids, are in a conflict of interest with their shareholders.

Because these perils exist, the Delaware courts developed a rich doctrine tailored specifically for takeover situations. This Part first explains the policy choices that led to the takeover doctrine. It then examines the specifics of that judicial standard and explains why a board's allegation of "substantive coercion" is the most demanding aspect of it.

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78 *See* Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 129 (2003).

79 *See* Kenneth A. Borokhovich et al., *CEO Contracting and Antitakeover Amendments*, 52 J. FIN. 1495, (1997).

80 *Id.* (reporting that managers with stronger antitakeover defenses extract higher compensation levels); *see also* Marianne Bertrand & Sendhil Mullainathan, *Executive Compensation and Incentives: The Impact of Takeover Legislation* (Nat'l Bureau of Econ. Research, Working Paper No. 6830, 1998), http://papers.nber.org/papers/W6830.pdf [https://perma.cc/7GKZ-BRU2] (reporting that managers subject to stronger antitakeover statutes extract higher compensation levels); Gompers et al., *supra* note 78, at 139–40 (reporting that managers with stronger antitakeover protections engage in more empire building); Garvey & Hanka, *supra* note 4, at 520 (concluding that antitakeover statutes allow managers to pursue value-destroying goals).

A. Delaware Intermediate Standard of Review

Delaware corporate law is generally board-centric. Its basic and long-standing principle (as well as that of U.S. corporate law) is that the power to manage the business and affairs of the corporation is conferred on the board of directors.[81] No matter how much shareholders want a business decision, they cannot force management to consider one. This broad power is coupled with the director-friendly business judgment rule[82]—a doctrine that insulates the directors from liability in nonconflicted business decisions. This rule recognizes that in the inherently risky environment of business, boards need to be free to take risks without a constant fear of lawsuits affecting their judgment.

However, lenient judicial review on the directors' unfettered authority turns strict when the directors are conflicted. When a majority of the directors approving the transaction are interested in or appear on both sides of a transaction, the corporate board does not enjoy the protection of the business judgment rule. Instead, the board has the burden of demonstrating that the transaction is inherently fair to the shareholders. This includes the demanding burden of showing both fair dealing and fair price.[83]

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81 *See, e.g.*, DEL. CODE ANN. tit. 8, § 141 (2016); REVISED MODEL BUS. CORP. ACT § 8.01 (AM. BAR ASS'N 1983); CAL. CORP. CODE § 300 (West 2016); N.Y. BUS. CORP. LAW § 701 (McKinney 2016); *see also* Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 358 (1991); Lynne L. Dallas, *The Control and Conflict of Interest Voting Systems*, 71 N.C. L. REV. 1, 11 (1992).

82 *See* Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) (setting out the rationale for the rule).

83 The entire fairness standard is triggered when a majority of the directors approving the transaction are interested in or appear on both sides of a transaction. At that point, the corporate board has the burden of demonstrating that the transaction is inherently fair to the shareholders by demonstrating both fair dealing and fair price. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (stating that directors must exhibit the "most scrupulous inherent fairness of the bargain" when they are on both sides of a transaction).

Because takeover decisions are crucial business decisions that the board is best positioned to evaluate, yet directors are personally conflicted when deciding them, the Delaware Supreme Court in *Unocal* unveiled an intermediate standard of review to adjudicate takeover cases.[84] Specifically, under that intermediate standard of review, the target board of directors may use defensive tactics to prevent a takeover only when it can show that (1) a legally cognizable threat to corporate policy and effectiveness exists[85] and (2) any board action taken in response to that threat is "reasonable in relation to the threat posed."[86]

B. The Substantive Coercion Threat

The first hurdle of Delaware's intermediate standard involves three categories of cognizable threats, as initially recognized in *Paramount Comm's v. Time, Inc.*:[87] (1) *structural coercion risk*, in which disparate treatment of non-tendering shareholders might pressure shareholders to tender,[88] as might occur with a two-tiered offer in which the back-end gets less than the front-end; (2) *opportunity loss,* which is the risk that a hostile offer might deprive target shareholders of the opportunity to select a superior alternative offered by target management or another

84 *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (1985).

85 *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1384 (Del. 1995) (citing *Unocal*, 493 A.2d at 955).

86 *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 92 (Del. Ch. 2011); *see also Unocal*, 493 A.2d at 955; Yucaipa American Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 335 (Del. Ch. 2010) (stating that "[I]t is settled law that the standard of review to be employed to address whether a poison pill is being exercised consistently with a board's fiduciary duties is the *Unocal* . . . standard").

87 *See* Paramount Comm's, Inc. v. Time, Inc., 571 A.2d 1140, 1152–53 (Del. 1989).

88 *See Airgas*, 16 A.3d at 96 (citing Ronald Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 258 (1989)).

bidder;[89] and (3) *substantive coercion,* which is the risk that shareholders will accept an underpriced bid because they mistakenly distrust management's representations of intrinsic value.[90]

Of these three categories of threats, the third places the most demanding burden on Delaware's intermediate standard. Where management alleges that a bidder's offer is structurally coercive, a court needs only to determine whether the hostile bid favors tendering shareholders over nontendering ones.[91] Similarly, to identify an opportunity loss threat, a court needs only to determine whether management or another potential bidder needs some additional time to formulate and present a more attractive alternative.[92] However, an allegation of substantive coercion requires much more than the review of a simple statement of management's immediate plans and the terms of a hostile offer. To support such an allegation, the board of directors must demonstrate that it has reasonably determined two elements:[93] (1) that the unsolicited bid offers inadequate value to the shareholders;[94] and (2) that shareholders will mistakenly accept that offer because of "ignorance or . . . mistaken belief" regarding the board's assessment of the long-term value of the target stock.[95] Both elements must be present because in the absence of the first, shareholders who accept the bid have not erred, and without the second,

89 *See Unitrin*, 651 A.2d at 1384 (quoting Gilson & Kraakman, *supra* note 88, at 267).

90 *Id.*

91 *See* Gilson & Kraakman, *supra* note 88, at 267–68 (citing AC Acquisitions Corp. v. Anderson, Clayton & Co. 519 A.2d 103 (Del. Ch. 1986)).

92 *See* Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 289 (Del. Ch. 1989).

93 *See Airgas*, 16 A.3d at 96 (citing Gilson & Kraakman, *supra* note 88, at 258).

94 *See* City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787, 798 (Del. Ch. 1988).

95 *See Unitrin*, 651 A.2d at 1385 (citing Paramount Comm's, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1989)).

shareholders will believe the board's assessment and reject underpriced bids.[96]

To establish the "inadequate value" prong, the target board, composed of a majority of outside, independent directors, should act deliberately, in an informed way, and in the good-faith pursuit of corporate interests.[97] It should further undertake a reasonable investigation and consult outside advisors before concluding that the offer is inadequate. The Delaware courts have recognized that such a board may follow a course designed to achieve long-term value even at the cost of immediate value maximization.[98]

After showing that the bid is inadequate, the board should show a reasonable concern that the target stockholders might tender to the bidder in ignorance or based upon a mistaken belief about how the board has represented the target stock's long-term value. For this, the board must be able to show one of the following two potentialities:[99] (1) that the stockholders will mistakenly tender to the bidder because they do not believe or understand (literally) the value of the management alternative, which could occur if the terms of the offer are, for example, uncertain;[100] or (2) absent a claim about shareholders being "confused" or "mistakenly tendering" (or even "disbelieving" management), that the majority of the target's investors are short-term (e.g., arbitrageurs, hedge funds, and event-driven investors) and will tender into the

96 *See* Gilson & Kraakman, *supra* note 88, at 260.

97 *See Airgas*, 16 A.3d at 124–25.

98 *See Paramount*, 571 A.2d at 1152; *see also In re* Dollar Thrifty S'holder Litig., 14 A.3d 573, 612 (Del. Ch. 2010) ("[O]ur law does not require a well-motivated board to simply sell the company whenever a high market premium is available.").

99 *See Airgas*, 16 A.3d at 108.

100 *See Paramount*, 571 A.2d at 1153 (concluding that the Time stockholders would mistakenly not believe the strategic benefits of management's proposed merger with Warner, the terms of which were uncertain).

bidder's offer despite an inadequate price tag.[101] This second possibility was recognized as a threat because if the majority does not care about the fundamental value of the target, it will leave the minority "coerced" into taking the inadequate bid.[102]

Once the target board has established that it is reasonably concerned about both prongs of substantive coercion, the Delaware courts will uphold the board's defensive tactics if they are proportionate to the threat posed. For example, whereas the *Interco* court stated that the low-level threat posed there justified maintaining defensive tactics against substantive coercion only for as long as the board needed to protect stockholder interests (by negotiating with the bidder, looking for a white knight, or structuring an alternative to the offer),[103] the *Airgas* court concluded that showing substantive coercion under the greater threat justifies maintaining a poison pill with no "set expiration date."[104]

V. THE INEFFECTIVENESS OF ADJUDICATING SUBSTANTIVE COERCION

Showing substantive coercion essentially requires a process-based review, which the directors satisfy by demonstrating good faith and reasonable investigation.[105] Proof of good faith and reasonable investigation is commonly provided by the fact that the decision to reject the bid was

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101 *See Airgas*, 16 A.3d at 95, 109 (stating that the board demonstrated this prong by showing that a large percentage (almost half) of Airgas's stockholders were merger arbitrageurs).

102 *See id.* at 109 (citing SEH Tr. 454 (Clancey)) ("[Essentially, the risk is] that the informed minority, in theory, will be forced to do something because of the bamboozled majority, or the majority who will act because their interests' time lines are different than that minority.").

103 *See* City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787, 798 (Del. Ch. 1988).

104 *Airgas*, 16 A.3d at 129.

105 *See Paramount*, 571 A.2d at 1152; Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

made by a board composed mostly of outside, independent directors[106] who backed their decision with opinions from outside financial and legal advisors.

Unfortunately, the Delaware courts have systematically failed in evaluating the review process of target boards. Professor Ronald Gilson, who initially offered the concept of substantive coercion with Professor Reinier Kraakman, has harshly criticized the Delaware Supreme Court for its misuse of the concept:

> Unfortunately, only the phrase and not the substance captured the attention of the Delaware Supreme Court; the mere incantation of substantive coercion now seems sufficient to establish a threat under Unocal *without any inquiry into the facts or management's explanation for the market's underpricing of the company's shares*.[107]

This Part first discusses the inevitable challenges that the Delaware courts face in their process-based assessment of substantive coercion. Second, it shows that the ineffective judicial review results in the ability of target boards to "just say no" to takeover bids. Finally, it analyzes the practical significance of boards' ability to "just say no."

A. Impediments to Judicial Review of Substantive Coercion

By relying on a process-based standard, the Delaware courts must assess two factors: (1) whether the investigation that a target board made before deciding to reject a bid was conducted by a majority of outside, independent directors, and (2) whether these outside directors exercised deliberate, informed, and good-faith pursuit of corporate interests, as supported by the legal and financial opinions they ordered.[108]

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106 *See Airgas*, 16 A.3d at 92.

107 *See* Ronald J. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 498 (2001) (emphasis added).

108 *See Airgas*, 16 A.3d at 92, 124–25.

As discussed in Part II, the legal independence that directors have does not guarantee that they exercise independent business judgment. This Section shows that, in addition, the financial and legal expert opinions that target boards have bought and paid for are extremely hard for courts to review effectively.[109]

First, financial advisors and legal counsels are themselves prone to conflicts of interest, which derive, for example, from their desire to retain and attract clients and possibly also from their psychological loyalty to managers.[110] These conflicts may encourage them to issue opinions in favor of the managers who hired them rather than opinions that reflect their genuine professional judgment.[111] For example, investment bankers typically assume that management's optimistic projections for future performance will be achieved and thus do not allow for the risk that they will not.[112] This enables them to find unfair a hostile bid price that a hypothetical well-informed investor would happily accept. Courts, unfortunately, recognize that they are not well equipped to review assumptions about the target's future performance because, as the *Airgas* court admitted, reasonable minds can differ greatly on this matter.[113]

Second, the advisors' conflict of interest is especially troubling because financial models and assumptions are hard to attack. Financial advisors can freely choose among

109 For skeptical accounts of the weight that investment banker fairness opinions deserve, see, e.g., Lucian Arye Bebchuk & Marcel Kahan, *Fairness Opinions: How Fair Are They and What Can Be Done About It?,* 1989 DUKE L.J. 27 (1989); William J. Carney, *Fairness Opinions: How Fair Are They and Why We Should Do Nothing About It,* 70 WASH. U. L.Q. 523 (1992); Robert A. Prentice & John H. Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They Be Allowed To?*, 15 DEL. J. CORP. L. 377 (1990).

110 *See* Bebchuk & Kahan, *supra* note 109, at 29, 37–46.

111 *Id.*

112 *See* Black & Kraakman, *supra* note 19, at 556.

113 *See Airgas*, 16 A.3d at 62.

several widely disparate and justifiable estimates to support their conclusions.[114] Insignificant changes in the financial assumptions can have a dramatic impact on the prediction of the intrinsic value of the firm. For example, a minor change in assumption about the future discount rate from 6% to 5% increases the firm's intrinsic value (based on a standard Discounted Cash Flow constant annuity model) by 20%.

Financial assumptions make an even greater impact when target boards contemplate a significant merger, as occurred in *Time,*[115] or a defensive restructuring, as occurred in *Pillsbury*[116] and *Interco*.[117] Then, more nonverifiable but significant assumptions, such as synergies, organizational reform value, market response, and cultural integration, have to be added to the financial models.

A third reason why investment bankers' opinions do not provide a serious check on management claims is that when a takeover target wants to oppose a hostile bid, the bankers will suggest that the price offered is "inadequate" rather than "unfair"[118]—something they can almost blindly assume since hostile bidders never start with their best offer.[119]

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114 *See* Bebchuk & Kahan, *supra* note 109, at 34–37. For example, in the *Airgas* case, the financial experts' wide discretion was attacked by Air Products and Shareholder Plaintiffs critique of the experts endorsement of two main aspects of Airgas's five-year plan: "(1) the macroeconomic assumptions relied upon by management, and (2) the fact that Airgas did not consider what would happen if the economy had a 'double-dip' recession." *Airgas*, 16 A.3d at 110.

115 *See* Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989).

116 *See* Grand Metro. Pub. Ltd. v. Pillsbury Co., 558 A.2d 1049 (Del. Ch. 1988).

117 *See* City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988).

118 *Id.* at 792.

119 Fair price means that the bid price falls within a range of reasonably fair prices for the selling shareholders. Conversely, inadequate price means that the bidder should have been expected to bid higher even if the bid price is fair. When the Delaware courts do not distinguish the two and allow boards to reject bids based on their "inadequacy," they open

Importantly, the Delaware courts have never focused on this difference between a fairness opinion and an inadequacy opinion.[120]

Moreover, after the banker solemnly blesses the target's alternative deal as fair and the bidder tops the target alternative with a higher bid price, the banker will simply raise the fairness range and proclaim the higher hostile bid price unfair.[121] Sometimes the cycle is repeated, as the hostile bidder raises its bid and the banker again raises its fairness range.[122]

B. The Resulting "Just Say No" Response

The inability of courts to effectively review target boards' allegations of substantive coercion resulted in their practical ability to "just say no" to unsolicited acquisition offers. In a series of court decisions throughout the years, the Delaware Supreme Court expanded board authority to block unsolicited bids. First, in *Paramount Communications v. Time* in 1990, it emphasized that courts are not supposed to make a substantive judicial review of boards' justifications for placing defensive tactics:

> To the extent that the Court of Chancery has recently [substituted its judgment as to what is a "better" deal for that of a corporation's board of directors] in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis. *See, e.g.*, *Interco* . . . and its progeny . . . .[123]

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the door to defensive tactics whenever the bidder does not offer his reservation price.

120 *Id.* at 797.

121 *Id.* at 792.

122 For a nice illustration of the distinction between a fairness opinion and an inadequacy opinion, and the plasticity of both, see Mills Acquisition Co. v. Macmillan, Inc. 559 A.2d 1261, 1271 (Del. 1989).

123 Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1989).

Five years later, in *Unitrin, Inc. v. American General Corp*,[124] it went even further and restated *Unocal*'s proportionality test, making it operate similarly to the lenient business judgment rule: it stated that a board's defense may now "be sustained if it is attributable to *any* reasonable judgment."[125] Reflecting on this decision, Chancellor William Allen noted that a prominent New York City practitioner had remarked to him after *Unitrin,* "So it looks like we're back to business judgment review, aren't we?"[126]

However, the most serious expansion of defensive tactics in response to substantive coercion was made in the 2011 seminal holding of the Delaware Chancery Court in *Airgas*.[127] There, Chancellor William B. Chandler III concluded that in adjudicating substantive coercion, courts should not focus on whether the target firm's shareholders are actually likely to mistakenly tender their shares to an inadequately priced bid, nor should they examine whether those shareholders are well-informed or sophisticated enough not to be fooled into accepting an inadequate bid. Rather, courts should focus on ensuring that the target board acted in good faith and articulated a reasonable basis for its belief that the bid price was inadequate. In so ruling, the Court admitted that, while it did not allow target boards to "just say never" in all circumstances, it did "bring us one step closer to that result."[128] This means that target boards can certainly rely on their power to "just say no."

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124 *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995).

125 *See* WILLIAM T. ALLEN & REINIER KRAAKMAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 570 (2003).

126 *See* Guhan Subramanian*, Bargaining in the Shadow of Takeover Defenses,* 113 YALE L.J. 621, 626–27 (2003).

127 *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011).

128 *Id.* at 129.

C. Problems with the Resulting "Just Say No" Response

The Delaware Supreme Court's expansion of a target board's authority to respond to an allegedly substantive coercion threat by just saying no is troubling. Because of the challenges that courts face in evaluating a target board's process, the legal and financial opinions the courts rely on, and the directors' bias to favor management, there is a risk that substantive coercion will become a platform for rubber-stamping management's entrenchment.

This concern, according to which boards might block hostile bids that are likely to increase shareholder value, is supported by a series of empirical studies. Such studies indicate that board resistance to unsolicited bids results in both short-term and long-term shareholder value destruction.[129] In the short term, when management resistance succeeds to fail the bid, shareholders lose, on average, 21% of their share value,[130] while, when such resistance is unsuccessful in rejecting the bid, it does not increase the bid premium significantly.[131] In the long term, during the thirty months following the unsolicited offer, target shareholders' stock return is, on average, 54% lower for targets that stayed independent than for targets that were acquired.[132]

VI. A PROPOSED REMEDY

While giving target boards the ability to "just say no" is undesirable, the concept of substantive coercion is important. As shown in the previous Parts, shareholders need to be protected from erroneously accepting underpriced bids. Yet,

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[129] *See* Jensen & Ruback, *supra* note 4 (reporting that corporate takeovers generate overall positive gains, while shareholders of target firms benefit and bidding firms do not lose).

[130] *See* Cotter & Zenner, *supra* note 4, at 86.

[131] *Id.* at 66.

[132] *See* Bebchuk et al., *supra* note 4, at 935.

because target directors are in a unique conflict of interest with their shareholders in takeover situations and because of the inherent challenges in adjudicating substantive coercion effectively, there is a need to improve the doctrine.

This Part proposes a novel arrangement aimed at achieving a better resolution in two major ways: (1) by improving the credibility of substantive coercion adjudication, and (2) by alleviating the conflict of interest in takeover situations so that boards would be encouraged to reject a takeover *only* when it stands to destroy long-term shareholder value. And the main way to achieve these goals is by enabling outside directors of target firms to express their genuine opposition to an unsolicited bid, which they can do by committing to buy from the target, if the bid fails, a certain amount of target stock at the bid price[133] and holding it for a specified time. As explained below, this arrangement should be adopted through adjustments to the Delaware Supreme Court's substantive coercion takeover doctrine.

A. Prerequisite: Allowing Outside Directors to Purchase Stock in Takeovers

Unfortunately, this arrangement can be implemented only after certain impediments in federal securities laws are removed. First, Rule 14e-3[134] currently prohibits directors who possess nonpublic material information about a tender offer[135] to purchase or have "the right to obtain" target stock.[136] No showing of personal benefit or misappropriation

133 In principle, directors who commit to buy such shares at a price higher than the bid price will deliver an even stronger message about their opposition to the bid. Alternatively, they could commit to buy less stock at a higher price to show the same opposition level.

134 17 C.F.R. § 240.14e-3 (2016).

135 Because the Williams Act requires hostile bidders to launch a tender offer once they wish to purchase more than 5% of the target's stock, all hostile bids must be conducted via a tender offer. *See* 15 U.S.C. § 78n(d)(1) (1982).

136 17 C.F.R. § 240.14e-3(a)(3) (2016).

is required. Because, as this Article showed earlier,[137] the target firms' directors often have such information, and because the proposed arrangement requires that the target commit to sell the stock that the directors commit to buy,[138] the arrangement is potentially proscribed by Rule 14e-3.

However, one might argue that Rule 14e-3 does not prohibit the arrangement because it (1) does not specifically proscribe a conditional (on the failure of the bid) commitment to purchase the target stock, and (2) exempts transactions for which public information was disclosed within a reasonable time prior to purchase. Therefore, the argument goes, the target directors are allowed to use the arrangement, especially if they do so during a predetermined "trading window" following release of the target's quarterly earnings.[139] Unfortunately there is no precedent indicating that making the directors' commitment to buy such stock conditionally renders it legal. Also, committing to purchase stock only during a predetermined "trading window" might not succeed because the commitment to buy the stock is determined when the inside information is still not being shared publicly and the tender offer is still "live." As this means that there is currently a legal risk in using the arrangement, this Article recommends creating a specific "safe harbor" that would not change any of the core prohibitions of Rule 14e-3 but would merely remove that legal risk.

Second, the insider trading "misappropriation theory"[140] holds that when a person uses confidential information for securities trading purposes in breach of a duty owed to the source of the information, he commits fraud in connection with a securities transaction and thereby violates SEC Rule

137 *See* discussion in Section II.A.

138 If the arrangement were designed so that the directors commit to buy the stock but the target does not commit to sell it, the directors' commitment would not be binding.

139 *See* Jesse M. Fried, *Hands-Off Options*, 61 VAND. L. REV. 453, 463–64 (2008).

140 *See* United States v. O'Hagan, 521 U.S. 642, 643 (1996).

10b-5.[141] Therefore, target directors who have confidential information about the target and commit to buy the target's stock might be conducting a fraudulent transaction. Indeed, it is doubtful that such an act, if made in good faith to protect the corporation from an undesirable takeover, violates the directors' fiduciary duty to the source of the information—the target corporation. Still, to avoid a legal risk for bona fide directors, this Article recommends that the SEC issue a guideline clarifying that use of the arrangement in good faith will not expose the target's directors to insider trading charges.

Finally, New York Stock Exchange ("NYSE") rules might complicate the application of the proposed arrangement. Unlike Nasdaq and the NYSE MKT (formerly, the American Stock Exchange), the NYSE requires[142] shareholder approval before directors are issued 1% or more of either the number of shares of common stock or the voting power outstanding. Because the arrangement provides that the directors' commitment is to buy newly issued target stock, the NYSE rules can complicate the arrangement if the directors commit to buying more than 1% of the target's issued shares.

Nonetheless, while changing the NYSE rules to allow the arrangement to work smoothly might do some good, its effect is unlikely to be material. First, the arrangement would probably not trigger the 1% threshold. 1% of the market capitalization of NYSE-listed firms is significant. For example, 1% of the market value of a mid-cap firm is worth at least $20 million, and for large-cap firms, this amount is even higher. Because the arrangement requires outside directors—part-timers who are paid, on average, more than forty times less than the CEO[143]—to make the stock

141 17 C.F.R. § 240.10b-5 (2016).

142 *See* New York Stock Exchange Listed Company Manual, § 312.03(b) (Jan. 11, 2013), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_12_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F [https://perma.cc/QJS4-YLGH].

143 The median total compensation for S&P 500 CEOs in 2015 totaled $10.8 million per year, while the median pay for an outside director of an

commitment, it is unlikely that they will commit to buying stock in such amounts just to show their genuine opposition to the bid.[144] Second, according to a new exemption to the rules from December 2015, said NYSE rule does not apply to small firms.[145] Third, even though it will complicate things in other ways, the target directors may avoid the applicability of the NYSE rule by committing to buy the stock from the shareholders and not from the target. Finally, even in those

S&P 500 company was only $255,000 per year as of October 2015. *See* EQUILAR/ASSOCIATED PRESS, *supra* note 64; Tom Huddleston, Jr., *Here's Why It Pays to Be a Corporate Director*, FORTUNE (Feb. 24, 2016), http://fortune.com/2016/02/24/sandp-500-nonexecutive-directors-pay/ [https://perma.cc/Y3YF-DCUU].

144 This is also the reason why higher thresholds are not expected to inhibit the arrangement. For example, Nasdaq, the NYSE, and the NYSE MKT require shareholder approval before listed companies can issue 20% or more of their outstanding common stock or voting power in a "private offering." See New York Stock Exchange Listed Company Manual, § 312.03(c), http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp_1_4_12_3&manual=%2Flcm%2Fsections%2Flcm-sections%2F [https://perma.cc/QJS4-YLGH]; NASDAQ Stock Market Listing Rules § 5635(d), http://nasdaq.cchwallstreet.com/NASDAQTools/PlatformViewer.asp?searched=1&selectednode=chp%5F1%5F1%5F4%5F3%5F8%5F26&CiRestriction=5635&manual=%2Fnasdaq%2FMain%2Fnasdaq%2Dequityrules%2F; New York Stock Exchange MKT LLC Company Guide, § 713(a), http://wallstreet.cch.com/MKTtools/PlatformViewer.asp?SelectedNode=chp_1_1_7&manual=/MKT/CompanyGuide/mkt-company-guide/. Also, the SEC requires a person or group of persons who acquires beneficial ownership of more than 5% of a voting class of a company's equity securities to file a Schedule 13D with the SEC. *See Schedule 13D*, SEC (Dec. 5, 2012) https://www.sec.gov/answers/sched13.htm [https://perma.cc/LV4H-L2HD]. However, the proposed arrangement is not expected to trigger this threshold because it does not aim to induce outside directors to gain a controlling interest in the target firm just to show their genuine opposition to the hostile bid.

145 In December 2015, the NYSE amended Section 312.03(b) of its Listed Company Manual to permit "early stage companies" to issue shares of common stock (or exchangeable or convertible securities) without shareholder approval to a related party, subsidiary, affiliate, or other closely related person of a related party or any company or entity in which a related party has a substantial direct or indirect interest. *See* New York Stock Exchange Listed Company Manual, § 312.03(b), *supra* note 142.

rare cases where the NYSE rule will constrain execution of the directors' commitment, it will not harm the validity of that commitment and thus will not jeopardize the benefits of the arrangement.

B. The Proposed Arrangement

The proposed arrangement, which focuses on identifying the desirability of the hostile bid as the target board genuinely perceives it, is borrowed from the approach that economists take in signaling models.[146] Throughout this Part, the arrangement is analogized to the problem of insurance companies that look to determine drivers' participation fees as a means to gauge the riskiness of drivers as they genuinely perceive themselves.[147]

Because important information about the riskiness of the driver cannot be credibly communicated, and because the driver is in a conflict of interest with the insurance company, the insurance company does not try to identify the riskiness of the driver by asking the driver to fill out long questionnaires. Instead, it offers the driver two types of contracts—one with a high premium and low participation fee, and the other with a low premium and high participation fee. The driver is better off choosing the second contract only if, after considering all the public, soft, and secret information she has, she genuinely believes that she is a good driver. If she is wrong about her estimate, she will end up paying more in total than if she chose the first contract.

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146 *See, e.g.,* Akerlof, *supra* note 6, at 488.

147 Although the insurance company paradigm uses solutions offered by screening (and not signaling) models, I draw this analogy because that paradigm illustrates an arrangement that focuses purely on eliciting private information. Also, both signaling and screening aim to solve the same asymmetric information issues, the only difference between them being the identity of the party that initiates transmission of the signal. While in signaling models the party who holds the information signals her information, in screening models (used by insurance companies) the uninformed party induces the informed party to reveal their information.

In addition to the valuable information that the driver transmits to the insurance company when picking the preferred contract, the insurance company benefits from improved incentives for the driver who wishes to take the high participation fee contract. For such driver, it is now more profitable to take extra care while driving because the consequences of an accident will be more costly, whereas the opposite is true for the driver who picks the low participation fee contract.

The case of target boards and shareholders is, in principle, comparable to that of drivers and insurance companies. Because important information about the quality of the target board cannot be credibly communicated, verified, or evaluated,[148] and because the target board, due to it conflict of interest with its shareholders, is uninterested to communicate such information to them, shareholders would not benefit from asking the board to disclose each piece of such non-verifiable information they need in order to evaluate the intrinsic value of the firm or its strategic alternatives. Instead, just like drivers, target boards should transmit their bottom-line understanding about the desirability of the bid based on the new set of incentives that the proposed arrangement provides them, and without trying to convey each piece of non-verifiable information separately. Specifically, target boards should choose between two contracts: one that involves the dismantling of their antitakeover defenses without incurring any cost, and one that enables them to maintain and erect defenses but potentially imposes on them a unique cost. If the directors choose the second contract, the arrangement will require them to commit to buy, if the bid fails, a specified amount of target stock at the bid price and hold it for the long term.[149] The directors will be better off choosing the second contract

148 *See* discussion in *supra* Section II.A.

149 For ease of exposition, this Article hereinafter refers to such commitment of outside directors per the proposed remedy as the "directors' stock commitment" or "the stock commitment."

only if they genuinely believe, after considering all the public, soft, and secret information they have, that the bid should be rejected because they will maximize long-term shareholder value better than the bidder. This result is equivalent to drivers who will choose the contract with the high participation fee only if they genuinely believe that they are careful drivers.

Just like with insurance companies, shareholders will benefit not only from the transmission of valuable information about the quality of the target board compared to the bidder but also from the improved incentives that the target board will have once it picks the contract that allows it to use antitakeover defenses in the face of the hostile bid. Specifically, it will become costlier for the target directors *not* to try to maximize long-term stock value because they stand to lose on their commitment stock as long as they do not do better than the bidder in the long term. Unlike with insurance companies, however, shareholders should not be concerned with the incentives of the board that picks the no-antitakeover defense contract, because that board is soon likely to be removed by the hostile bidder.

Despite the seemingly analogous situation between shareholders and insurance companies, there are important differences. Unlike insurance companies, which do not suffer from collective action problems and which focus on maximizing profits, shareholders, as explained in Section II.B, might not choose to maximize long-term firm value, and even when they are motivated to do so, their collective action problems might prevent them from making the right decision. Thus, unlike insurance companies, which set up the rate of participation fees, the proposed arrangement suggests that shareholders (the equivalent of insurance companies), who are typically dispersed, should not determine the directors' stock commitment; rather, target boards (the equivalent of drivers) should determine that commitment.[150]

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[150] *See supra* note 147.

Also, because target boards are in a conflict of interest with their shareholders, empowering the boards to decide their own stock commitment amounts is problematic. Thus, as this Article explains below, their commitment decision should be monitored twice—first, in a nonbinding manner, by engaging the target's major long-term investors, who may be assisted by their proxy advisory firms, and second, by courts that adjudicate substantive coercion.

Specifically, a board that wishes to fend off a hostile bid may apply the following proposed arrangement by having its outside directors hold an executive session and pass the following resolution:

> After thoroughly discussing the recommendations of the special committee that was commissioned to evaluate the desirability of the unsolicited bid, and after receiving the endorsements of the Corporation's ten major long-term institutional investors and ISS [Institutional Shareholder Services] to the resolutions herein, we hereby resolve as follows:
>
> The unsolicited bid price is clearly lower than the intrinsic value of the Corporation and its strategic alternatives and hence poses a serious threat to the Corporation's shareholders, policies, and effectiveness. Therefore, we support the Board resolution to place certain defensive tactics, specified in Exhibit A herein.
>
> Because the bid price is inadequately low, we encourage each outside director, in order to demonstrate his or her personal belief in rejecting the bid, to commit to buy from the Corporation, and if the bid fails, some Corporation stock at the bid price and hold it for a specified time.
>
> Specifically, we recommend that each outside director commit to use one third of his or her cash compensation during a single calendar year following the failure of the bid to purchase stock from the Corporation at the bid price and to hold such stock for at least three years. We also recommend that the outside directors' Stock Ownership Policy will apply to their holding of such stock in the event of director retirement.

> The final decision to commit to buy and hold such shares is left for each outside director's consideration. Each director's commitment decision is attached in Exhibit B herein and constitutes an integral part of this resolution.
> We will convene a full board meeting to resolve that the Company will issue new stock, after the bid fails, and will sell it to each of the outside directors pursuant to his or her said commitment.

The following sections discuss the various elements of the proposed arrangement.

1. The Stock Commitment Should Be Made by Outside Directors

This Article suggests that targets' outside directors exclusively make the stock commitment. It suggests this not only because outside directors already fill the vast majority of board seats, occupying 85% of S&P 500 firms' directorships,[151] but also because keeping inside directors away will help to effectively achieve the main goals of the proposed arrangement.

First, because outside directors, unlike insiders, are independent[152] their entrenchment bias is significantly weaker, making them less incentivized to withhold their genuine beliefs from courts. Moreover, the arrangement will increase their independence as it specifically requires them to consider putting their own money on the line to justify their decision to place defenses, making them less likely to bend to the wishes of the CEO. In addition, the stock

151 *See* Ann Yerger, *Corporate Governance by the Numbers*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Aug. 9, 2016), https://corpgov.law.harvard.edu/2016/08/09/corporate-governance-by-the-numbers/ [https://perma.cc/TWE2-V5HL].

152 Under the NYSE rules, for a director to be independent, the board must affirmatively determine that the director has "no material relationship with the listed company." *See* NYSE Arca Equities Rules, 5.3(k), NYSE (Oct. 12, 2011), http://nysearcarules.nyse.com/pcx/pcxe/pcxe-rules/chp_1_1/chp_1_1_6/default.asp [https://perma.cc/4J7Q-UJ2P].

commitment per the arrangement will increase their interest in the firm, thereby empowering them vis-à-vis the insiders.

Second, reliance on outside directors fits nicely with the current Delaware doctrine, under which directors are conferred with the power to decide whether to fend off unsolicited bidders.[153] With power comes responsibility; such directors should also be the ones who can use the proposed arrangement to justify their decisions.

Third, the arrangement requires outside directors to commit less stock than insiders to make credible stock commitments, thereby lowering its costs. Because outside directors stand to lose their future salaries if the bid is accepted—and again, their salary is, on average, more than forty times lower than the CEOs' compensation[154]—and because outside directors are not disproportionately invested in the firm through career concerns of reputation and success, their personal benefit from rejecting the bid is significantly lower than that of insiders. This reduces the cost they need to incur in order to credibly signal the undesirability of the bid.

2. The Committed Stock Should Be Purchased from the Target

The stock that outside directors commit to buy should be purchased from the target rather than from its shareholders. Designing the arrangement this way has two main benefits. First, it renders the directors' commitment binding and therefore easier to evaluate compared to merely a legally qualified promise for the benefit of others.[155] As demonstrated in the sample board resolution above, when the stock commitment is made to the target, the target can

153 *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

154 *See supra* note 143.

155 For the limits of a contract for the benefit of third parties, see, e.g., Arthur Corbin, *Contracts for Benefit of Third Persons*, 27 YALE L.J. 1008 (1918).

(and should) make a matching commitment to sell the committed stock, if the bid fails, to the directors. Unlike the target company, the dispersed shareholders are unable to make such a commitment because of their collective action problems and because their identity might change between the time of the directors' commitments and the time of the failure of the bid.

Second, only when the directors' commitment is made to the target does it affect all shareholders equally. The directors then execute it by buying newly issued stock at a premium. Such new issuance functions economically as a "reverse dividend" to the committed directors alone, thereby positively affecting the value for the other shareholders pro rata. Conversely, if the commitment were made to the shareholders, it would require making another costly tender offer just to ensure that the limited amount of shares that directors buy at a premium is bought pro rata from all shareholders.

3. Stock Commitment Should Be Made Concurrently with Board Rejection of the Bid

To prevent gaming, the proposed arrangement suggests that directors' final individual commitments to buy and hold target stock should be made and announced simultaneously with their decision to reject the bid.[156] It further recommends that courts draw judicial inference from the timing of those stock commitments in the later litigation stage. As shown in the sample resolution above, one practical way to make a concurrent stock commitment is by annexing the individual stock commitment decisions to the board resolution that rejects the bid.

[156] The proposed arrangement is not intended to evaluate "preemptive" defensive tactics—that is, defenses that are placed without a concrete threat that might be posed. As the Delaware Court indicated in *Moran,* such defenses should be reevaluated once a takeover attempt is posed. The proposed arrangement kicks in after that. *See* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350 (Del. Ch. 1985).

If the directors were allowed to wait and consider using the proposed arrangement only after fiduciary duty litigation was filed, they would tend to do so. The directors might postpone their stock commitment decision in order to save their personal commitment costs in case their decision to place antitakeover defenses does not lead to litigation. This chance of not incurring the costs associated with the proposed remedy would, in turn, encourage directors to distort their response to bids and reject them too frequently.

Moreover, if directors could wait until litigation ensues, they would tend to make excessive commitments, thereby increasing the arrangement costs. Because litigation increases the risk of removal in the takeover and adds the risk of liability for breach of fiduciary duty, the perceived cost for directors of not making a persuasive commitment would increase. This would push them to make stock commitments that are too high, thereby triggering excessive costs and complicating the inferences that courts could make from their decision to commit to buy stock.

For the same considerations that weigh against letting target boards decide on their individual commitments until litigation is filed, the directors should not be allowed to change their stock commitments after having announced them. Otherwise, boards would be encouraged to make low commitments first, and then, if they realize that they face fiduciary duty litigation down the road, increase them.

Finally, if the directors' commitment is made only after litigation ensues, directors will not have sufficient time to engage with their shareholders effectively. The following Subsection describes the importance of such engagement.

4. Directors' Stock Commitment Should Be Made After Engagement with Major Long-Term Shareholders

Despite the serious shortcomings inherent in shareholder choice in takeover situations that is identified in Part II, the

target's outside directors should be encouraged to engage with long-term, focused institutional investors[157] before deciding whether to accept the bid and before making their stock commitments. Long-term institutional investors, such as pension funds, insurance companies, and major endowment managers, support long-term, sustainable corporate strategies;[158] have in-house analysis departments; are dedicated to corporate governance engagement and analysis; and have corporate governance teams that can access sell-side research and speak with analysts.

For the purpose of engaging with the target board, these major investors may be assisted by their proxy advisory firms, such as Institutional Shareholders Services ("ISS"). ISS has comprehensive data to support shareholder analysis. Its scores provide an indication of management quality, deliver a snapshot view of risk, and are supported by factor-level data that are critical to the shareholders' evaluation

157 To decide which shareholders qualify under such definition, targets can, as a point of reference, use the thresholds of stakes and holding periods stipulated in the SEC's May 2009 proposed proxy access rule or in its August 2010 final Rule 14a-11. Under the proposed rule, a shareholder or shareholder group that owns more than 1% of a large U.S. public company (defined as having market capitalization greater than $700 million), more than 3% of a midsize public company (market capitalization of between $75 million and $700 million), or more than 5% of a small public company (market capitalization less than $75 million) would be qualified to place nominees on the company's proxy statement. The proposed proxy access rule did not require a holding period for shareholders to qualify for proxy access. The final Rule 14a-11 mandates proxy access to any shareholder or shareholder group that has held more than 3% of a U.S. public company's shares for more than three years. Exemptions to Facilitate Intrastate and Regional Securities Offerings, 17 C.F.R. §§ 200, 230, 239, 240, 249, 270, 275 (2016).

158 *See* ERNST & YOUNG, 2016 PROXY SEASON PREVIEW: A FOCUS ON THE LONG TERM (2016), http://www.ey.com/GL/en/Issues/Governance-and-reporting/EY-2016-proxy-season-preview-a-focus-on-the-long-term [https://perma.cc/M3T7-3G9N].

process.[159] Moreover, ISS has tremendous influence on firms, which will empower investors in their engagement with the directors.[160] For example, ISS can urge shareholders to initiate no-vote campaigns against directors who will not commit enough stock per the arrangement or to make "against" say-on-pay recommendations for boards that choose to reject a bid that it favors.[161]

Thus, this Article proposes that courts give judicial weight to enhanced shareholder engagement in implementing the proposed remedy. Such judicial inference would fit the prominence that shareholder engagement has recently gained. In particular, during the last six years, shareholder engagement increased eleven-fold, encompassing 66% of S&P 500 firms in the 2016 proxy season.[162]

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159 *See* INSTITUTIONAL SHAREHOLDER SERVS., ISS GOVERNANCE QUICKSCORE 3.0 (revised 2015), https://www.issgovernance.com/file/products/quickscore_techdoc.pdf [https://perma.cc/N2QL-LTES].

160 Companies often tailor their policies to meet ISS guidelines, and firms lobby for ISS support to fend off shareholder proposals. For example, when ISS recommends against say-on-pay, shareholder support levels are typically reduced by 20 to 30%. Consistent with this pattern, in 2015 approximately 20% of the companies that received "against" vote recommendations from ISS failed their say-on-pay vote. *See* FREDERIC W. COOK & CO., INC & SIMPSON THACHER, U.S. EXECUTIVE COMPENSATION 2015 RECAP, KEY DEVELOPMENTS & NOTABLE TRENDS 5 (2016), http://www.stblaw.com/docs/default-source/memos/firmmemo_fwcook_03_31_16.pdf [https://perma.cc/5VGD-QQDG]. Also, the relentless efforts that HP's former CEO, Carly Fiorina, made to gain ISS support in the HP Compaq merger demonstrates the decisive importance of ISS. *See* Pui-Wing Tam & Gary McWilliams, *ISS Recommends H-P Holders Vote In Favor of Acquisition of Compaq*, WALL ST. J. (Mar. 6, 2002), https://www.wsj.com/articles/ SB1015352824755238080 (reporting that "many money-management firms take ISS's reports into account before voting in a proxy battle").

161 ISS and other proxy advisory firms have not been shy about using withhold-vote campaigns to punish directors who make decisions they do not like. *See* Guhan Subramanian, *Corporate Governance 2.0.*, HARV. BUS. REV., Mar. 2015, at 99.

162 *See* ERNST & YOUNG, *Four Takeaways from Proxy Season 2016* (2016), at 2, *available at* http://www.ey.com/Publication/vwLUAssets/EY-

5. Boards Should Recommend and Individual Directors Should Decide the Stock Commitment Amounts

As reflected in the sample executive session resolution in the beginning of this Section, the proposed arrangement provides that independent directors should decide collectively (1) whether to accept the bid, and (2) whether they recommend that each individual director commit to buy a certain amount of stock per the arrangement and hold it for a certain time. The final decision on whether to commit such stock and, if so, how many shares and for how long, should be left to each director individually. This recommendation not only strikes the right balance between the individual directors' property and privacy rights, on the one hand, and the prerogative of the board, on the other hand, but also—and mainly—is expected to contribute to the optimal functioning of the proposed arrangement.

The proposed arrangement provides that boards make a collective recommendation about stock commitment amounts for two major reasons. First, such a recommendation communicates the entire board's official understanding about the severity of the threat that the unsolicited bid poses to corporate policies and effectiveness. Second, it helps prevent director free riding. Without a strong sense of collegiality among the outside directors or a concrete fear that inside directors will punish those outside directors who do not make significant stock commitments, there is a risk that each director will commit to buy a suboptimal amount of stock—not because she disbelieves the desirability of the defensive tactics, but because she wants to free ride the stock commitment of her fellow directors. The board's collective decision will work against this by imposing peer pressure on

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four-takeaways-from-proxy-season-2016/$FILE/EY-four-takeaways-from-proxy-season-2016.pdf [https://perma.cc/J9UR-9EZD] (explaining that in the 2016 proxy season 66% of proxy statements for S&P 500 companies disclosed engagement with their shareholders, whereas in 2010 only 6% of S&P 500 firms disclosed engagement).

each director to avoid committing below the recommended level.

Yet the proposed arrangement suggests that stock commitment amounts be made by each outside director individually because the cost of such a commitment may vary significantly for each director. For example, even if all directors agree that the bid price is significantly lower than the intrinsic value of the firm and that, for many of them, the cost of committing to buy and hold stock at the bid price is fairly low, for some directors that cost may be high. This might be so if the directors need more liquidity, are more risk averse, or are less wealthy, or if their overall portfolios are less diversified. Moreover, the personal benefit from making the stock commitment—namely, avoiding removal from the board—can vary as well, depending on the director's age, tenure, shareholder support, and, especially, plans to remain with the firm.

6. Deciding Directors' Stock Commitments

Because the directors' stock commitment should communicate the target board's genuine belief about the desirability of the takeover, it is essential that their commitment be effectively decided by the outside directors and interpreted by courts and shareholders. The analytical process this Article uses for deciding and understanding the commitment amounts involves two stages: (1) find the credible commitment amount based on a theoretical model this Article constructs, and (2) make a series of downward adjustments to such amount.

a. A Model for Deciding Directors' Stock Commitment Amounts

The game theoretical model in the Appendix provides a framework to decide the amounts of director stock

commitment that will render it credible.[163] The model builds on well-established signaling models in game theory.[164] It begins by identifying the maximal stock commitment amount of an outside pivotal director, who genuinely believes that the bid price exactly equals the intrinsic value of the firm (a bid for which long-term shareholder value is not expected to change). This amount is found at the point where her total costs equal her total benefits from making her commitment per the proposed arrangement.

Because the pivotal director's stock commitment is expected to increase the odds that the takeover will be rejected, the director's benefits from making the commitment includes keeping her pecuniary and nonpecuniary benefits related to her directorship.[165] In particular, by securing her board position, she keeps her future salaries, prestige, and network. Given that median pay for current outside directors in S&P 500 firms is $255,000,[166] this benefit is fairly

163 The intuitive explanation in this Part generally follows the logic of the formal model in the Appendix, but it adds a preliminary step by identifying the "pivotal director" commitment amounts.

164 *See, e.g.*, Akerlof, *supra* note 6.

165 Because the stock commitment also helps in keeping the executive's position, the outside director who makes the stock commitment will not only prevent her removal by the bidder, but also increase her bond with the incumbent executives, thereby improving the odds of her placement on future management slates for director election.

166 *See* Huddleston, *supra* note 143 (reporting that "the median pay for an independent board member of an S&P 500 company was $255,000 per year" as of October 2015). Today, it is common to find a three-tiered compensation structure for outside directors, with audit committee members at the top, then compensation committee directors, and all remaining directors in a third group. *See* Ann Bares, *Back to the Future: A Reversal of the Committee-Based Board Compensation Trend?,* COMPENSATION FORCE (Apr. 16, 2012), http://www.compensationforce.com/board_of_director_compensation/ [https://perma.cc/53ZD-BTK4]. Because the stock commitment benefits increase with expectation for future salaries, the stock commitment amount for directors in the upper tiers should be higher than those for directors in the lower tiers. As this Article demonstrated above, one practical way to reflect this is by having the stock commitment framed as a percentage of future salaries.

significant, especially when the director has long-term plans to serve on the target board. In addition, studies indicate that the roles of prestige and network in outside director appointments are significant.[167] Because the director's service on the board is likely to increase her prestige and network whereas a successful takeover stands to harm them, opposing the takeover and making a credible commitment is likely to increase the director's prospects to receive other directorships.

Yet the pivotal director's stock commitment incurs a series of costs: (1) the opportunity cost of buying stock that is traded at a certain low price for a premium; (2) liquidity costs, as the funds that the director locks into their commitment will not be available for any other investment or consumption activity; and (3) some diversification costs, because the director's stock commitment per the arrangement will add to their other involuntary, firm-specific investments, such as restricted stock compensation and SOP.

Yet only a few of these commitment costs and benefits are significant. Primarily, making a credible commitment will help the pivotal director keep her future salaries but will also cost the director the bid premium times the amount of commitment stock. Again, the director's maximal stock commitment is found at the point where the sum of her benefits equals the sum of her costs. For example, if committing to buy 100 shares at the bid price and to hold them for three years costs the director $50, such a commitment represents her maximal commitment level if the sum of her commitment benefits also equals $50.

After thus finding the maximal stock commitment amount of the pivotal director, the model demonstrates that only outside directors who are willing to match such a stock commitment can transmit their belief that the bid should be rejected in a way that will be perceived as genuine. "Good

[167] *See* Tom Kirchmaier & Michael G. Kollo, *The Role of Prestige and Networks in Outside Director Appointments* (Aug. 20, 2007) (unpublished manuscript) (on file with the London School of Economics).

Type Directors" are defined as directors who genuinely believe that that they will do *better* than the bidder in maximizing the target's long-term value.[168] Because, unlike the pivotal director, Good Type Directors expect to pocket a net profit from selling their committed stock in the long term, they expect to make a total net profit from matching the pivotal director's maximal stock commitment. Conversely, "Bad Type Directors," or directors who genuinely believe that that they will do *worse* than the bidder in maximizing the target's long-term value, are likely to sell their commitment stock at a loss, making it unattractive for them to match the pivotal director's maximal stock commitment.

b. Downward Adjustments

After using a theoretical model to find the threshold indicative of a credible commitment amount, it is important to note that in the real world the theoretical threshold should be adjusted downwards. First, because my model ignores external constraints on directors' opportunism, the threshold should be adjusted downwards for targets with good corporate governance. The checks and controls that such targets impose effectively reduce the risk that their directors will behave opportunistically. Therefore, greater reliance should be put on those directors, and their need to commit stock to justify their decision to reject a bid should be reduced.

A target's corporate governance quality can be assessed during the engagement phase mandated by the arrangement. ISS developed a comprehensive governance risk tool called QuickScore, which provides corporate

[168] This Article uses "good type directors" and "bad type directors" as an analogy to the two types of employees—good and bad—that Michael Spense used in his hypothetical example in his seminal signaling article. See Spence, *supra* note 6.

governance scores to firms.[169] Other corporate governance indicators should be considered as well. For example, "say-on-pay" results can indicate overall shareholder satisfaction with the target's corporate governance; specifically, a favorable vote of over 90% of the shareholders can indicate good corporate governance.[170] The twenty-four provisions included in the Gompers, Ishii, and Metrick corporate governance index,[171] or the six-factor entrenchment index developed by Bebchuk, Cohen, and Ferrell,[172] can also aid in the assessment.

There are three other reasons for adjusting the threshold for directors' credible stock commitment downwards. First, because—unlike in my mathematical model—directors are typically risk-averse and the future value of targets is uncertain, outside directors will discount their stock commitments. Second, outside directors' stock commitments are not an exclusive factor in the court's determination, a fact that reduces a director's potential benefits from making the commitment while not changing its costs. Finally,

169 QuickScore allows investors to assess their firms' level of corporate governance risk. Scores are based on each company's policy relative to what ISS views as "best practice" in the relevant global market. Answers are converted into numerical values using a grading system determined by ISS, and the results are converted into overall scores and levels of concern (e.g., low, medium, and high) in each of four areas. Generally, QuickScore's scoring for a question uses a scale of minus 5 to 5, with 0 being neutral. Scores are then normalized on a 100-point scale (e.g., 0 to 100). *See* INSTITUTIONAL SHAREHOLDER SERVS. INC., *supra* note 159; GARY HEWITT, INSTITUTIONAL S'HOLDER SERVS. INC., GOVERNANCE RISK INDICATORS 2.0 (2012), http://www.issgovernance.com/file/files/GRId2.0_Technical Document 20120306.pdf [https://perma.cc/M9BA-C8TT].

170 During the 2011–2014 proxy seasons, 75% of companies received over 90% favorable votes from their shareholders. *See* Joseph E. Bachelder III, *A Say on "Say-on-Pay": Assessing Impact After Four Years*, HARV. L. SCH. F. CORP. GOV. & FIN. REG. (Apr. 3, 2015), https://corpgov.law.harvard.edu/2015/04/03/a-say-on-say-on-pay-assessing-impact-after-four-years/ [https://perma.cc/J7FQ-UWYG].

171 *See* Gompers et al., *supra* note 78.

172 *See* Lucian Bebchuk et al., *What Matters in Corporate Governance?,* 22 REV. FIN. STUD. 783 (2008).

outside directors' available cash for making their stock commitments is limited. Most of their pay is in the form of restricted stock, and even stock that is no longer restricted might be subject to SOPs. Therefore, as this Article demonstrates in the sample board resolution above, the commitment can practically be applied only to a certain percentage of the directors' cash compensation component.

7. Special Cases That Justify Partial or No Applicability of the Arrangement

The preceding Section has shown that it is generally possible to decide the stock commitment amounts that directors should make. This Section argues that there are nevertheless special cases in which a partial or full exemption from the arrangement is warranted—in particular, cases of multiple simultaneous or sequential bids, cases of nuisance and opportunistic bids, and instances in which independent directors stand to retire.

a. Multiple Offers

The case of target firms that face multiple takeover attempts, simultaneous or sequential, requires special attention because applying the arrangement strictly to each bid separately might cause outside directors to run out of cash, rendering them unable to commit shares against all of the bids. It can also create an unreasonable burden on outside directors in firms that face multiple takeover attempts and might discourage talented directors from serving in such firms—firms that might really need them.

In the case of multiple simultaneous bids, or bids in a "bidding war," the solution put forth by this Article is to allow boards to use the arrangement only against the most attractive bid. Because a director's credible stock commitment against the most attractive bid shows that all other bids are unattractive, that commitment should suffice for courts and shareholders. Indeed, deciding which bid is the most favorable for shareholders might require some discretion because some bids involve noncash components.

But boards and courts, assisted by investment bankers, make such judgments routinely. Also, target boards have an incentive to correctly evaluate which bid is most attractive because otherwise they run the risk that courts and shareholders will perceive their stock commitment as too weak.

In the case of multiple sequential bids—bids that are filed after a previous bid has failed but before the holding period of the shares that directors committed in opposition to it has expired—the proposed arrangement recommends allowing target directors who wish to commit shares against the new bid to sell such previously committed stock despite the fact that its holding period has not lapsed yet. Such potential sale would prevent opportunistic bidders from taking advantage of the liquidity shortage that target directors might otherwise suffer when facing sequential bids.

Directors should use the proposed arrangement against a new bid even if it is not as favorable as the bid they previously opposed. The need for their new commitment comes from the concern that, between the time of the previous bid and the time of the new bid, market conditions might have worsened, directors' expectations for intrinsic value might have lowered, and the stock price might have dropped. Because of the distinct solutions that the arrangement provides for nuisance and opportunistic bids, it is not expected that such a requirement would be excessively burdensome.

b. Nuisance and Opportunistic Bids

Because opportunistic bidders might try to file nuisance bids just to disrupt the target and impose costs on its outside directors, the arrangement suggests exempting target directors from making stock commitments against such bidders. In particular, it recommends that target boards be exempted from using the arrangement in order to show their opposition to bids that are not fully financed or are reversible. Courts, in turn, should be prevented from drawing negative inferences about the directors' decision to

avoid making a stock commitment under such circumstances.

The arrangement further suggests that if the majority of outside directors perceive a bid to be opportunistic and meritless, the board should be allowed to call a special shareholder meeting to approve exemption from the arrangement. But to prevent misuse by boards—as would occur, for example, by bundling such decisions with measures that enjoy shareholder support[173]—it recommends that such shareholder exemption may only be requested on a case-by-case basis (i.e., boards should not be allowed to initiate charter or bylaw provisions exempting themselves from the prescribed arrangement except for case-specific shareholder-approved instances).

c. Directors Who Retire Soon After the Takeover Attempt

The case of directors who will retire soon after a failed takeover requires special treatment. The main personal benefit for directors who make a stock commitment in opposition to a takeover—improving the chance of keeping their jobs—disappears if they plan to leave the firm anyway. Therefore, the arrangement suggests that when a director commits to not running for the next election, that director should be exempted from committing stock against the takeover. With such a guarantee in place, courts and shareholders will know not to confuse the director's lack of commitment with a genuine support of the bid. In addition, the director's oral statements about the desirability of the bid will be given more credibility, given that the director has no apparent self-interest in rejecting or accepting the bid.

To be sure, the case of directors who know that they will retire soon is different from that of directors who will retire soon but are unaware of it when making their stock commitment. For directors who do intend, at the time of the

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[173] *See generally* Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1551 (2010).

takeover, to stay with the firm but who end up leaving before the holding period of their committed stock expires, this Article suggests that they fully abide by arrangement at the time of the takeover. However, they should be allowed to sell their committed stock once they leave the firm because it is unfair to expose them to the consequences of other peoples' decisions once they can no longer influence them. Also, such relief is consistent with restrictions on shares held under director SOPs.[174]

8. Integrating the Arrangement into Delaware's Takeover Doctrine

In principle, once the legal impediments specified in Section A of this Part are removed, target directors may use the proposed arrangement voluntarily, without it being formally adopted by any legal standard. Still, in order for the arrangement to work properly the Delaware courts should formally integrate it into their takeover doctrine. Otherwise, target boards would not be expected to use the arrangement voluntarily. Currently, as described in Section V.B, target boards are often able to "just say no" and avoid effective judicial review, which leaves them without any incentives to incur the personal costs of the arrangement to potentially improve their persuasive power in court.

Also, in those rare cases when target boards stand to lose the trial, they might not use the arrangement effectively because of uncertainty about the weight that judges might give it. For example, because it has not been formally integrated into legal doctrine, target boards might mistakenly assume that the court will give the arrangement only minor weight. This, in turn, will induce the directors to commit too low, or not commit at all, thereby suggesting to the court that the directors do not genuinely believe that the bid should be rejected.

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[174] *See* Shilon, *supra* note 59 (explaining that, save for financial firms, shares held under SOPs may be sold immediately after the manager leaves the firm).

Thus, courts should integrate the arrangement into their takeover doctrine and do so specifically by giving the directors' stock commitments significant weight in adjudicating substantive coercion—that is, when they decide whether the unsolicited bid price is too low, which is the first step in proving substantive coercion.

In addition, the directors' stock commitment will be significant in substantiating the other elements required to prove substantive coercion. Specifically, in addition to showing that the bid price is too low, the board should demonstrate (1) that the shareholders will accept the offer because of "ignorance or mistaken belief" regarding the board's assessment of the long-term value of the target stock[175] (ignorance that has been bolstered by the magnitude of soft, secret, and other inside information that has contributed to the level of the directors' stock commitment);[176] and (2) that the specific defensive tactics taken by the board are reasonable in relation to the threat posed.[177] Here, the intensity of the directors' stock commitment indicates the severity of the threat and, hence, the proportionality of the defensive tactics that were placed in response to it.

Yet, while courts should give significant weight to the directors' stock commitment, they should not perceive that commitment as conclusive evidence of the directors' credibility vis-à-vis their assessment of the hostile bid. First, just like with most legal standards, there is no absolute certainty in determining the exact amounts that render such commitments credible. The model developed herein narrows down the controversy to potential disagreements on assumptions and measurement of certain variables, but it

175 *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1384 (Del. 1995).

176 In addition, target boards may use the analysis discussed *supra* in Section V.B. to show that shareholder choice is expected to deviate from maximizing long-term firm value even if the target's intrinsic value is known to the shareholders.

177 *See supra* note 86.

cannot extinguish all uncertainties or disagreements. Second, in addition to factors that target boards are tasked to evaluate, courts should consider systemic, macroeconomic, and legal policy matters.

9. Enforceability

For a director's stock commitment to have credibility regarding his assessment of the hostile bid, that commitment must be enforceable. Because the commitment is made as a binding board resolution, the target has the right to sue directors who does not execute their stock commitment. If it does not, all shareholders who own shares contemporaneously with the lawsuit and at the time that the commitment was made are entitled to sue that director in a derivative suit.[178] Typically, the bidder will be entitled to use this right as a shareholder as well. This is because (1), the bidder would have accumulated up to 5% of the target shares when the director's stock commitment was made,[179] and (2) the bidder would still be a shareholder at the time of the lawsuit because the director's commitment would have been executed right after the failure of the bid.

It should be stressed that the Author believes the arrangement is desirable in each of its elements; its adoption is not contingent upon every element's incorporation. Readers may conclude that they support directors' stock commitment in takeovers but might object to one or more of the elements proposed. For example, they might suggest that the directors' stock commitments be addressed directly to shareholders[180] or that boards be allowed to commit to buy shares for more than the bid price. Still, this arrangement can be useful in furthering the discussion on incorporating

178 *See* FED. R. CIV. P. 23.1(b)(1) (2016).

179 Because of the bidder's incentive to purchase shares at a low price before she launches the bid, she will typically acquire up to 5% of the target stock, the maximum amount she is allowed to acquire before making a tender offer.

180 *See* Bebchuk, *supra* note 4.

managerial stock commitments in opposition to hostile takeovers.

VII. THE POTENTIAL BENEFITS OF THE PROPOSED ARRANGEMENT

The preceding Part proposes an arrangement to allow outside directors of target firms to communicate their opposition to a takeover bid by committing to buy from the target—if the bid fails—a certain amount of target stock at the bid price and hold it for a specified period. The arrangement explicitly requires that the stock commitment be made concurrently with the board decision to reject the bid and after meaningful engagement with the target's major, long-term shareholders. It also offers a practical way to decide stock commitment amounts by recognizing that some cases require tailored solutions. This Part discusses the potential benefits of the proposed arrangement regarding the information and incentives of every player, as well as the systemic benefits involving enhanced long-term focus by public firms and shareholders as well as the use of market solutions over judicial intervention.

A. Information Improvements

Part III explained why courts have failed to receive soft, proprietary, and other inside information about the desirability of the bid. Section V.A discussed why shareholders lack the necessary information and expertise to evaluate hostile bids. Under the proposed arrangement, however, such valuable information is credibly transmitted from target boards to shareholders and courts. Instead of following the current doctrinal approach, which unsuccessfully tries to verify each piece of material information, the arrangement induces outside directors to transmit their bottom-line understanding about the desirability of the bid. The game theory model in the Appendix shows that directors will be motivated to transmit such information truthfully.

Because the arrangement requires directors to transmit their genuine understanding about the bid when they respond to it, it ensures that such information is disseminated to all market participants even before courts become involved. It also empowers the target's long-term shareholders by giving them a formal role in the decision-making process. Further, stock markets are expected to be responsive to the directors' stock commitments, and if those markets are efficient, they will reflect such information instantaneously after the commitments are made. If markets perceive the stock commitments credibly so that the chance of the current takeover bid to be completed is low, market prices will signal that market expectation to the bidder, which will motivate the bidder to either withdraw his bid or improve it considerably. Importantly, such informational improvement will be done only in the shadow of future litigation, but without the actual need for it.[181]

The game theory model also predicts that the potential improvement in information access would improve asset allocation efficiency. Currently, bidders have only public information about the current value of the target's assets. Because the arrangement will reflect the target board's genuine understanding of the intrinsic value of the target, it will foster more informed competition for its assets. As bidders acquire a better understanding of the incumbent managers' ability to appreciate the value of the target's assets, they will also achieve more certainty about whether they can improve upon the incumbents' use of the assets. This will allow them to better compete for the control of those assets.

181 Because the proposed arrangement allows target boards to use effective defensive tactics before litigation ensues, and because the stock market response to the directors' stock commitments is expected to reveal their credibility, the probable outcome of future litigation will be known to the parties. Therefore, the parties will be better off taking such expected outcome into account and responding to it without wasting the resources to engage in such litigation.

B. Incentive Improvements

This Section discusses the potential benefits of the proposed arrangement. It shows that those benefits are expected to result in both ex-ante and ex-post improvements.

1. Ex-Post Benefits

By ensuring that directors would incur personal costs when they choose to reject hostile bids, the proposed arrangement is expected to reduce target boards' current tendency to reject such bids excessively.[182] In particular, keeping private benefits would become personally unattractive for Bad Type Directors. Moreover, by giving judicial weight to the requirement that directors' final stock commitments be made concurrently with their rejection of the bid, the arrangement encourages Bad Type Directors to dismantle their defenses early. This is because Bad Type Directors are expected to have a weak defense in the fiduciary duties litigation that will follow, and they will face personal liability if they do not repeal their defenses beforehand.

During takeover battles, the arrangement is expected to affect bidders in different ways. Those who are not expected to do better than the incumbents will be motivated to give up, thereby saving litigation costs and disruption to targets. Conversely, those who are expected to do better than management will be encouraged to continue the bid and will have better prospects and stronger incentives to refer to courts if targets do not dismantle their defenses.

In addition, to reduce their commitment costs after they have managed to defeat the bid, the target's outside directors will have a strong interest in pushing managers to run the firm so as to maximize the stock price in the long term. Such incentive is expected to increase the true independence of

182 For a discussion on the current tendency of target boards to reject takeover bids excessively, see *supra* Part IV.

these directors, improve corporate governance, and reduce agency costs.

2. Ex-Ante Benefits

The arrangement helps outside directors avoid choosing between incurring the arrangement's commitment costs or losing their jobs. It encourages them to reduce the likelihood of attracting hostile bids, which they can do by performing their duties faithfully, reducing agency costs, and maximizing the firm's intrinsic value.

The ex-ante benefits are superior to the incentives provided by golden parachutes—those special payments to managers when the company undergoes a takeover.[183] The idea behind golden parachutes was to weaken managers' incentives to resist takeovers excessively by rewarding them for not opposing such takeovers. In so doing, however, golden parachutes encourage managers to facilitate value-destroying takeovers.[184] The proposed arrangement, on the other hand, makes it cost-effective for Good Type Directors to resist value-destroying bids and, by exempting nuisance and opportunistic bids, makes it unlikely that value-destroying bids will be accepted. It also strengthens market discipline, whereas golden parachutes make managers less fearful of a takeover,[185] increase managerial slack,[186] and reduce firm

183 *See, e.g.*, Jay C. Hartzell et al., *What's in It for Me? CEOs Whose Firms Are Acquired*, 17 REV. FIN. STUD. 37 (2004).

184 *See* Lucian Bebchuk et al., *Golden Parachutes and the Wealth of Shareholders*, 25 J. CORP. FIN. 140, 153–54 (2014) (reporting that golden parachutes make it attractive for executives to go along with some value-decreasing acquisitions that do not serve shareholders' long-term interests).

185 For the effect that golden parachutes have on manager incentives by making acquisition more attractive to managers, *see* Richard A. Lambert & David F. Larcker, *Golden Parachutes, Executive Decision-Making, and Shareholder Wealth*, 7 J. ACC. & ECON. 179 (1985); Michael C. Jensen, *Takeovers: Their Causes and Consequences*, J. ECON. PERSP., Winter 1988, at 21, 39–41; Marcel Kahan & Edward B. Rock, *How I*

value.[187] Finally, golden parachutes impose a salient expense on shareholders, whereas the arrangement imposes a unique expense on outside directors.

C. Increasing Long-Term Focus

One of the major criticisms about hostile takeovers is that they lead to an inordinate focus on short-term results.[188] Some argue that bidders take advantage of any short-term decline in stock price and prey on the target. More generally, short-termism is often described as the biggest failure of corporate governance today;[189] even 2016 presidential candidate Hillary Clinton pledged to change America's "obsession" with quarterly earnings.[190] It is ironic that companies such as Dell must go private in order to focus on the long term.[191]

The proposed arrangement shifts target boards' and bidders' focus during hostile takeovers away from short-term to long-term value creation. By making directors' stock commitment cheap when the long-term intrinsic value of the

Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law, 69 U. CHI. L. REV. 871, 898–99 (2002).

186 *See* Bebchuk et al., *supra* note 184, at 141, 153 (explaining that the pattern of deterioration in shareholder value before, around, and after golden parachute adoption is consistent with increased managerial slack as a result of the weakening effect of golden parachutes on the disciplining forces of the market for corporate control).

187 *Id.* at 141, 143 (reporting that firms that adopt a golden parachute experience a reduction in their industry-adjusted Tobin's Q's, as well as negative abnormal stock returns both during the intervolume period of adoption and subsequently).

188 *See* Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 188 (1991).

189 *See* Subramanian, *supra* note 161, at 98.

190 *See* Myles Udland, *Hillary: Corporate America Is Obsessed with "Quarterly Capitalism" — Here's How I'd Change That*, BUS. INSIDER (Apr. 1, 2016), http://www.businessinsider.com/hillary-clinton-quarterly-capitalism-2016-4 [https://perma.cc/73K8-AVFT].

191 Subramanian, *supra* note 161, at 98–99.

firm is high, the arrangement protects firms with long-term focus from myopic bidders. Conversely, by making such commitments too expensive for boards when the long-term prospects are not as good as the current bid price, the arrangement encourages bidders to take over boards with no viable long-term strategies.

Furthermore, the arrangement alleviates the current unrelenting pressure on firms to meet quarterly earnings expectations—a pressure that makes managers fear that even a penny missed could mean a plummet in their stock price.[192] Because the directors' stock commitment would be publicly announced, the target's stock price is expected to adjust to the information embedded in that commitment about the target's long-term value. Such information will counterbalance the present singular focus on quarterly earnings.

Finally, the arrangement empowers long-term shareholders. By instructing courts to give weight to effective board engagement with long-term shareholders, it changes the board's decision-making process from unilateral to collaborative. Also, for directors who wish to oppose the bid and stay in office, it requires them to bond with their long-term shareholders by holding for the long term the stock they committed to buy. Such emphasis on long-term shareholders is especially warranted in takeover situations because expert arbitrageurs and other short-term-driven investors typically flock to the target company, hoping to make a quick profit at the expense of long-term shareholder value.[193]

192 *Id.* at 98.

193 *See* Keith M. Moore et al., *The Behavior of Risk Arbitrageurs in Mergers and Acquisitions*, J. ALT. INV., Summer (2006), at 19, 26; Francesca Cornelli & David D. Li, *Risk Arbitrage in Takeovers*, 15 REV. FIN. STUD. 837 (2002).

D. Empowering Markets

The arrangement also empowers markets and is thus expected to shift a significant amount of the current takeover action away from the courtroom. First, as explained above, the arrangement is expected to improve the informational efficiency of stock markets by reflecting the material information embedded in the directors' stock commitments about the target's long-term value. Second, because it mandates an early engagement with long-term shareholders, boards and long-term shareholders, assisted by ISS, are expected to negotiate and perhaps reach a solution before litigation is filed. Third, as explained above, because the directors' stock commitment, as well as the market response to it, will be known to the bidder, the bidder will have a better understanding of the target's value, which will push the bidder to make an informed decision as to whether to withdraw, keep, or improve the bid instead of submitting to litigation. Fourth, when the bidder decides to increase the bid price, the directors' stock commitments can serve as a bargaining tool for the target, backing up the poison pill.

Finally, if courts decide to dismantle the target defenses and leave the takeover decision to the stockholders, the arrangement ensures that the directors' stock commitments will improve shareholder choice. Consistent with Professor Bebchuk's view,[194] directors' stock commitments per the proposed arrangement have the power to truthfully convey to shareholders the directors' inside understanding about the bid. The ability to use the arrangement after a court has decided to dismantle the target's takeover defenses is important because the court might order a repeal of the defenses even if it thinks that the bid is undesirable for the shareholders—for example, if the target board was unable to prove that shareholders suffer from "ignorance or . . . a mistaken belief" regarding the target's intrinsic value.[195]

194 *See* Bebchuk, *supra* note 4, at 1001–02.

195 Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1384 (Del. 1995).

VIII.WOULD THE PROPOSED ARRANGEMENT INVOLVE ANY SIGNIFICANT COSTS?

Communicating target boards' genuine beliefs about the desirability of unsolicited bids through the proposed arrangement would be unlikely to involve any significant costs. This Section considers the five main ways in which the proposed arrangement could initially be considered costly, and concludes that these concerns are unwarranted.

A. Directors' Professional Decisions Should Not Be Made on Their Own Dime

Currently, U.S. corporate law does not require directors to incur any direct personal costs to justify their business judgment. To the contrary, the law protects them from incurring personal costs when they make mistakes,[196] when they have a financial interest in a corporate transaction,[197] and even when they breach their fiduciary duties.[198] One

196 To encourage directors to take reasonable risks, the well-known business judgment rule insulates them, save for clearly egregious circumstances, from being held to breach their duty of care, even when they make erroneous business decisions. *See* REVISED MODEL BUS. CORP. ACT § 8.31(a)(2) (AM. BAR ASS'N 2003). Moreover, most Delaware companies adopted charter amendments to do away with directors' liability for duty-of-care violations pursuant to the authorization of title 8, section 102(b)(7) of the Delaware Code. *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2016); John Coffee, *Harvey Goldschmid: The Scholar as Realistic Reformer,* 116 COLUM. L. REV. 1 (2016) (describing that within a few years after the 1983 adoption of section 102(b)(7), the vast majority of public corporations adopted a charter provision exculpating directors from liability to stockholders for monetary damages for breaches of the duty of care, except under certain limited circumstances).

197 When directors have a personal financial interest in a corporate transaction, corporate law merely imposes certain procedures before a board action may be taken. *See* WILLIAM T. ALLEN ET AL., CASES AND COMMENTARIES ON THE LAW OF BUSINESS ORGANIZATIONS 269 (4th ed. 2012).

198 Directors who are held liable for a breach of their fiduciary duties often avoid personal liability owing to the indemnification, exemption, and insurance arrangements they entered into with their firms pursuant to title 8, section 145 of the Delaware Code and section 8.57 of the Revised

concern about the arrangement is that it violates this first principle by expecting the outside directors to spend their own money in case they wish to pass a board resolution to fend off a hostile bid.

The proposed arrangement, however, does not require outside directors to spend money out-of-pocket to reject the bid. Instead, it expects Good Type Directors to convert some future cash compensation into restricted stock, while it anticipates that Bad Type Directors will not commit at all. As demonstrated in the sample board resolution provided in Part VI, a practical application of the arrangement can be the conversion of a certain portion of the directors' future cash compensation into restricted stock at the bid price. Such a change in the director's future compensation is in line with a recent trend in director compensation schemes: substituting cash with restricted stock.[199]

B. The Difficulty in Deciding the Credible Commitment Threshold

Another concern about the arrangement is that it is hard to implement because of the practical difficulty inherent in finding the directors' exact commitment level that will render that commitment credible. Finding the exact maximal willingness of the pivotal director to buy stock is complicated and challenging, the argument goes, and making the necessary downward adjustments—based on the target's quality of corporate governance, directors' risk aversion, and weight that courts are expected to give to such a commitment—makes it unrealistic to assume that target boards, shareholders, and even courts will have a reasonable

Model Business Corporation Act. *See* DEL. CODE ANN. tit. 8, § 145 (2016); REVISED MODEL BUS. CORP. ACT § 8.57 (AM. BAR ASS'N 2003).

199 While the cash component of S&P 500 directors increased by less than 25% between 2010 and 2014, the weight of restricted stock spiked by 39%, making it the most dominant component in director pay. *See* EQUILAR INC., DIRECTOR PAY TRENDS 2015: RETAINERS RISE TO REFLECT BOARD RESPONSIBILITIES 10 (2015).

estimation of how many shares the directors should commit to buy in order to genuinely oppose the bid. Accordingly, shareholders and courts would be unable to distinguish between Good Type and Bad Type Directors.

This Article, however, indicates that the above concern is unwarranted. First, despite its theoretical complexity, the important and most dominant factors of the model are easy to determine and measure. Specifically, the main benefit for the directors is keeping their future salaries,[200] and the main cost is the opportunity cost of buying the commitment stock at the bid premium instead of at the market price. Second, the reasonableness of the commitment amounts is ascertainable because, unlike insurance companies' participation fees, the directors' commitment amounts are not decided unilaterally but after thorough collaborative efforts. Such efforts include early engagement with long-term shareholders, assisted by ISS, as well as courts' later monitoring of the commitment amounts and a possible final shareholder vote. Third, even if there is no certainty regarding the exact threshold for credible commitment, the arrangement guarantees important improvements. The directors' stock commitments should be weighed by courts and shareholders in conjunction with all other factors pertaining to the takeover—one of several important factors in the complete mosaic of relevant information.

C. Decrease in Board Independence

Some critics might argue that requiring outside directors to purchase more restricted stock than they already have will compromise their independence. To be able to sell their committed stock at a profit, they may be tempted to adopt

[200] Because the commitment is made by outside directors, and because there is no limit on the number of directorships one can take, it is practically irrelevant to check whether the director can find an alternative directorship if the director is removed. If inside directors make the commitment, however, the calculation of this factor, as well as of others, would become significantly more complicated.

excessively bullish strategies or to turn a blind eye to dubious accounting management practices. Alternatively, because of the additional investment that the arrangement imposes on them, the outside directors will be too cautious in directing the target's future strategy, which will motivate them to turn down value increasing projects.

The reality of director compensation, however, proves that this concern is also not warranted. In particular, outside directors' pay is already dominated by restricted stock,[201] and since firms expect the directors to keep such stock for the long term, they subject their directors to SOPs.[202] The proposed arrangement is consistent with current director compensation schemes and contributes to their efforts to increase directors' stock holding for the long term.

D. The Arrangement Costs Might Be Rolled Over onto Shareholders

It could also be argued that the target's executives will compensate outside directors for the costs that directors are expected to incur in connection with the arrangement's stock commitments. It would be in the CEO's and other executives' interests that the outside directors make high commitment amounts, thereby ensuring their credible resistance to the takeover. Therefore, these executives may informally and secretly promise to make the directors whole for their commitment costs—at the expense of the target's shareholders.

The reality of corporate governance today, however, refutes this argument. First, director compensation is transparent. Current disclosure rules for director pay are

201 In 2014, Fortune 500 outside directors received 56% of their pay in stock. *See* Bowie, *supra* note 58.

202 *See* EQUILAR INC., DIRECTOR STOCK OWNERSHIP GUIDELINES (Mar. 9, 2016), http://www.equilar.com/reports/33-director-stock-ownership-guidelines.html [https://perma.cc/Z46E-4JLE] (reporting that, for the past three years, 90% of Fortune 100 companies disclose director stock ownership guidelines).

clear and detailed,[203] so it is impossible to hide any changes in that pay. Second, if executives compensate outside directors by providing them with additional pay for consulting services or other benefits in addition to their director pay, it will clearly violate director independence rules and force the directors to resign.[204] Third, if the executives try to compensate the outside directors for their commitment costs nonetheless, ISS and other proxy advisory firms can be expected to punish both the directors and the executives by effectively pushing institutional shareholders to vote "against" the target's compensation arrangements in the shareholders "say-on-pay" vote.[205] Moreover, because ISS and other proxy advisory firms have often used withhold-vote campaigns to remove directors who make decisions they do not like,[206] it is reasonable to expect that they will use this tactic against directors who are practically indemnified for their commitment costs.

203 *See, e.g.*, Ryan Villard, *Bigger Shoes to Fill*, C-SUITE 10, 12 (2017), https://www.cooley.com/~/media/cooley/pdf/reprints/2017/2017-02-01-c-suite-issue-22.ashx?la=en [https://perma.cc/8GQ7-BYQ5] (explaining that boards have responded to growing scrutiny around director pay by increasing transparency and shareholder engagement).

204 For example, according to the NYSE director independence rules, a director may not be deemed independent if he or she receives an annual payment of more than $120,000 for the past three years from the company, other than for director and committee fees. *See* New York Stock Exchange Listed Company Manual, § 303A.02 (2017).

205 ISS recommendations on say-on-pay make a great difference. For example, ISS "against" voting recommendation on say-on-pay in 2012 resulted in a significantly reduced level of shareholder support of 65% versus 95% support in executive pay arrangements for firms fortunate enough to receive a "for" ISS recommendation. *See* John D. England, *Say on Pay Soul Searching Required at Proxy Advisory Firms*, PAY GOVERNANCE (June 2012), http://paygovernance.com/say-on-pay-soul-searching-required-at-proxy-advisory-firms/ [https://perma.cc/NBL9-PDND].

206 Subramanian, *supra* note 161.

E. Panglossian Claims

Finally, no discussion of a legal reform can conclude without addressing the "Panglossian argument," which says markets are efficient, and therefore we live in the best of all possible worlds.[207] If a given arrangement were value increasing, the parties involved would have already proposed it because they would benefit from it.[208] Thus, if the proposed arrangement were efficient, it would have already been implemented voluntarily.

The analysis in this Article shows, however, that the Panglossian argument is weak in the case of the reform under consideration. As discussed in Section V.A, U.S. federal laws have long prohibited directors from trading stock in connection with a takeover. In particular, the tender-offer-specific SEC Rule 14e-3,[209] as well as the insider trading "misappropriation theory," do not enable target directors who possess nonpublic material information to buy, or to commit to buy, target stock. Such federal prohibition does not leave it to the discretion of state courts, such as the Delaware Supreme Court, to adopt the arrangement, let alone allow firms to write charter or bylaws provisions that will encourage outside directors to adopt it. The outside directors themselves, even if they feel very strongly about the arrangement advocated in this paper, are forced to refrain from using it because of the aforementioned laws.

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207 *See* Stephen J. Gould and Richard C. Lewontin, *The Spandrels of San Marco and the Panglossian Paradigm: A Critique of the Adaptationist Programme*, PROCEEDINGS OF THE ROYAL SOCIETY OF LONDON (1979) (describing Dr. Pangloss, a naive optimistic philosopher from a parody of Gottfried W. von Leibniz in one of Voltaire's 1759 pamphlets, who claims that our world is the best of all possible worlds).

208 This notion is similar to the idea of Coasian bargaining, according to which individuals may be able to solve the problem of externalities through negotiation, without involving a government. *See* Ronald Coase,. *The Problem of Social Cost*, 3 J.L. & ECON., 1 (1960).

209 17 C.F.R. § 240.14e-3 (2016).

IX. CONCLUSION

This Article analyzes a basic problem in American corporate law: how to improve shareholder protection from underpriced takeover bids. Shareholders need such protection not only because they typically lack access to material information pertaining to the intrinsic value of the target and, hence, the desirability of the bid, but also because the interests of some shareholder groups might deviate from maximizing long-term shareholder value, leading those groups to substantively coerce the firm and the other shareholders into accepting an undesirable bid. Target boards, the stewards of the corporation who are also best situated to evaluate the desirability of the bid, have a conflict of interest with their shareholders and tend to reject hostile bids to an excessive degree. Finally, the current process-based Delaware takeover doctrine is ineffective because it fails to distinguish between directors' legal independence and their factual independence. Courts also lack competence in reviewing the financial and legal expert opinions that target boards rely on to justify their takeover decisions.

This Article has proposed a novel legal arrangement based on well-established economic game theory models. The core purpose of the arrangement is to ensure that target boards which wish to reject unsolicited acquisition offers signal their genuine beliefs about the undesirability of the bid by committing to purchase from the target if the bid fails and to hold for a specified period of time a certain amount of the target's shares at the bid price. Just like drivers who choose their participation fees, target boards are not expected to convey each piece of nonverifiable information separately, but should transmit to outsiders their bottom-line understanding about the desirability of the bid as a whole—an understanding that is communicated by their stock commitments. The motivation directors have to commit comes from their assurance that in a potential fiduciary duty lawsuit, courts would give their commitments significant weight in substantiating their defense that they rejected the bid to protect their shareholders.

This Article explains how the proposed arrangement would address important problems in corporate takeovers. Because target boards would find it cost-effective to credibly transmit their genuine bottom-line understanding about the desirability of the bid, the effectiveness of courts' judicial review would greatly improve. The fact that directors would no longer be able to reject takeovers and keep their jobs without incurring any personal costs would make them more fearful of a takeover, thereby improving market discipline and reducing agency costs. However, because directors would now incur personal costs for rejecting hostile bids, their ex-post tendency to reject such bids to an excessive degree would be reduced. Finally, by favoring firms with high long-term value, the arrangement would assist in efforts to improve what is perhaps the biggest failure of corporate governance today: its emphasis on short-term performance.

More work remains to be done before the consequences of the proposed arrangement can be fully assessed. The analysis of this Article can provide a framework for such examination. Protecting shareholders from underpriced corporate takeovers is a subject that warrants a careful reconsideration by all interested in improving corporate governance and corporate control.

APPENDIX[210]

An unsolicited bidder approaches target shareholders and offers to tender all of the target's shares at a total price of B.[211]

Let $\alpha \ni [0,1]$ be the fraction of the target's outstanding shares that its outside directors commit to purchase at the bid price and hold for the long term, should the bid fail. α is observed by courts and target shareholders.

Let V be the target value if the target stays independent. Unlike incumbent directors, courts and target shareholders are unable to observe V.

If the court is persuaded that α is big enough to credibly signal the incumbent's belief that B<V, it allows the board to fend off the raider.

There are two possible types of directors, θG and θ_B, as follows:

θ_G —"Good Type Directors," who produce a relatively high V, V(high), satisfying V(high)>B. The probability for "Good Type Directors" is 1- λ.

θ_B —"Bad Type Directors," who produce a relatively low V, V(low), satisfies V(low)<B. The probability for "Bad Type Directors" is λ

A-priori, prob. (θ_G) = prob. (θ_B) = 0.5.

Let P be the net sum of the outside directors' private benefits of control. P is known to both courts and target managers. If courts allow defensive tactics, the directors' ability to extract private benefits of control is unchanged. Conversely, when courts decide that the directors' commitments are not credible enough to successfully articulate a cognizable substantive coercion threat, then directors lose P.

Directors suffer from liquidity constraints and are risk-averse.

210 The model contained herein is based on Spence, *supra* note 6, at 363.

211 The model contained herein can also explain offers for less than all of the target's shares, provided that the offer is not structurally coercive.

Let C_i (α) be the aggregate cost of the outside directors' commitments. Index i is either θ_G or θ_B. Such cost consists of liquidity costs, risk-aversion costs, and the difference between B and V. Liquidity costs and risk-aversion costs are similar between Good and Bad Type Directors, but Good Type Directors observe a higher V than Bad Type Directors. Hence, C_B (α) > C_G (α) for any α. Also, standard assumptions apply here, satisfying C_i (0) = 0, C'_i (α) > 0, C''_i (α) > 0, C'_B (α) > C'_G (α) for any α.

A court forms a belief, $\mu(\alpha$,P,C$(\alpha))$, as to the relationship between α and V and, in particular, decides whether α constitutes a credible commitment for target directors to be of type θ_G. Accordingly, the court issues a judicial decision, D (μ), whereby it holds that the target board has successfully articulated a cognizable substantive coercion threat to the target's effectiveness and policy *if and only if* it is more likely that target directors are θ_G than θ_B.

Bad Type and Good Type Directors maximize their utility functions, respectively:

$U_B(\alpha)$ = P (D(α)) - $C_B(\alpha)$

U_G (α) = P (D(α)) - $C_G(\alpha)$

α and D(μ) do not affect V, θ or P.

Solution of the model - General:

A director's commitment choice, α, a court decision function D(μ), and a belief function $\mu(\alpha$,P,C$(\alpha))\ni[\theta_G,\theta_B]$ giving courts' probability assessment that directors are of a certain type after observing α, is a Bayesian equilibrium (BE) if

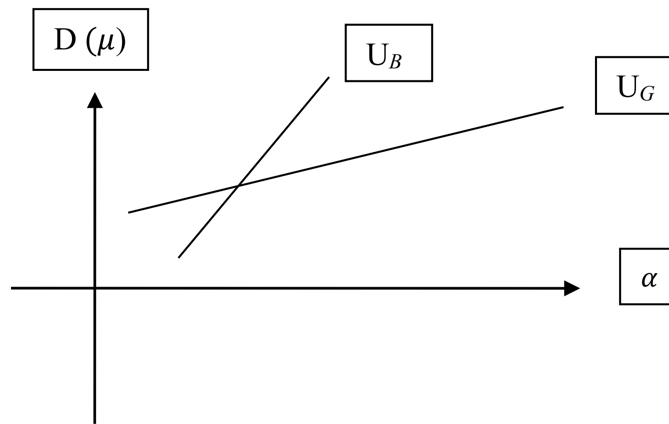
(i) α is optimal given D.

(ii) D is optimal given α.

(iii) Consistency between court beliefs $\mu(\alpha$,P,C$(\alpha))$ and strategy D(μ).

Directors choose α to maximize their utility function $U_i(\alpha)$ = P(D(α))$-C_i(\alpha)$. As shown in Figure AP-1, the director utility function's slope is lower for Good Type Directors because any incremental increase in α increases P identically for both types of directors alike but increases costs more significantly for Bad Type Directors, as $C'_B(\alpha)$ > $C'_G(\alpha)$ for any α.

Figure AP – 1 – Directors' Utility Functions



An Asymmetric Information Solution of the Model – Separating Equilibrium

In a separating Bayesian Equilibrium, D*(α^*_G)= θ_G D*(α^*_B)= θ_B. Also, α^*_B=0 and $\alpha^*_G \in [\alpha', \alpha'']$.

Courts are unable to observe V and, hence, are unable to infer the type of incumbent directors. However, they can observe P and all characteristics of directors' commitment costs other than V. Therefore, they are able to infer the utility function of a hypothetical target's pivotal director, who is able to generate V=B. Hence, courts infer such a director's maximum willingness to commit.

Courts form their belief, $\mu(\alpha$,P,C$(\alpha))$, as follows:

iff $\alpha^* \geq$ max α^* (marginal incumbent directors), then $\theta = \theta_G$, and

iff $\alpha^* <$ max α^* (marginal incumbent directors), then $\theta = \theta_B$.

Good Type Directors will choose to commit, in equilibrium, at the minimum credible level, which equals to max α^* (pivotal director). Committing in excess of that level will be costly for the directors but not generate any marginal benefit. Committing at a lower level will mistakenly identify θ_G as θ_B. Figure AP – 3 illustrates that for θ_G, providing a credible commitment always dominates a decision not to commit at all. It essentially builds on the result that, for θ_G,

P > C_G (α*) for any $\alpha* < \alpha''$. Figure AP-3 illustrates that it is always true that $\alpha* < \alpha''$. This outcome results from the property that the maximum willingness to commit for θ_G (which is α'') is always higher than the maximum willingness to commit for the pivotal director who only generates V=B. This happens because commitment costs are lower for θ_G than they are for the said pivotal director. For θ_G, the nominal cost of holding the commitment stock, (B-V), is negative, while this sum equals to zero for the pivotal director and all other commitment costs are equal.

Figure AP – 2: Separating Equilibrium