

COMPETITION FOR CORPORATE CHARTERS AND THE LESSON OF TAKEOVER STATUTES

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In this Essay, Professor Romano considers the efficacy of competition among states for tax revenues generated by corporate charters. To this end, she focuses on how state takeover regulation—regulation which tends to benefit management rather than shareholders—affects this competition. She argues that federalism provides a safety net which protects investor interests and reduces the likelihood of self-serving management decisions. Professor Romano concludes that the current state-based system of incorporation is preferable to a national regime.

INTRODUCTION

THIS Essay concerns competition among states for the business of corporate charters, which, in my judgment, is the genius of American corporate law. In the United States, corporate law—which concerns the relation between a firm's shareholders and managers—is largely a matter for the states. The legislative approach is, in the main, enabling: code provisions supply standard terms for corporate governance, and these terms function as default provisions that firms can tailor more precisely to their needs through charter amendments. Moreover, firms choose their state of incorporation, a statutory domicile independent of physical presence, which can be changed through shareholder-approved reincorporation. Firms can therefore not only particularize their charters under a state code, but they can also seek to incorporate in the state whose code best matches their needs—i.e., the state whose code minimizes their cost of doing business.

The central problem animating corporation codes is the separation of ownership from control in the modern public corporation. Large firms typically have numerous shareholders with small holdings who cannot actively exercise control over the firm or monitor management. In addition, managers running such firms usually have infinitesimal shareholdings. This creates an agency problem because management's operation of a firm may deviate from the shareholders' wishes in maximizing firm value. A primary purpose of corporation codes is to create corporate governance devices that seek to mitigate the agency problem by better aligning managers' incentives with shareholder interests. Prominent examples are shareholder-elected boards of directors, shareholder voting on

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fundamental corporate changes, and fiduciary duties imposing liability on managers who act negligently or with divided loyalty.

Shareholder-manager relations in public corporations are also subject to an array of national controls under the federal securities laws. The federal securities laws regulate the issuance and trading of securities, the continuing disclosure responsibilities to investors of public firms, and the ground rules of takeovers—corporate acquisitions that, in contrast to mergers, are achieved by tender offers to the shareholders, and thus bypass incumbent management's approval.¹ Unlike state corporation laws, federal regulations are mandatory. The federal securities laws' reach into traditional spheres of state jurisdiction, such as fiduciary duties, has been expanded and contracted over time by federal courts. But even here, the national legislation is not preemptive; it expressly preserves a role for states in securities regulation.

State jurisdiction over corporate law is a function of federalism. A federal system of government produces a number of benefits for its citizens. First, a federal system protects individuals from the immense power of national government as the states are a counterweight to the national government.² Second, compared to a centralized governmental system, a federal system allocates public goods and services more efficiently, and increases individual utility due to its ability to match specific government policies with diverse citizen preferences regarding such policies. In a federal system, states and municipalities compete for citizens, who choose to reside in the jurisdiction offering their preferred package of public goods and services.³ Finally, federalism spurs innovation in public policy given the incremental experimentation afforded by having a laboratory of fifty states competing for citizens and firms.⁴ A policy improvement identified by one state is rapidly enacted by other states.⁵

Just as a federal system's benefits are axiomatic in American politics, it is also well recognized that federalism can impede the administration of government and thereby diminish individual welfare. In particular, where a public policy's costs and benefits do not fall within a jurisdic-

1. See Securities Exchange Act of 1934, 15 U.S.C. § 78a-78ll (1988); Securities Act of 1933, 15 U.S.C. § 77a-77bbbb (1988). The states also regulate securities, and, unlike the federal regime, many states engage in merit regulation under which state officials must be satisfied about the merits of a security before it can be sold. Firms traded on national exchanges are, however, typically exempt from state regulation.

2. This insight is not new to the federalism debate. See, e.g., Alexis de Tocqueville, *Democracy in America 1835* (R. Heffner ed., 1956).

3. The classic article presenting this thesis is Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. Pol. Econ. 416 (1956).

4. Recent discussions of the benefits and costs of federalism include *Competition Among States and Local Governments: Efficiency and Equity in American Federalism* (Daphne A. Kenyon & John Kincaid eds., 1991) [hereinafter *Competition*]; Thomas R. Dye, *American Federalism: Competition Among Governments* (1990).

5. For a brief summary of numerous studies of the diffusion of legislative and other public policy measures across the states, see Albert Breton, *The Existence and Stability of Interjurisdictional Competition*, in *Competition*, *supra* note 4, at 38.

tion's boundaries, the optimal quality and quantity of public goods and services will not be produced. For example, a state will not want to pay for a benefit experienced by nonresidents, such as an agricultural spraying program that benefits adjoining jurisdictions, or highways used by interstate travellers, and hence it will underprovide the good. Similarly, a state may export to nonresidents the cost of providing goods and services to their residents. For example, a state can adopt taxes that are more likely to be paid by out-of-state, rather than in-state, individuals or firms (such as natural resource states' severance taxes, Nevada's gaming taxes, or Iowa's single-factor corporate tax formula).⁶ Another consequence of federalism is the potential for interjurisdictional competition that is a negative-sum game. For example, competing states have been known to adopt economic development policies under which the subsidies offered to firms cost more than the local jobs they create.⁷

The corporate law literature is a microcosm of this tension in the policy debate over federalism because an important theme in the literature is the effect of competition among states for tax revenues generated by corporate charters. Corporation codes can be viewed as products whose producers are states, and whose consumers are corporations. A key question is whether there is any reason to suppose that code provisions benefit investors? The concern arises because Delaware, which is a small state by any measure (population, geography, industrial production, and agricultural production), has dominated all the rest in granting corporate charters. Approximately half of the largest industrial firms are incorporated in Delaware, and more corporations listed on national exchanges are incorporated in Delaware than in any other state. Moreover, the vast majority of reincorporating firms move to Delaware. This is a stable and persistent phenomenon; Delaware has been the leading incorporation state since the 1920s. As a result, a substantial portion of the state's revenue—averaging 15.5% from 1960 through 1990⁸—is derived from incorporation fees.

The dynamic business environment in which firms operate places a premium on a state's responsiveness to corporations' legislative demands—that is, on a state's ability to adapt its corporation code to changing business circumstances. It also places a premium on having a decentralized regime. This is because the trial and error process of interjurisdictional competition enables a more accurate identification of optimal corporate arrangements when there is fluidity in business

6. Advisory Comm. on Intergovernmental Relations, *Interjurisdictional Tax and Policy Competition: Good or Bad for the Federal System?* 36-37 (Apr. 1991). Iowa's single-factor corporate tax formula based on sales helps local firms that sell the bulk of their products out-of-state.

7. See Daphne A. Kenyon & John Kincaid, *Introduction, in Competition, supra* note 4, at 22-23.

8. See Roberta Romano, *The Genius of American Corporate Law* (1993) [hereinafter *Corporate Law*]; Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Organization 225, 240 (1985).

conditions. Delaware excels in both of these areas. It has consistently been the most responsive state; when Delaware is not the pioneer of a corporate law innovation, it is among the first to imitate.

Delaware's extraordinary success in the corporate charter market, due to its responsiveness to changing corporate demands, is the source of a perennial corporate law debate on the efficacy of federalism. This is a debate over who benefits from the laws produced in a federal system and, in particular, from Delaware's corporation code—managers (who select the state of incorporation) or shareholders (who ratify that selection)? If managers and not shareholders benefit, then, from the objective of corporate law itself, the current allocation of authority between the state and national governments would be undesirable.

The best assessment of the evidence is that a federal system is for the better and that Delaware's code, for the most part, benefits shareholders. Indeed, with the widespread enactment of state laws regulating takeovers, the debate's focus in the late 1980s shifted away from Delaware and towards other states' actions. In this important area of statutory innovation, an interesting role reversal occurred: Delaware was a laggard rather than a leader.

Until the Supreme Court upheld state takeover regulation in 1987,⁹ takeover statutes could be largely ignored when evaluating the efficacy of state competition because the statutes' constitutionality could be questioned.¹⁰ The persistent and rapid proliferation of takeover statutes across the states thereafter presented an apparently thorny question for advocates of federalism. Many commentators consider these statutes to be harmful to shareholders because the statutes aim to thwart takeovers from which shareholders benefit handsomely and top management loses.¹¹ The question is how best to understand the enactment of these statutes? Is there something special about takeover laws, as compared to other provisions in corporation codes, that suggests that they are legislative anomalies? If this is the situation, takeover regulation might merit a jurisdictional exception to come under exclusive national government control. But if there is no basis for distinguishing between the legislative process and the impact on investors of takeover statutes and other corporation laws, then the persistence of these statutes could call into question the efficacy of the federal system.

This Essay evaluates whether confidence in the efficacy of state competition should be shaken by the onslaught of state takeover legislation during the 1980s. The strongest case for national regulation involves

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

10. For example, most federal courts reviewing takeover statutes after *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), found them unconstitutional. See Roberta Romano, *The Political Economy of Takeover Statutes*, 73 Va. L. Rev. 111, 118 (1987); Manning G. Warren, III, *Developments in State Takeover Regulation: MITE and Its Aftermath*, 40 Bus. Law. 671, 679 n.57 (1985).

11. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 220-22 (1991).

takeover statutes because managers' and shareholders' interests diverge sharply and jurisdictional spillovers affecting third parties, such as employees, are thought to be present. If national regulation cannot be justified in this apparently compelling context, then reform proposals which find fault with state competition and seek to nationalize corporation codes¹² should be approached with considerable skepticism.

The answer provided in this Essay is that the saga of state takeover statutes does not remove the burden of persuasion placed on advocates of national corporate laws by research on the effects of state competition on shareholders. In fact, the lesson to be drawn is quite the opposite. While state competition is an imperfect public policy instrument, on balance it benefits investors. More important, there is little basis for supposing that national regulation of corporate charters would be a better system, while there are sound reasons for supposing it would be worse.

I. THE FEDERALISM DEBATE IN CORPORATE LAW

In the 1970s, William Cary and Ralph Winter developed the classic positions in the modern debate over whether state corporation codes benefit shareholders. Cary contended that Delaware's heavy reliance on incorporation fees for revenues leads it to engage in a "race for the bottom" with other states in which laws are adopted that favor managers over shareholders.¹³ He therefore advocated national legislation establishing corporate law standards to put an end to state competition. This position was, for many years, the consensus view of corporate law commentators,¹⁴ and his agenda continues to attract support.

Winter agreed with Cary's characterization of the powerful force of competition producing laws that firms demand, but he identified a crucial flaw in Cary's analysis which, when corrected, suggested that the race was more for the top than the bottom: Cary had overlooked the many markets in which firms operate (capital, product, and corporate control markets) that constrain managers from choosing a legal regime that is detrimental to shareholders.¹⁵ Winter's important point was that firms operating under a legal regime that did not maximize firm value would be outperformed by firms operating under a legal regime that did, and would therefore have lower stock prices. A lower stock price would subject a firm's managers to the possibility of either employment termination

12. See, e.g., Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435 (1992).

13. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974).

14. For example, in June 1976, 80 law professors signed a letter endorsing a role for the national government in corporate law. See *Corporate Rights and Responsibilities, Hearings before the Sen. Comm. on Commerce*, 94th Cong., 2d sess., at 343 (1977) (letter submitted by David L. Chambers).

15. See Ralph K. Winter, Jr., *Government and the Corporation* (1978); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977) [hereinafter *State Law*].

(because the firm goes out of business due to its higher cost of capital than competitors with value-maximizing domiciles) or replacement by a takeover bidder who can increase firm value by reincorporating under a value-maximizing regime. This threat of job loss provides a powerful incentive to align managers' and shareholders' interests in the choice of a legal regime. Winter's critique forced adherents of Cary's position to amend it. The contention became that markets are imperfect constraints on managers and, hence, that there is sufficient slack in the system to enable managers to select states with non-value-maximizing legal regimes.

Since the publication of the Cary and Winter articles, empirical studies have sought to arbitrate the debate over who benefits from state corporation codes by determining the economic impact of managerial discretion to choose among alternative corporation codes by changing a firm's incorporation state. They conclude that the choice benefits rather than harms shareholders. The conclusion rests on widely-accepted financial econometric techniques known as event studies, which examine whether particular information events—discrete public events introducing new information to financial markets, such as a firm's decision to reincorporate—produce a significant effect on a firm's stock prices.¹⁶ If an information event is considered beneficial to shareholders (that is, if investors believe that it enhances the value of their equity investment), then stock prices will significantly increase upon the public announcement of the event. If an event is perceived as detrimental to shareholder wealth, then stock prices will significantly decline. Such stock price effects are typically referred to as abnormal returns. The posited relationships between changes in stock price and reincorporation announcements restate the Winter and Cary theses in testable event study form. The implication of Cary's thesis that shareholders are harmed by Delaware's code is that firms should experience a significant negative price effect when they announce a reincorporation in Delaware. Similarly, Winter's hypothesis predicts a significant positive effect.

There have been five event studies of reincorporations. While several have found significant positive price effects upon reincorporation in Delaware, no study found a negative stock price effect as Cary would have predicted.¹⁷ The data are therefore most consistent with Winter's hy-

16. The researcher examines whether the average residuals of a regression of observed stock price on predicted stock price are significantly different from zero.

17. See Allen Hyman, *The Delaware Controversy-The Legal Debate*, 4 Del. J. Corp. L. 368 (1979) (positive returns); Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 Iowa L. Rev. 1 (1989) (significant positive abnormal returns on event date); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: 'Unhealthy Competition' versus Federal Regulation*, 53 J. Bus. 259, 274-75 (1980) (significant positive abnormal returns two years before event); Jeffrey Netter & Annette Poulsen, *State Corporation Laws and Shareholders: The Recent Experience*, 18 Fin. Mgmt (No. 3) 29, 36 (1989) (positive abnormal returns in short interval around event significant at 10% level); Romano, *supra* note 8, at 269-70 (significant posi-

pothesis of the efficacy of competition.

Some advocates of national corporation laws question the usefulness of event studies. Melvin Eisenberg and Lucian Bebchuk contend that event studies do not indicate investors' evaluation of the new state's regime because of the possibility of confounding signals if a reincorporation announcement is accompanied by disclosure of a new corporate strategy.¹⁸ In such a situation, a positive stock price reaction may be the result of investors' assessment of the new strategy and not the value of the new statutory domicile. It is, however, improbable that such information could swamp an otherwise significantly negative stock price effect of a reincorporation. If this offsetting effect hypothesis is correct and reincorporation has a wealth-decreasing effect, we should observe a significant negative stock price effect for firms changing domicile to engage in activities that are perceived to favor managers over shareholders. In contrast, there should be no offsetting effect for those reincorporating in order to undertake activities deemed beneficial to shareholders. The stock price effect is not, however, significantly different across firms reincorporating for different business purposes—that is, for those planning to undertake activities that commentators consider adverse to shareholder interests (fortifying takeover defensive tactics) and those which they do not criticize (implementing a mergers and acquisitions program or reducing taxes).¹⁹ Shareholders also must approve a reincorporation, and the SEC requires detailed disclosure of differences in legal regimes in proxy materials. It is not credible to contend that informed shareholders will approve a destination state whose regime is adverse to their interests. Moreover, if management threatened not to undertake a newly proposed value-maximizing strategy for the firm if shareholders were to vote against reincorporation in a state with a non-value-maximizing regime, such conduct would be a breach of fiduciary duty.²⁰

Bebchuk further questions whether event studies can ever resolve the state competition debate. He asserts that even if the findings of positive or insignificant stock price effects upon reincorporation are bolstered by further studies finding even stronger positive stock price effects, this will not arbitrate the Cary-Winter debate because there could always be some code provision that disadvantages shareholders but whose negative impact is netted out by greater positive price effects of other code provisions.²¹ However, it should be noted that Bebchuk's contention, while

tive abnormal returns on and in short interval around event, for portfolio of all reincorporating firms, as well as firms reincorporating for acquisition purposes).

18. See Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1509 (1989); Bebchuk, *supra* note 12, at 1448-49. At the time of a reincorporation, firms often disclose information concerning corporate policy changes, undertaking the move to reduce the cost of implementing the new strategy. See Romano, *supra* note 8, at 253-54.

19. See Romano, *supra* note 8, at 272.

20. See *Lacos Land Co. v. Arden Group, Inc.*, 517 A.2d 271, 278 (Del. Ch. 1986).

21. See Bebchuk, *supra* note 12, at 1449-50.

cast as a criticism of the empirical basis for supporting a federal system of state corporation laws, acknowledges that state competition is on the whole beneficial for shareholders because the effect of good provisions outweighs the bad.²² Far from shifting the burden of proof from advocates of national regulation to advocates of state competition, this argument implies that state competition generally benefits shareholders. Thus, those who would promote Cary's position have the burden of demonstrating empirically which particular code provisions harm shareholders and why national legislation would be more likely to alleviate the problem.

II. TAKEOVER STATUTES: CORPORATE LAW ANOMALY OR PARADIGM?

In the context of takeover laws, the benefits of state competition appear to be problematic. In contrast to most corporation code contexts, the conflict of interest between managers and shareholders in the takeover setting is stark. In a takeover, management is placed in an endgame situation. By supporting a bid that provides a hefty premium, and thereby benefitting shareholders, management subjects itself to a risk of loss of employment upon the bid's success. While target shareholders experience abnormal returns in takeovers ranging between twenty and forty percent,²³ managers are frequently replaced. Studies find a higher than average turnover in management after a takeover, particularly after a contested takeover.²⁴ Indeed, the larger management's wealth change from a takeover (i.e., the larger its stock and option holdings) and, thus,

22. Indeed, Bebchuk's theoretical analysis of those state code provisions that have undetected marginal negative impact, and thus require national legislation, identifies fiduciary duty provisions. See *id.* at 1483-84. Yet, there have been several event studies that have isolated the impact of statutes that limit a director's fiduciary duties for negligence and the impact of adopting conforming charter amendments or reincorporating in order to obtain the benefit of such statutes, and the majority find positive or insignificant stock price effects over the relevant event periods. See, e.g., Bradley & Schipani, *supra* note 17, at 65-69; Vahan Janjigian & Paul J. Bolster, *The Elimination of Director Liability and Stockholder Returns: An Empirical Investigation*, 13 J. Fin. Res. 53 (1990); Netter & Poulsen, *supra* note 17, at 37-39; Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 Emory L.J. 1155 (1990) [hereinafter *Corporate Governance*]. Michael Bradley and Cindy Schipani emphasize that Delaware firms experienced significant negative returns on the limited liability statute's effective date, which was 12 days after its enactment. See Bradley & Schipani, *supra* note 17, at 56-57. This finding is irrelevant to an assessment of the statute's impact because no new information was released on this later date. These studies are discussed in greater detail in Corporate Law, *supra* note 8.

23. For reviews of studies on returns to target shareholders, see Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. Fin. Econ. 5 (1983); Gregg A. Jarrrell et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. Econ. Persps. 49 (Winter 1988). It should be noted that the weight of the evidence indicates that these takeover gains are efficiency-related and are not wealth transfers from other participants in the firm. See Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 Yale J. on Reg. 119, 120-21 (1992).

24. For a review of studies on management turnover, see Eugene Furtado & Vijay

the more closely aligned management's interests in the bid are with those of the shareholders, the less likely management will resist a takeover.²⁵

In addition to the agency problem, jurisdictional spillovers in the form of negative externalities—i.e., effects on third parties outside the manager-shareholder relation (such as workers)—are thought to be present in the takeover context. As noted earlier, this is a conventional argument against federalism and for resorting to national regulation. Takeover statutes thus provide the strongest case in theory for national preemption of the states. Moreover, they are the one area of state legislation where empirical studies provide support for Cary's characterization of state codes, although not for the laws of Delaware: researchers have found significantly negative stock price effects upon enactment of takeover statutes in several states other than Delaware.²⁶ Accordingly, the case for national regulation stands or falls in this most compelling context.

A. *A Brief History of Takeover Regulation*

Takeover regulation in the United States is an area of dual jurisdiction. The ground rules for tender offers are set forth in the Williams Act, national legislation which was enacted in 1968.²⁷ From management's perspective, the primary benefit of the Williams Act is that it facilitates delay. For example, the Act provides opportunities for litigation alleging material misstatements or omissions in disclosure documents. If target management is successful in a preliminary hearing, it obtains an injunction which halts a bid's progress temporarily until a trial on the merits, or until a flawed disclosure is corrected. This is often akin to defeating a bid because delay either permits competing bidders to come forward, allowing management time to locate a more preferred partner, or provides management with the opportunity to restructure defensively in order to avoid acquisition altogether.

To the extent that competition increases the bid price, shareholders can benefit from delay. This benefit may be more apparent than real, however, because by increasing initial bidders' costs, delay is likely to reduce the probability of a bid in the first place, which lowers share-

Karan, *Causes, Consequences, and Shareholder Wealth Effects of Management Turnover: A Review of the Empirical Evidence*, 19 *Fin. Mgmt.* (No. 2) 60 (1990).

25. See Ralph A. Walkling & Michael S. Long, *Agency Theory, Managerial Welfare, and Takeover Bid Resistance*, 15 *Rand J. Econ.* 54 (1984).

26. See *infra* note 46 and accompanying text.

27. The Williams Act (Act of July 29, 1968), Pub. L. No. 90-439, 82 Stat. 454 (amending the Securities Exchange Act of 1934, 15 U.S.C. § 78a-78f). The Williams Act was further amended in 1970. Its main components are: (1) substantive regulation of terms and procedures for bids, such as requirements of withdrawal rights, pro rata acceptance of shares if a bid is over-subscribed, and regulation of extensions and changes in bids, see 15 U.S.C. § 78n (adding § 14(d)); (2) prebid disclosure (of ownership and intention) upon acquisition of a five percent block, see 15 U.S.C. § 78m (adding § 13(d)); and (3) antifraud protection for communications concerning the offer by the bidder or incumbent management, see 15 U.S.C. § 78n (adding § 14(e)).

holder welfare.²⁸ Moreover, in over twenty percent of takeover contests in which management employed litigation as a defensive maneuver, the target remained independent upon defeating the bid, and shareholders did not receive a premium.²⁹

At approximately the same time as the enactment of the Williams Act, Virginia adopted the first state takeover statute. Thereafter, many states intervened in takeovers, with the pace of legislation accelerating in the mid-1970s as the number of takeovers increased.³⁰ Finding the Williams Act to be inadequate as a defense to takeovers, states sought to fashion rules that were more favorable to incumbent managements. Under the first generation of state laws, tender offerors had to submit plans to a state agency and obtain approval before proceeding with bids. This regulation was far more advantageous to management than obtaining a preliminary injunction against a bidder for violation of the Williams Act, because state review tended to be extremely protracted.

Bidders quickly attacked state takeover statutes using two constitutional arguments related to the supremacy of the national government over the states: (1) burdening interstate commerce, and (2) preemption by the Williams Act. The issue was preliminarily resolved in 1982, when, in *Edgar v. MITE Corp.*, the Supreme Court found that first generation takeover regulation burdened interstate commerce.³¹ A plurality considered the statutes preempted as well.³²

MITE did not, however, deter states from attempting to intervene in bids. They quickly fashioned new regulations, known as second generation statutes, which exhibited greater diversity in approach than first generation statutes. The most prominent of such laws are: (1) "control share acquisition" statutes, which restrict the voting rights of bidders' shares without the other shareholders' approval; (2) "business combina-

28. See 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); Alan Schwartz, *Search Theory and the Tender Offer Auction*, 2 J.L. Econ. & Org. 229 (1986). The effect of takeover actions on shareholder welfare has been roundly debated. For a review of the debate, see Romano, *supra* note 23, at 122-55.

29. See Gregg A. Jarrell, *The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?*, 28 J.L. & Econ. 151 (1985).

30. See Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cin. L. Rev. 457, 458-60 (1988).

31. 457 U.S. 624, 646 (1982). Ralph Winter distinguished first generation takeover statutes from state competition over corporate codes by stressing that first generation takeover statutes have extraterritorial effect—i.e., they apply to firms with plants located in the legislating state, and not solely to domestically-incorporated corporations. Winter maintained that this jurisdictional provision enabled states to restrain the competition for charters and, thus, to enact shareholder wealth-decreasing laws. See *State Law, supra* note 15, at 268, 287-89. Subsequent generation takeover statutes do not have such broad jurisdictional hooks; consequently, they do pose analytical problems for state competition advocates. In fact, in a recent comment, Winter noted the possibility that some states (particularly those regulating takeovers) may not seek to maximize franchise tax revenues and, hence, the "race to the top [may be a] walk." Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 Colum. L. Rev. 1526, 1528-29 (1989).

32. See *MITE*, 457 U.S. at 639.

tion freeze" statutes, which limit bidders' ability to engage in business combinations and other related transactions with targets after a bid's success; and (3) "fair price" statutes, which require bidders to pay at least as much for shares in the second stage of a two-tier acquisition as they paid in the first stage.

Unlike first generation statutes, second generation statutes regulate a corporation's internal affairs (i.e., matters of corporate governance), which are the province of the incorporation state. These statutes often codify defensive tactics that firms can, and did, undertake voluntarily by charter amendment. Such an approach was considered a constitutionally acceptable means of avoiding *MITE*'s strictures. Regulating matters of internal affairs is a valid exercise of state power, despite an impact on commerce, because it does not meet the *MITE* Court's tests of unconstitutionality. Because these statutes' jurisdiction depends on the incorporation state and not on presence of assets (which was the jurisdictional basis of first generation statutes), second generation statutes do not have an unconstitutional extraterritorial effect: a firm cannot be subject to inconsistent regulations as only one state has jurisdiction. In addition, the new statutes do not discriminate against out-of-state shareholders because they affect shares of all bidders, regardless of domicile. Indeed, the *MITE* court emphasized in its Commerce Clause analysis that Illinois had "no interest in regulating the internal affairs of foreign corporations."³³ Further, by phrasing the statutes so that they involve internal affairs, states ensure that the question of preemption is not revived; such matters are conventionally thought to be in a state's exclusive sphere of authority, and the Williams Act is not regarded as having altered the historical regulatory balance between Congress and the states.

In 1987, following a series of lower court decisions invalidating control share acquisition statutes, the Supreme Court, in *CTS Corp. v. Dynamics Corp. of America*, upheld Indiana's version of the statute.³⁴ This decision made clear that the states have a role in takeover regulation and, with this decision, takeover legislation proliferated. Most states continued to innovate, enacting multiple takeover statutes that provided firms with a menu of defensive protections. The most popular recent form of regulation is the "other constituency" statute, which permits or requires corporate boards to consider the interests of nonshareholder groups in their decisions, and which has been adopted in over half of the states; the most draconian is Pennsylvania's "disgorgement" statute, which prohibits failed bidders from earning a profit on the sale of their shares. The surge of takeover regulation slowed, however, by the early 1990s, as the acquisitions market came to a standstill.

33. *Id.* at 645-46.

34. *See CTS Corp.*, 481 U.S. 69, 86-87 (1987).

B. *The Politics of Takeover Statutes*

The politics of takeover statutes are consistent with the view that management reactions to takeovers evidence an agency problem. Top management, the clear loser from hostile takeovers, is the principal promoter of takeover legislation, rather than the shareholders who benefit from the transactions. Takeover laws are typically sponsored by a local chamber of commerce at the behest of a major domestic corporation that is the target of a hostile bid.³⁵ They are often rapidly enacted, sometimes over a few days in special emergency sessions (depending on the urgency of the situation of the firm seeking the legislation). Moreover, the statutes are usually enacted without public hearings. Legislative support is bipartisan and near unanimous.

Takeover statutes are not, as some might suspect, promoted by a broad coalition of business, labor, and community leaders who fear that a change in control will have a detrimental effect on the local economy. While union representatives endorse takeover legislation in some states, in the vast majority, the other organized group besides management that promotes the legislation is the corporate bar. Anecdotal accounts suggest that the roles of these two groups are reversed when contrasted to the usual legislative process of corporate law reform: business lobbying organizations lead the way in takeover statutes whereas the bar is the prime mover behind most corporation code changes.³⁶

The absence of broad-based lobbying for takeover statutes does not mean that legislators voting for such statutes are not motivated by a concern for saving local jobs. But if workers', and not managers', jobs are the primary motivation of legislators, such a perception is not well-founded. Numerous studies have sought to measure the effects of takeovers on employment and wages.³⁷ They fail to find a detrimental impact on labor: takeovers generally do not affect the employment of production workers, nor do they reduce union wages.³⁸ In the small set of cases where labor suffers losses as a result of a takeover (primarily reductions in administrative staff employment), the loss is a very small proportion of the bid premium (i.e., ten to twenty percent).³⁹

35. For a listing of firms and states, see Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 Wis. L. Rev. (No. 3) 365 (1988); Romano, *supra* note 30, at 461 n.11.

36. See Romano, *supra* note 10, at 122-36.

37. See, e.g., *infra* notes 38-39. For a non-technical review of this extensive literature, see Romano, *supra* note 23.

38. See, e.g., Frank R. Lichtenberg & Donald Siegel, *The Effect of Ownership Changes on the Employment and Wages of Central Office and Other Personnel*, 33 J. Law & Econ. 383 (1990) (analyzing the effects of corporate takeovers on production and administrative personnel); Joshua G. Rosett, *Do Union Wealth Concessions Explain Takeover Premiums?*, 27 J. Fin. Econ. 263 (1990) (examining the impact of corporate takeovers on long-term and short-term union wages).

39. See Sanjai Bhagat et al., *Hostile Takeovers in the 1980s: The Return to Corporate Specialization*, in *Brookings Papers on Economic Activity: Microeconomics 1990*, at 1 (Martin N. Baily & C. Winston eds., 1990).

Moreover, a close examination of the political process of takeover legislation raises serious questions of whether employee welfare is a concern in the first place. Business groups—the moving force behind takeover statutes—vigorously oppose plant-closing legislation; takeover statutes regulating severance pay and union contract security are careful to exempt friendly acquisitions; and other constituency statutes do not require boards to consider worker interests, nor do they provide workers with the right to enforce the statute against a board that did not act in their favor. If employee, rather than top management, job security, was the true object of concern, we would not observe such carefully crafted distinctions.

Like most forms of pork barrel legislation, takeover statutes are almost always unanimously approved. The likely explanation for such legislative unanimity is that the benefits and beneficiaries (real or supposed) of such legislation are highly concentrated—many, if not most, of the target company's managers and workers reside within the state—while the costs are borne largely by a group of loosely organized, geographically dispersed shareholders. When viewed in this light, unanimity in the enactment of takeover statutes appears to be a function of a previously noted disadvantage of federalism: the benefits and burdens of a law may not be contained within the legislating jurisdiction. When such spillover effects occur, interjurisdictional subsidization and exploitation can occur as citizens of the legislating state benefit from a law while citizens of other states bear the cost. This is the theoretical underpinning of the case for national regulation.⁴⁰

C. *Delaware's Unique Position on Takeover Regulation*

A striking anomaly in state takeover regulation is that Delaware has been much slower to respond than other states in this corporate law reform context alone. Delaware did not enact a first generation statute until 1975, seven years and six states after Virginia's initial legislation, and it did not adopt a second generation statute until after the Supreme Court's *CTS* decision. With regard to most major corporate law reforms, however, Delaware was the first or second state to act.⁴¹ Moreover, both of Delaware's takeover statutes were less restrictive of hostile bids than those of other states. For instance, its first generation statute did not have a hearing requirement and, unlike other states, had an opt-out provision.⁴² Its second generation statute bans business combinations for only three years (compared to New York's five years) and can be avoided entirely if the acquirer obtains eighty-five percent of the stock in the transaction in which it becomes interested.⁴³

40. See Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 Va. L. Rev. 563 (1983).

41. See Romano, *supra* note 8, at 240; *Corporate Governance*, *supra* note 22, at 1160.

42. See Del. Code Ann. tit. 8, § 203 (Supp. 1982).

43. See Del. Code Ann. tit. 8, § 203 (1991).

Several important features related to interstate externalities distinguish Delaware from other states and in large part explain the difference in Delaware's takeover statutes as compared to those of other states. They also help explain why enactment of takeover regulation in Delaware was protracted despite its demonstrated ability to move quickly on matters of corporate law reform. First, Delaware has a more diverse corporate constituency (including both target companies and bidders) than other states. In fact, there is a significant negative correlation between a state's having been at the forefront in enacting a second generation statute before the *CTS* decision, which is an indicia of an aggressive anti-takeover regulatory stance, and the number of hostile bidders incorporated in a state.⁴⁴ Second, the very large number of firms incorporated in Delaware, few of which are physically present in the state, means that no one firm's management has the clout to get a bill enacted. This also makes it cheaper for shareholder groups and institutional investors to lobby the Delaware legislature, as the cost is spread over a large number of portfolio holdings. Finally, although it is not a formal requirement, all corporate law legislation in Delaware is initiated, reviewed, and formally approved by the bar prior to introduction in the legislature. The diverse interests represented by the Delaware bar at the earliest stages of legislation make it more difficult to enact statutes with unintended consequences and mitigate the harmful effects on shareholders of takeover laws that are enacted. This is because the Delaware bar represents a far broader set of constituent interests than the corporate bar in other states; bidders, as well as targets, have local Delaware counsel.⁴⁵

D. *Wealth Effects of Takeover Regulation*

Empirical research on the wealth effects of takeover laws is, as previously noted, most consistent with Cary's view of the harmful effect of state competition. Event studies find either statistically significant negative stock price effects or no effect.⁴⁶ Jonathan Karpoff and Paul

44. See Romano, *supra* note 10, at 142-45.

45. In other states, the local corporate bar tends to be aligned with incumbent management because when firms merge, the acquirer's counsel will typically be counsel to the combined entity.

46. The following studies found significant negative stock price effects from takeover statutes: Adam Broner, Office of Economic Policy, New Jersey Shareholders Protection Act: An Economic Evaluation (1987); Donald G. Margotta, Stock Price Effects of Pennsylvania Act 36 (Feb. 1991) (unpublished manuscript, on file with the *Fordham Law Review*); Jonathan M. Karpoff & Paul H. Malatesta, *PA Law: State Antitakeover Laws and Stock Prices*, 46 *Fin. Analysts J.*, Jul.-Aug. 1990, at 8; Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second Generation State Takeover Legislation*, 25 *J. Fin. Econ.* 291 (1989) [hereinafter *Wealth Effects*]; Michael Ryngaert & Jeffrey Netter, *Shareholder Wealth Effects of the Ohio Antitakeover Law*, 4 *J.L. Econ. & Organization* 373 (1988); Michael Ryngaert & Jeffrey Netter, *Shareholder Wealth Effects of the 1986 Ohio Antitakeover Law Revisited: Its Real Effects*, 6 *J.L. Econ. & Organization* 253 (1990); Laurence Schumann, *State Regulation of Takeovers and Shareholder Wealth: The Case of New York's 1985 Takeover Statutes*, 19 *Rand J. Econ.* 557 (1988); J. Gregory Sidak & Susan E. Woodward, *Corporate Takeovers, the Commerce Clause, and the Effi-*

Malatesta, in the most comprehensive event study of takeover statutes, examined the stock price effects of forty second generation statutes which were enacted through 1987 and were covered in the press. They find a small, statistically significant decrease in stock price (-.3%) on the two-day interval of the earliest press reports of proposed legislation.⁴⁷ They find no significant stock price effect on important dates in the statutes' legislative histories (i.e., dates of bill introduction, floor votes, and gubernatorial signing) that were not simultaneously covered in the press. Further, there is no significant effect over longer intervals around press report dates. When the sample used in the study is broken down by type of takeover statute, the abnormal returns have a negative sign for control share acquisition, fair price, and business combination freeze provisions, but only the negative returns for business combination freeze provisions are statistically significant.⁴⁸ Finally, when the data are examined over time, only statutes enacted in 1986 or later had a significant negative price effect.⁴⁹

It is important to note that event studies of Delaware's second generation statute find no significant stock price effect.⁵⁰ This datum is consistent with the view that Delaware's efforts at regulating takeovers are less

cient Anonymity of Shareholders, 84 Nw. U. L. Rev. 1092 (1990); Samuel H. Szewczyk & George P. Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310*, 31 J. Fin. Econ. 3 (1992). In contrast, the following studies did not find any significant stock price effect from takeover statutes: Donald G. Margotta & Swaminathan Badrinath, *Effects of New Jersey Shareholder Protection Legislation on Stock Prices* (1987) (unpublished manuscript, on file with the *Fordham Law Review*); John S. Jahera & William N. Pugh, *State Takeover Legislation: The Case of Delaware*, 7 J.L. Econ. & Organization 410 (1991); Donald G. Margotta et al., *An Analysis of the Stock Price Effect of the 1986 Ohio Takeover Legislation*, 6 J.L. Econ. & Organization 235 (1990); William N. Pugh & John S. Jahera, Jr., *State Antitakeover Legislation and Shareholder Wealth*, 13 J. Fin. Res. 221 (Fall 1990); Romano, *supra* note 10; Roberta Romano, *What Is the Value of Other Constituency Statutes to Shareholders?*, U. Toronto L.J. (forthcoming Spring 1993). Some of the studies in the latter category, such as Margotta & Badrinath, *supra*, find significant negative effects for some event time intervals but not for other intervals, and therefore conclude that the laws have no detrimental wealth effects.

47. *Wealth Effects*, *supra* note 46, at 308-09.

48. *See id.* at 312-14. The average abnormal returns across the three types of statutes do not, however, differ significantly.

49. This is not surprising, as investors could have assumed that statutes enacted prior to 1986 (the year before *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69 (1987), was decided) would be found unconstitutional under *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). It is unfortunate that Karpoff and Malatesta chose 1986 as the year for dividing their sample; 1987, the year of the *CTS* decision, would have allowed for a breakdown that captured the change in legal uncertainty. The choice was presumably dictated by the number of observations in the subsamples because the study's data ended in 1987. It must be noted, however, that despite the constitutional uncertainty, the 1986 Indiana statute upheld in *CTS* had a significant negative impact upon its enactment. *See Sidak & Woodward, supra* note 46, at 1100. This suggests that the insignificant effect of pre-1986 statutes is not a function of investors expecting their invalidation by courts, but rather, of their assessment of the statutes' substantive effect on bids.

50. *See Jahera & Pugh, supra* note 46, at 416-27; *Wealth Effects, supra* note 46, at 315.

restrictive than other states. Thus, when focusing on takeover statutes, one sees a 180-degree role reversal of the Cary scenario of state competition: Delaware is more a "reluctant follower" than a leader because it seeks to maintain its dominant market share while other states "race for the bottom" to entrench management.⁵¹ Whatever the adverse effect of state competition in regulating takeovers, Delaware is not the source of the problem.

Quite apart from Delaware's steady legislative policy of sailing against the wind when it comes to takeover regulation, California, a major corporate domicile, has still not adopted any takeover regulation.⁵² Thus, because not all states regulate takeovers, a firm's relative value will be affected by remaining in a lesser valued (i.e., more regulated) regime.

Paradoxically, Pennsylvania's disgorgement statute provides a good example of the beneficent effect of state competition. Event studies of Pennsylvania firms have identified large significant negative abnormal returns at the time the disgorgement statute was enacted.⁵³ After unsuccessfully opposing the legislation's adoption, institutional investors threatened to sell their shares in firms covered by the statute, and a majority of corporations opted out of the statute.⁵⁴ As indicated in table 1, of publicly-traded firms with a Pennsylvania domicile whose choices were identified, 127 firms opted out of the statute in whole or in part, while only 72 firms did not opt out.⁵⁵ The proportion opting out is higher among the larger firms (firms likely to have a higher proportion of institutional investors): 43 of 58 exchange-listed firms opted out, compared to 84 of 141 over-the-counter firms. Exchange-listed firms that opted out, in fact, have a higher proportion of institutional owners than those that did not opt out of the statute.⁵⁶ These data indicate that when a corporation's investors express concern about the impact of a particular statute on their firm, managers will be responsive to their concerns. Researchers have further found that firms that opt out of the statute experience positive abnormal returns.⁵⁷

51. See Mark J. Roe, *Takeover Politics* 52-53 (Brookings Discussion Paper in Economics No. 91-4, 1991).

52. See Easterbrook & Fischel, *supra* note 11, at 223.

53. See, e.g., Szewczyk & Tsetsekos, *supra* note 46, at 9-15, 19. For a review of several studies of this statute which all report similar results, see M. Wayne Marr, Jr., *Survey of Empirical Studies: Pennsylvania Act 36*, 48 *Fin. Analyst J.* 52 (1992).

54. See Leslie Wayne, *Many Companies in Pennsylvania Reject State's Takeover Protection*, *N.Y. Times*, July 20, 1990, at A1. Firms were permitted to opt out of the statute within 90 days of the effective date, provided their boards approved an amendment to the corporate by-laws.

55. I would like to thank the many Pennsylvania firms whose counsel provided me with information about their firm's choice, and Robert Daines, who provided assistance in compiling this information.

56. See Szewczyk & Tsetsekos, *supra* note 46, at 18.

57. See *id.*; Marr, *supra* note 53, at 3. Significant positive abnormal returns were experienced by the full sample of firms opting out of all or some of the provisions and the subsample of firms opting out of all of the provisions, but the abnormal returns for the

TABLE 1. FIRM CHOICES ON COVERAGE OF PENNSYLVANIA'S 1990 TAKEOVER STATUTE

Choice	Exchange firms ^a	Other firms ^b	Total
Opting out of entire statute	18	33	51
Opting out of control share acquisition ^c , disgorgement and other constituency provisions	0	2	2
Opting out of control share acquisition ^c and disgorgement provisions	21	39	60
Opting out of control share acquisition ^c and other constituency provisions	0	1	1
Opting out of disgorgement and other constituency provisions	0	1	1
Opting out of disgorgement provision only	3	0	3
Opting out of control share acquisition ^c provision only	1	8	9
Not opting out of statute	15	57	72
Unidentified	5	104	109
<u>Total</u>	63	245	308

^a Pennsylvania firms listed on New York Stock Exchange or American Stock Exchange

^b Pennsylvania firms listed on other exchanges, NASDAQ's NMS system, or traded over-the-counter

^c Opting out of control share acquisition provision automatically opts firm out of labor protection provisions as well

The large-scale withdrawal by Pennsylvania firms from inclusion under a value-decreasing statute is powerful support for the acuity of Winter's insight in his critique of Cary. Capital markets discipline managers, notwithstanding their best efforts at entrenchment, by placing a floor on deleterious state competition. This contention is further supported by the fact that few other states have followed Pennsylvania's lead and enacted a disgorgement provision.⁵⁸

III. SHOULD TAKEOVER REGULATION BE NATIONALIZED?

In state takeover regulation, it is clear that Delaware stands out from the pack. Still, it is arguable that Delaware would not have enacted any

subset of firms that only partially opted out were insignificant. See Szewczyk & Tsetsekos, *supra* note 46, at 17.

58. According to the Investor Responsibility Research Center, only one other state, Ohio, has copied Pennsylvania's disgorgement provision. Telephone Interview with Investor Responsibility Research Center (1992) (discussing State Takeover Laws, as updated through summer 1991).

takeover legislation in the absence of state competition.⁵⁹ Acknowledging that the dismal track records of most states in takeover regulation raise serious questions concerning the efficacy of state competition does not imply that national regulation of takeovers is the solution to an imperfect federal system. This is just the beginning of the inquiry.

The principal analytical problem in advocating national control is that, while everyone affected by the regulation will now reside in the legislating jurisdiction, the beneficiaries—corporate managers—are still a concentrated group, and those bearing the costs—shareholders—are still dispersed. Collective action problems involving this asymmetric organizational advantage of managers over shareholders are not avoided at the national level. Regardless of forum, managers are more easily organized across firms than shareholders. Business trade organizations, such as chambers of commerce, provide valuable information to their members, inducing individual participation in collective activity.⁶⁰ Shareholder organizations are at a comparative disadvantage because they provide individuals with far fewer inducements to action (although, in recent years, institutional investors have begun to organize and engage in lobbying activities in reaction to efforts by state legislatures to expropriate their wealth). Further, individuals are more likely to coordinate their actions to avoid losses than to achieve gains because of risk aversion (they care more about preventing losses than achieving gains of equal magnitude).⁶¹ This factor also favors incumbent managers, who, in contrast to shareholders, stand to lose from takeovers. Finally, the cost-benefit calculus is not changed by moving from state to national level: the average top manager's financial interest in the outcome of a takeover will still be much higher than the average shareholder's interest and, of course, management's lobbying expenditures will still be paid by the corporation.

It is possible that, while the national political dynamic still favors managers, Congress's output might differ from that of the states. The record to date, however, is that in the takeover area, Congress mimics the states.⁶² The impetus for congressional action on takeovers—which, in the 1980s, consisted primarily of holding hearings and introducing bills—is the same as that for state action: a hostile bid for a major firm located in the sponsoring legislator's state.⁶³ In addition, the principal witnesses at congressional hearings are corporate managers, government employees, and elected officials; labor groups are rarely witnesses and shareholder witnesses are rarer still.⁶⁴ More important, the vast majority

59. See Roe, *supra* note 51, at 52.

60. See Romano, *supra* note 30, at 468-70.

61. See Russell Hardin, *Collective Action* 82-83, 120-21 (1982); Romano, *supra* note 30, at 470.

62. See Romano, *supra* note 30, at 470-81.

63. See *id.* at 481-84; Kenneth Lehn & James W. Jones, *The Legislative Politics of Hostile Corporate Takeovers* 31 (Mar. 19-21, 1987) (unpublished manuscript, on file with the *Fordham Law Review*).

64. See Romano, *supra* note 30, at 485.

of the bills introduced in Congress rival or outdo state laws in efforts at restricting bids.⁶⁵ It is significant that the bills that have been on Congress's takeover agenda in recent years have been overwhelmingly one-sided against bidders because successful law reform is typically a recombination of old elements already in the legislative hopper rather than a completely new proposal.⁶⁶ Of course, the Williams Act itself was not neutral regulation; it tilted the contest towards incumbent management and away from bidders.⁶⁷

Despite the heightened level of congressional interest, no major substantive takeover statutes were enacted in the 1980s,⁶⁸ in large part because the Reagan and Bush Administrations opposed greater regulation. Lacking presidential and agency support, Congress had little incentive to legislate, for it would have faced either a veto fight or an uncooperative agency that could thwart legislative objectives by unenthusiastic implementation. In addition, the Supreme Court's *CTS* decision reduced the pressure on Congress to act because it enabled target managers to concentrate their appeals for relief on state legislatures, which had already shown themselves to be very cooperative. Indeed, state legislatures were capable of acting far more quickly than Congress, which would hardly finish the hearings stage in its legislative process before a protective state takeover statute was enacted or the bid inspiring its action was completed.

National mood is another important variable in policy agenda formation,⁶⁹ and the public, while largely ignorant of the economic effects of takeovers, has an unfavorable opinion of takeovers.⁷⁰ For example, the public consistently adopts the following negative, yet uninformed, opinions: (1) that workers are the losers, and executives and the acquiring firm's shareholders are the winners, in takeovers; and (2) that mergers are bad for the economy.⁷¹ There is, however, scant evidence to support such beliefs. In fact, a massive literature on acquisitions points precisely in the opposite direction: as noted earlier, the losers in takeovers tend to be top and middle-level management, and not production workers;⁷² in addition, it is target and not acquiring firm shareholders who gain from

65. *See id.* at 472-73.

66. *See* John W. Kingdon, *Agendas, Alternatives, and Public Policies* 131 (1984).

67. *See* Easterbrook & Fischel, *supra* note 11, at 224-25.

68. The tax code was amended to increase acquisition costs by imposing penalty taxes on greenmail payments and certain golden parachutes, *see* Romano, *supra* note 23, at 174, restricting the use of net operating losses and repealing the distribution of appreciated property without payment of the corporate level tax. Most of the provisions did not have a significant impact on acquisitive activity because companies could simply comply with the permitted parachute payment or gross-up management's pay to cover the tax, and net operating losses and the step-up in asset basis are not important factors in acquisitions.

69. *See* Kingdon, *supra* note 66, at 153.

70. *See* Romano, *supra* note 30, at 490-502.

71. *See id.* at 492, 495-96.

72. *See* Romano, *supra* note 23, at 129-31, 141-42.

takeovers.⁷³

Social psychologists' finding that subjective availability affects judgments of causality suggests an explanation for the peculiar persistence of the public's inaccurate impressions: in judging relative frequencies of events, people tend to be influenced by the accessibility of the event in their cognitive processes, even though there is no correlation between the event's accessibility and its objective probability.⁷⁴ For example, an individual will vividly remember a news story on a takeover that resulted in unemployed workers and use this event as evidence of the negative effects of acquisitions, while numerous accounts of acquisitions with no job losses do not disconfirm the initial account because the subsequent stories are not dramatic enough to register with the observer.

The combination of a poorly informed public and of management's organizational advantages in lobbying creates little political incentive for national legislators to act differently from state legislators when it comes to regulatory proposals on takeovers. As a consequence, national legislation will not be more hospitable to the market for corporate control than state legislation. A leading publication for institutional investors, reached the same conclusion in an editorial responding to the enactment of the 1990 Pennsylvania takeover statute. *Pensions and Investment Age* wrote: "Some leaders in the investment community suggest looking to Congress to head off the states. But federal representatives succumb to the same temptations as state legislators."⁷⁵

CONCLUSION: POLICY IMPLICATIONS FOR TAKEOVER REGULATION

The recent history of state takeover laws does not weaken the case for state competition but is an example of the merits of state competition. As illustrated by the Pennsylvania experience, the federal system provides a safety valve against harmful laws. Some jurisdictions will have no or only mild takeover regulation and this constrains how far other jurisdictions can go, as well as how far management can go, in taking advantage of value-decreasing regimes, especially when the less harsh laws are in major corporate law states such as Delaware and California.

Can we do better? Scholarly research suggests that some state takeover laws are more harmful than others. For example, as noted earlier, unlike other forms of takeover regulation, control share acquisition statutes and business freeze combination statutes have significant negative stock price effects. The optimal policy would be to repeal such legislation. But repeal is improbable given present political realities. The second best policy is to adopt a politically more palatable reform that makes it easier for firms to opt out of a takeover statute. This would provide

73. *See id.* at 122-24.

74. *See* Richard Nisbett & Lee Ross, *Human Inference: Strategies and Shortcomings of Social Judgment* 18-19, 21-22 (1980).

75. *Demand Liberty, or Sell*, *Pensions and Investment Age*, Apr. 30, 1990, at 16.

shareholders with a more meaningful choice concerning takeover regulation. In particular, the statutory defaults should be changed from opt-out to opt-in regimes, as is the practice followed by Georgia.

The conventional approach to statutory default provisions is to choose what the majority of firms would adopt if they had to specify a provision in their charter. This approach avoids the transaction costs of holding a shareholder vote when approval would be pro forma. The negative stock price effects of takeover statutes suggest, however, that shareholders would not prefer to be covered by such statutes. Indeed, because firms could voluntarily adopt through charter amendments most restrictions imposed by takeover statutes without authorizing legislation, the clear implication of management's lobbying is that they believe that it is easier to convince a state legislature of a takeover provision's desirability than their shareholders. Reforming the statutory defaults to require shareholder approval at least guarantees that the decision to reduce stock prices by regulating takeovers is put into the hands of those who bear the financial consequence.

Because management has an advantage over shareholders in using the proxy mechanism, the difference between opting out and opting in may have an important effect on outcomes. Firms pay for management's proxy expenses as incurred, whereas firms reimburse outsiders' expenses only when the outsiders are successful in gaining control and are thus in a position to propose reimbursing themselves. Moreover, management is unlikely to propose that the corporation defray the expenses of its opposition. Thus, because an investor's pro rata benefit is unlikely to cover solicitation costs, an investor is unlikely to propose a charter amendment (including one to opt out of a takeover statute). In addition, shareholders that are willing to bear solicitation costs will still be subject to a further difficulty: in many states, management must initiate charter amendments. This problem underscores what should be viewed as the minimally acceptable reform regarding takeover statutes: statutory rules for charter amendments ought to be changed to permit shareholder initiation of proposals, at least in specific areas where there is a conflict of interest between managers and shareholders.

Can we do worse than the current regulatory regime? Shifting jurisdiction from the states to the national government would be the proverbial cure that is worse than the disease. Federal regulation is not a solution to concerns over state intervention in the market for corporate control because the restraint that federalism exerts on the form of takeover statutes is not present in a national regime. At the national level, there is no alternative incorporation site offering a less restrictive takeover regime to which investors can shift their funds. Without alternative sites, it is not possible to set a floor on how low a legislature that is captured by management can go. In addition, the diversity of state laws in unsettled or controversial subjects such as takeovers produces a continuing flow of information concerning the actual effects of different pol-

icy choices that would be extinguished under any uniform national approach. Finally, members of Congress experience the same pressure as members of state legislatures to tilt the regulatory apparatus toward management, and while the downside of the state system will remain in the national arena, federalism's upside protection against poor policy choices will be absent.

These considerations counsel against championing national intervention. Expecting national legislation to reverse state restrictions on takeovers is, at best, wishful thinking and could well be counter productive because it will, in all probability, produce even more damaging legislation with none of the safety valves present in a federal system. Instead, we should explore removing the current national restrictions. The most politically feasible way to do this is through small-scale experimentation that is designed to discover the optimal regime by enabling firms to opt out of the Williams Act, or parts thereof, upon a shareholder vote. The desirability of enabling codes at the state level should be duplicated in the national regime. But a more important undertaking at this time is to educate the public about how the market for corporate control works for their benefit.⁷⁶ For without popular support, Congress and state legislatures will be unlikely to cross the organized and politically well-connected opponents of hostile takeovers.

76. See Romano, *supra* note 30, at 504. In criticizing my thesis, Morey McDaniel asserts that the public is concerned about the losers from takeovers, not the winners. See Morey W. McDaniel, *Stockholders and Stakeholders*, 21 *Stetson L. Rev.* 121, 154 n.120 (1991). This contention entirely misses my point that there is a vast amount of misinformation concerning workers as the alleged victims of hostile takeovers being peddled to the public by corporate managers. Although there is considerable evidence that top managers—who are the principal publicists concerning the evils of hostile takeovers—often do lose their jobs, there is *no* systematic evidence that workers are harmed by takeovers. See Romano, *supra* note 23, at 129-31, 141-42.