

STATE ANTI-TAKEOVER LEGISLATION AND THE NATIONAL ECONOMY

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In this Article, Professor Jonathan Macey argues that current anti-takeover laws waste corporate assets, fail to protect the shareholders' interests and present a significant threat to our national economy.

Professor Macey asserts that takeovers maximize shareholder wealth and produce corporate efficiency by forcing lower prices and improvements in productivity. Conversely, anti-takeover laws harm firms because the laws create uncertainty for shareholders. Professor Macey attacks public interest arguments raised in favor of these laws which suggest that shareholders need the protection of the laws. He says that shareholders are not victims of coercion in a legitimate takeover attempt, but rather enjoy the profits of an auction market for their stock. The problem of collective action on the part of shareholders is best solved at the firm level through intra-firm agreements or anti-takeover devices adopted through normal intra-firm decision-making. Professor Macey then rejects the local interests justification for these laws, arguing that takeovers result in at most a geographic shifting of wealth. He also disputes the notion that these laws prevent management from focusing on short-term gains, because he sees no tension between maximizing firm value for the present and for the future.

Finally, Professor Macey predicts adverse consequences for the national economy as a result of the current wave of state anti-takeover legislation. Shareholders will no longer realize the maximum value for their shares and the market for corporate investment will be chilled. Professor Macey also concludes that the problems inherent in state laws are equally present in federal laws. He argues that the only laws necessary are enabling legislation permitting intra-firm agreements between shareholders and management for responding to tender offers.

I. INTRODUCTION

We seem to have come full circle in providing legal rules for corporations in this country. In post-revolutionary America, corporate charters were not granted as a matter of right as they are today.¹ Consistent with the British system in existence at the time, states granted corporate charters to individual entrepreneurs on a case by case basis.² Because the decision to grant or deny a firm status as a corporation involved the

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1. The modern chartering system is characterized by the ability of firms to incorporate for any lawful purpose, a right not common in the United States until 1875. Shugart & Tollison, *Corporate Chartering: An Exploration in the Economics of Legal Change*, 23 *ECON. INQUIRY* 585, 585 (1985) (citing *Liggett Co. v. Lee*, 288 U.S. 517 (1933)).

2. *Id.* at 586 ("The few organizations incorporated for business purposes were patterned after the English trading company and their charters typically conferred monopoly privi-

political process, state legislators were able to trade corporate charters for political favors. Firms were quite willing to pay legislators for the privilege of obtaining a charter, either in the form of outright bribes or in the form of promised political support, because a corporate charter often conveyed monopoly status upon the lucky recipient.

In the wake of the Supreme Court's decision in *CTS Corp. v. Dynamics Corp. of America*,³ which validated the ability of state legislators to insulate incumbent management teams from threats of competition, those in charge of the corporate firm once again are returning to their local legislators for protection against the forces of competition. As before, the statutes being passed are promulgated to protect the interests of individual firms rather than the interests of the public or the shareholders of the firms affected.

The statutes come in a variety of forms,⁴ but all share the common feature of serving to consolidate the ability to respond to tender offers

lege for the term of the corporate contract.") (citing 1 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* (1974)).

3. 107 S. Ct. 1637 (1987).

4. The current spate of state anti-takeover laws is a medley of laws known as "second-generation" and "third-generation" laws. Second-generation laws were written to avoid the constitutional problems that caused the Supreme Court to invalidate the first-generation laws, as in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982). Third-generation laws were passed after the Court's opinion in *CTS Corp. v. Dynamics Corp. of America*, 107 S. Ct. 1637 (1987).

Anti-takeover provisions come in four varieties. See Mendelsohn & Berg, *Tender-Offer Battles in Legislative Arena Shift to Pre-emption*, *Legal Times*, Sept. 14, 1987, at 26, col. 3. The first are called control-share acquisition provisions. Statutes with such provisions require shareholder approval before acquirers of large blocks of stock can vote their shares. The typical thresholds are 20, 33 and 50%. See *Id.* at 26, col. 3.

Certain anti-takeover statutes contain so-called "fair price" provisions, which require that a firm obtain a two-thirds or higher supermajority vote of its shareholders before entering into a business combination with a person owning a certain, threshold percentage of the firm's stock. The only way to avoid the necessity of a shareholder vote is for the business combination to obtain the approval of the board of directors or for the acquirer to pay a fair price for the shares acquired in the combination. See Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 116 (1987). A "fair price" is defined as "the higher of any price the interested party [acquirer] paid to obtain its shares or the market price at the time of the combination." *Id.*

A third variety of state anti-takeover provision is contained in "redemption rights" statutes and "control-share acquisition statutes." These statutes entitle shareholders to receive, on demand, from an acquirer, an amount of cash equal to the "fair value of the stock, including the proportional increment payable as a control premium. . . . The effect of the statute is to convert partial offers into any-or-all offers." *Id.* at 116-17.

The fourth variety of state law is the five-year freeze-out fair-price statute. See Mendelsohn & Berg, *Tender-Offer Battles in Legislative Arena Shift to Pre-emption*, *Legal Times*, Sept. 14, 1987, at 26, col. 3. These statutes prohibit business combinations with interested shareholders for five years after the acquisition of the interest. These statutes resemble the fair-price statutes because they generally require approval of a majority of disinterested shares even after the five-year period has elapsed. See Romano, *supra*, at 117 n.17.

An additional wrinkle in some state anti-takeover statutes, such as the one adopted in Minnesota, is that they require boards of directors to consider how a takeover of the firm would affect a number of constituencies besides shareholders when the boards are deciding how to respond to a tender offer. For example, in Minnesota directors are required to evaluate how a takeover could

in the hands of the incumbent managers of the firms that are the targets of such offers.⁵ Some statutes go so far as to enable managers and directors to abrogate the fiduciary duties of care and loyalty traditionally owed to shareholders by enabling or requiring such managers and directors to consider the effects of a takeover on customers, employees, suppliers, creditors and even the local economy when deciding whether or not to resist a takeover.⁶ Other state statutes provide discretion to incumbent managers and directors to impede and delay unwanted tender offers, thereby significantly raising their cost.⁷

This Article argues that, while resistance to tender offers may be in the shareholders' interest in certain instances, in other situations it clearly is not. Takeovers generally maximize shareholder welfare by weeding out inefficient incumbent management and permitting new management teams to increase the value of the firm by redeploying the firm's assets to more profitable uses. Inhibiting takeovers transfers wealth from shareholders to incumbent management teams. In those instances where resistance furthers shareholder welfare, adequate provision for resistance can be obtained through intra-firm contracts. Such intra-firm agreements manifest themselves in the form of amendments to corporate charters and by-laws. No state legislation, other than enabling laws that ensure the validity of these intra-firm contractual arrangements, is needed to protect shareholders.

In a pioneering article, Roberta Romano argued that the state of Connecticut enacted an anti-takeover statute at the behest of a single politically powerful corporation, rather than through the interplay of a number of competing interest groups.⁸ The corporation, the Aetna Life and Casualty Company, persuaded the Connecticut legislature to pass the statute despite the strong possibility that the firm's own shareholders would have declined to support a similar measure if the matter had been put to them for a vote.⁹ Romano observed that several other state statutes were apparently passed at the behest of particular firms. Specifically, she noted that Maine, Pennsylvania, Illinois and Missouri had

affect employees, suppliers, creditors and even the communities where the corporation is located or has significant operations. See Goodman, *State Takeover Legislation*, 1 *INSIGHTS: THE CORP. & SEC. L. ADVISOR* 2 (1987). The Minnesota statute also requires the board to evaluate the effect of the takeover on the state and national economies. *Id.*

5. See D. Oesterle, *State Takeover Statutes: "Economic Folly?"* (1987) (manuscript on file with author).

6. See *supra* note 4.

7. *Id.*

8. Romano, *The Political Economy of Takeover Statutes*, 73 *VA. L. REV.* 111, 122-34 (1987) ("Although the takeover legislation was unopposed in the state legislature, there is no evidence to support a coalition explanation.").

9. *Id.* at 129-30.

passed statutes to benefit individual firms that were threatened with outsider takeovers.¹⁰

Other state anti-takeover measures also appear to reflect the lobbying of a single-minded political group of individual firms rather than a broader political consensus. The action of the legislature that Romano observed in Connecticut appears to be repeating itself across the country. In North Carolina, for example, Burlington Industries persuaded the legislature to adopt an anti-takeover statute in order to thwart a hostile takeover by Asher Edelman and Dominion Textile Corporation.¹¹ Indiana enacted a control-share acquisition statute and a freeze-out fair-price statute in response to the threatened takeover of Arvin Industries by the Belzberg family.¹² Similarly, the threatened takeover of Goodyear Tire and Rubber Company "galvanized the Ohio legislature to pass a new [anti-takeover] law."¹³ And it is well known that Washington's anti-takeover statute was passed at the behest of Boeing Industries.¹⁴

The list goes on. In perhaps the most shameless transfer of wealth from shareholders to incumbent management, Dayton Hudson Corporation prevailed upon the Governor of Minnesota to call a special legislative session so that a law could be passed to protect the firm from takeover by Dart Group, Inc.¹⁵ In Massachusetts, to relieve any lingering doubts about the special-interest basis of that state's anti-takeover statute, the Governor appeared at a Gillette Company plant to sign the statute into effect. Gillette had been the subject of a takeover attempt by Revlon.¹⁶ In Wisconsin, when the G. Heileman Brewing Company of LaCrosse came under attack from Bond Holdings Corporation, Heileman persuaded Governor Tommy Thompson to convene a special legislative session at which a particularly draconian anti-takeover measure was enacted into law.¹⁷

10. *Id.* at 137.

11. Goodman, *State Takeover Legislation*, 1 *INSIGHTS: THE CORP. & SEC. L. ADVISOR* 2 (1987).

12. Mendelsohn & Berg, *Tender-Offer Battles in Legislative Arenas Shift to Pre-emption*, *Legal Times*, Sept. 14, 1987, at 26, col. 3.

13. OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, *SHAREHOLDER WEALTH EFFECTS OF OHIO LEGISLATION AFFECTING TAKEOVERS*, at 1 (May 18, 1987).

14. *N.Y. Times*, Aug. 11, 1987, § 4, col. 3.

15. See Glassman, *Free Gift*, *THE NEW REPUBLIC*, July 27, 1987, at 10.

16. See Goodman, *supra* note 11, at 2.

17. Ironically, soon after the Wisconsin act was signed into law, Heileman and Bond began negotiating and Heileman's management ultimately endorsed an offer of \$40.75 for the firm's stock. It seems likely that the Wisconsin law actually facilitated the merger by improving Heileman's negotiating position. *Note*: The Wisconsin law was recently struck down by the United States District Court for the Eastern District of Wisconsin. *RTE Corp. v. Mark IV Indus., Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 93,789 (May 6, 1988).-*Eds.*

This Article considers the effects that these state anti-takeover provisions are likely to have on the national economy if they are allowed to proliferate at their current rate. First, this Article begins with a general discussion of the benefits that takeovers have on the economy and an analysis of the ways in which state anti-takeover laws deprive the economy of these benefits. Second, this Article analyzes the various arguments in favor of state takeover provisions. This Article will show that most states are peculiarly ill-suited to provide socially desirable takeover legislation because the parties with the greatest stake in achieving efficient legal rules are systematically underrepresented in the political process. State anti-takeover laws represent the creation of a political externality in which state legislatures are able to provide benefits to local interests by imposing costs on politically disorganized individuals who do not reside within the state.

Ultimately, the proffered public interest explanations of these statutes must give way to recognition that the statutes are nothing more than extremely costly devices for providing job protection for inefficient top level managers of poorly run firms and for keeping jobs in particular regions at the expense of more productive workers in other regions. Such protectionism is costly not only to the shareholders of these firms, but also to consumers and workers. This Article concludes with a discussion of the long-term economic effects of these statutes.

II. THE ROLE OF TAKEOVERS IN THE NATIONAL ECONOMY

Perhaps a complete answer to the question of whether takeovers benefit the national economy is contained in the evidence of the gains realized by those lucky shareholders whose firms are the subject of a tender offer. The Office of the Chief Economist of the Securities and Exchange Commission found that target firm shareholders enjoyed an average gain of 53.2% on the sale of their shares.¹⁸ Assuming that bidding firms are acting rationally,¹⁹ the gains to target shareholders must reflect the fact that the acquirer believes the target firm is either (1) currently undervalued or (2) properly valued under its current management, but capable of attaining higher value if reorganized or managed by a different management team. In light of the overwhelming evidence supporting the hypothesis that capital markets are efficient in the sense that they fully reflect all available information about the firms whose shares are being traded,²⁰ significant takeover activity is very unlikely to occur for the reason that target firms somehow are undervalued in

18. Comment & Jarrell, *Two Tier and Negotiated Tender Offers*, 19 J. FIN. ECON. 283 (1987).

19. See *infra* section III. D.

20. See *infra* notes 40-47 and accompanying text (discussing capital market efficiency).

the marketplace. Rather, it is more likely that tender offers are launched because the acquirer can realize gains by reorganizing the firm, replacing existing management, or combining the target firm's assets with the assets of the bidding firm so as to create value.

The wealth-enhancing view of takeovers is supported by the fact that top managers lose their jobs when their firms are the subject of a successful hostile takeover. Sixty-two percent of top managers lose their jobs within three years of a hostile takeover compared with a rate of 21% every three years in firms with no change in control.²¹ As Professor Michael Jensen recently observed:

The restructuring of corporate America . . . that is being brought about by the takeover market is streamlining many of the largest and most complex corporations that are simply too large, too complicated and too unfocused to be efficient. Restructuring is bringing top level managers closer to employees, customers and shareholders. We must not strangle these productive forces.²²

Thus, not only are takeovers beneficial to the shareholders of the firms being acquired, takeovers also provide substantial benefits to society at large. These gains come in the form of improving the productivity of American corporations so that goods and services reach Americans at lower prices, and enabling American firms to compete more effectively in global product markets.

The individual firms involved in a particular takeover are not the only firms that benefit as a consequence of a robust market for corporate control. Professors Easterbrook and Fischel argue that all firms will be more productive if incumbent management has reason to believe that a hostile takeover is a possibility. The threat of displacement in such a takeover provides management with a strong incentive to maximize firm value. "[S]hareholders benefit [from tender offer bids] even if their corporation never is the subject of a tender offer. The process of monitoring by outsiders poses a continuous threat of takeover if performance lags. Managers will attempt to reduce agency costs in order to reduce the chance of takeover. . . ."²³

The point here is not simply that state anti-takeover laws harm the shareholders of the firms directly affected by the laws—that point is

21. Jensen, *A Helping Hand for Entrenched Managers*, Wall St. J., Nov. 4, 1987, at 30, col. 6.

22. *Id.*

23. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1174 (1981) (footnote omitted).

obvious and well documented.²⁴ Rather, the point is that state legislation restricting takeovers harms not only the firms in the particular state involved but all firms in all states. The possibility of states passing such legislation at short notice upon the request of the incumbent management of a particular firm means that no shareholder is safe from having her wealth appropriated by an opportunistic incumbent management team determined to keep its job at the expense of shareholders. The existence of anti-takeover statutes, along with the possibility that more will be passed, reduces the incentives to prospective bidders to engage in a search for mismanaged firms and underdeployed assets by lowering the expected payoff of such a search. Incumbent management, no longer threatened with the possibility of a takeover, has less incentive to maximize firm value.

Suppose, for example, that firm X is chartered in a state which does not possess an anti-takeover statute, and firm Y is chartered in a state which does have such a statute. Further suppose that the two firms are identical in all respects except for their situs of incorporation. It would seem that firm X will be worth more than firm Y because its managers will have greater incentive to maximize value for shareholders by, for example, improving product quality, because failure to make such improvements might result in a hostile takeover. Unfortunately, there exists the possibility that a threat of impending takeover might result in the management of firm X prevailing upon the legislature of the state in which it is incorporated to pass an anti-takeover statute of its own. Failing that, firm X might reincorporate in a state which does have an anti-takeover statute in order to thwart a threatened takeover. The fact that these options are available to firm X's management reduces the value of firm X because the options reduce the probability that there will be a hostile tender offer for the firm's shares at a premium over the current market price, and also because they reduce the incentives that potential bidders have to monitor the firm's management.

While it may be possible for firms to issue credible, bonded promises to refrain from reincorporating or lobbying their local legislatures as described above, such contracting is by no means costless or certain because there exists the possibility that firms will renege on their promises after an initial bid is made. Indeed, such post-bid opportunism often will be in the interests of target firm shareholders because it will facilitate the creation of an auction market for the target firm,

24. See *infra* notes 61-66 and accompanying text (discussing empirical evidence of wealth effects of state anti-takeover laws).

thereby enabling the firm's shareholders to realize an even higher price for its shares.²⁵

State anti-takeover statutes also harm the shareholders of all firms because, taken together, the patchwork quilt of state and federal laws concerning takeovers is likely to increase significantly the costs to firms that engage in the already costly business of launching tender offers. As these costs go up, the possibility of shareholders realizing the significant gains that accompany such transactions goes down, as fewer firms are willing to serve in the role of bidder-monitor.

Arthur Fleischer, Jr., a noted takeover specialist, has observed that "[i]f state acts continue to be upheld, takeovers may be regulated by a patchwork combination of federal and state laws with the nature and extent of investor protection and the balance between bidders and targets dependent upon the state in which the target is incorporated."²⁶ Other practitioners have reached identical conclusions.²⁷ Simply put, when the rules of the takeover game become more complicated, the advantages of playing the game decline. Of particular concern is the fact that an individual firm may be subject to the anti-takeover provisions of more than one state's statute because many of the statutes purport to apply to firms with headquarters or significant operations within the state as well as to firms incorporated in the state.

Thus it seems probable that anti-takeover laws passed by particular states impose costs on all firms, regardless of the locations of the firms. Such statutes lower the returns to bidders of engaging in the costly search necessary to discover poorly managed or otherwise undervalued firms. This diminution in returns to bidders reduces their incentives to engage in searches and results in lower levels of monitoring for potential firms. These lower levels of monitoring translate into increased managerial shirking, that is, reduced managerial performance. In the near-term shareholders are harmed. Ultimately consumers are harmed as well because the managerial entrenchment caused by state anti-takeover laws leads to lower quality products being produced at higher prices by firms isolated from the discipline of the market for corporate control.

An additional, and generally ignored, economic benefit of a robust market for corporate control is the role that takeovers play in reducing the incidence of bankruptcies in the economy. From an economic per-

25. See Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 728-30 (1987).

26. Goodman, *supra* note 11, at 2 (quoting Arthur Fleischer, Jr.).

27. See Mendelsohn & Berg, *supra* note 12, at 27, col. 1 ("[I]t is possible for 50 separate state anti-takeover [statutes] to coexist. Such a fragmentary tender-offer regulatory system could create uncertainty, inconsistency and confusion in our capital markets, thereby impairing our national economy.").

spective, takeovers are low-cost substitutes for insolvencies and dissolutions. They serve the important purpose of facilitating the restructuring of inefficient conglomerate business forms and the redeployment of under-utilized assets. As Professor Dewey observed early in the takeover debate, such transactions "have virtually nothing to do with either the creation of market power or the realization of scale economies. They are merely a civilized alternative to bankruptcy or the voluntary liquidation that transfers assets from falling to rising firms."²⁸ And as Henry Manne pointed out in his classic article, *Mergers and the Market for Corporate Control*, mergers are "desirable before bankruptcy becomes imminent in order to avoid that eventuality."²⁹ In other words, if mergers were not retarded by legal impediments, "we should anticipate relatively few actual bankruptcy proceedings in any industry which was not itself contracting. The function so wastefully performed by bankruptcies and liquidations would be economically performed by mergers at a much earlier stage of the firm's life."³⁰

The observation that hostile takeovers are a low-cost substitute for insolvency is a direct implication from the observation that takeovers serve the important purpose of causing assets to flow to their highest valuing users. The problem is that many state legislators would prefer to see a firm languish or die at home rather than thrive in some other state.

III. THE PUBLIC INTEREST ARGUMENTS IN FAVOR OF STATE ANTI-TAKEOVER LEGISLATION

Several public interest explanations are advanced to counter the contention that state anti-takeover laws are nothing more than amorally redistributive special interest legislation that provide benefits for incumbent management at the expense of workers and shareholders.³¹ Proponents of these statutes argue that they are needed to protect workers from being displaced from their jobs and to protect shareholders from their inability to mount a collective response to a hostile bid. In addition, proponents of these statutes argue that they are needed to protect incumbent management from being so mesmerized by the

28. Dewey, *Mergers and Cartels: Some Reservations about Policy*, 51 AM. ECON. REV. 255, 257 (1961).

29. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 111 (1965).

30. *Id.* at 112.

31. The term "amorally redistributive" as a description for statutes that transfer wealth from poorly organized political groups to better organized groups was first used by Richard Posner. See Posner, *Economics, Politics, and the Reading of Statutes and the Constitution*, 49 U. CHI. L. REV. 263, 268 (1982).

short-term need to maximize current share prices that they neglect the long-term welfare of their firms.

Beginning with the problem of shareholders' inability to mount a collective response to coercive offers, this Section of this Article considers the various public interest arguments supporting state anti-takeover legislation. In the end, it is apparent that none of these arguments has merit. Managerial self-interest remains the sole explanation for state anti-takeover legislation.

A. The Problem of Collective Shareholder Response

In theory, tender offers for the shares of publicly held firms can coerce shareholders into selling their shares at suboptimal prices. Rational shareholders fear that if they do not tender they will lose any opportunity of realizing a premium for their shares, because a sufficient number of their fellow shareholders will tender to satisfy the requirements of the purchaser. Therefore, shareholders who are offered an immediate premium for their shares have a strong incentive to tender at once in order to ensure that they will receive that premium, even if they think that by refraining from tendering they might later realize an even greater price. This predicament is a classic collective action problem: if all shareholders could get together and coordinate their response to the bid (that is, if together they could agree to hold out for more money) then they would be able to realize an even higher price.³² In the absence of such coordination, however, the shareholders will be "coerced" into tendering at a sub-optimal price.³³

One mechanism for overcoming the collective action problem facing target firm shareholders is to authorize incumbent management or some other more independent group to negotiate on behalf of the target shareholders.³⁴ To the extent that state anti-takeover statutes empower

32. Readers with a background in economics will recognize that characteristics of the classic prisoner's dilemma face target shareholders. For descriptions of the prisoner's dilemma game, see P. SAMUELSON, *ECONOMICS* 482-83 (8th ed. 1970).

33. See Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 *YALE L.J.* 13, 19-28 (1985); Easterbrook & Fischel, *supra* note 23.

34. In theory, the common law fiduciary duties of care and loyalty require managers to place the interests of shareholders first when evaluating outside bids. But judicial enforcement of these fiduciary duties is problematic, as it is exceedingly difficult for courts to determine when particular managerial defensive tactics are in shareholders' interests and when they are not. See Macey & McChesney, *supra* note 33, at 53-60 (discussing one particular defensive tactic, corporate greenmail payments, and concluding that "after the fact, it is difficult to determine whether a specific greenmail payment ultimately served the interests of the shareholders."). In addition, the derivative suit, which is the legal mechanism through which most shareholder complaints reach the courts, is itself fraught with difficulties. See Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 *CORNELL L. REV.* 261, 292 (1986) (the widespread assumption that "liability rules enforced by derivative suits play a

incumbent managers to engage in such negotiations on behalf of shareholders, the statutes can conceivably be viewed as valuable devices for overcoming the shareholders' collective action problem.

The anti-takeover statutes being considered here do not merely empower incumbent management to bargain on behalf of shareholders; they virtually mandate that shareholders provide managers with this authority. In light of the ability of shareholders to enact intra-firm contracts that empower managers to act on shareholders' behalf in the event of a takeover, state legislation accomplishing the same end seems not only unnecessary but positively detrimental to shareholders' interests for several reasons.

First, the requirement that incumbent management negotiate on behalf of shareholders deprives the shareholders of the ability to elect an alternative bargaining agent for the purpose of negotiating with outside bidders. The obvious conflict of interest between shareholders, who are interested in maximizing the price of their shares, and managers, who are interested in retaining and securing their positions, suggests that at least some firms might find it desirable to elect bargaining agents other than incumbents.

Similarly, despite the existence of a collective action problem, shareholders of certain firms might not benefit by providing third parties with power to bargain with prospective bidders. Where a firm has a number of institutional investors, or other highly aggregated shareholders, the collective action problem may not loom particularly large because communication and coordination among individual shareholders is possible at low cost.

In addition, the ability to bargain collectively is not an unmitigated good. As discussed above, this bargaining ability raises the expected costs to bidding firms and thus lowers the probability that a prospective bidder will ever emerge to offer shareholders a premium for their shares. This decreased probability of a future offer lowers the present value of the firm's shares. Empowering incumbent management to negotiate with prospective bidders lowers the level of monitoring carried on by such outside bidders, and this lower level of monitoring represents another cost to shareholders. Only if these costs are offset by the gains associated with empowering incumbent management to negotiate will target shareholders benefit from empowering management to engage in such negotiations.

The point here is not that defensive tactics that mitigate the collective action problem facing target shareholders are always contrary to shareholders' interests. Rather, the point is that every firm has unique

fundamental role in aligning the interests of manager and investors . . . is not supported by either the theory of liability rules, the available evidence, or the structure of corporate law.").

problems and thus defensive tactics that benefit one firm may harm another. The optimal solution appears to be to address the problem at the firm level rather than at the level of state-sponsored legislation.

One final argument in favor of legislating at the state level to solve this collective action problem concerns uncertainty in the legal system. It might be argued that state legislation is necessary because privately implemented anti-takeover provisions may be struck down by the courts as involving a breach of management's fiduciary duty of care or loyalty to target firm shareholders.³⁵ This argument is wholly unpersuasive. If there is ambiguity about the legality of the intra-firm contracting process that enables shareholders to solve the collective action problem facing them in a tender offer situation, the problem could easily be solved by legislation empowering firms to enact such intra-firm agreements.³⁶ The mandatory provisions currently being passed by state legislatures are entirely inappropriate because shareholders are not sufficiently empowered to opt out of them.³⁷

B. The Goal of Protecting Local Jobs

In light of the fact that major national unions and other elements of organized labor in the United States are voicing opposition to state anti-takeover statutes, the argument that these statutes benefit workers immediately appears suspect. Proponents of the statutes claim that without the statutes heartless raiders (perhaps even "looters") will take over good old American firms and fire all of the workers or unilaterally reduce their wages. The available evidence indicates that this is not the case.³⁸ Indeed, a recent National Bureau of Economic Research study of takeovers in Michigan shows that wages and employment of firms involved in acquisitions actually increase.³⁹

Acquirers often sell subsidiaries and divisions of the firms that they take over. However, these spin-off transactions generally do not result in loss of jobs for rank-and-file employees because the new firm owners seldom if ever liquidate the subsidiary and fire the employees. Generally only the administrative positions of relatively high-level employees be-

35. See D. Oesterle, *supra* note 5, at 12; see also Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117, 133-35 (1986).

36. See Haddock, Macey & McChesney, *supra* note 25, at 727-37.

37. The subject of the opt out provisions of these state anti-takeover statutes is worthy of an article in-and-of itself. Suffice it to say that for many of the provisions, firms simply are unable to opt out, and for these, that is, managers and directors generally can opt in either by doing nothing or by acting unilaterally, that is, without shareholder approval.

38. See Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, at 19 (1987) (unpublished manuscript).

39. C. BROWN & J. L. MEDOFF, *THE IMPACT OF FIRM ACQUISITIONS ON LABOR* (working paper 1987).

come redundant after a takeover. At worst, the workers in a particular state will be displaced by workers in another state as the firm's assets are redeployed to that state. But when this happens, overall national employment is unaffected. The only effects are local. When state anti-takeover statutes prevent jobs from leaving one state for another, they result in discrimination against out-of-state workers in favor of local workers. This local favoritism is inconsistent with the spirit of the national labor union movement.

C. Prevention of Managerial Focus on the Short-Term

Many of the managers of America's large, publicly held corporations argue that the very threat of hostile takeovers is bad for American business. The harm comes because managers, constantly threatened with losing their jobs, do not focus on the long-term strategic planning that is vital to their firms' health but instead focus on the short-term goal of keeping share prices high in order to ward off potential bidders.

In this regard the words of John G. Smale, the chairman and chief executive officer of Procter & Gamble, are instructive:

Widespread hostile takeover activity has made maximizing immediate shareholder value appear to be the basic purpose of a business enterprise. Some defend hostile takeovers as adherence to free enterprise—as reliance on market forces to structure and restructure our economy. But this emphasis will, if not appropriately curbed, have just the opposite effect. . . . I can say that by focusing on the short term, our publicly held business enterprises will see their competitive position decay, their resiliency in difficult times undermined, and their standing in society compromised.

There is, of course, nothing new about a corporation's fundamental responsibility to its owners. What is new is the role of what I'll call the "temporary" owner, whose sole interest is that of a speculator looking for the "fast buck."⁴⁰

This argument is flawed in two important respects. First, it misconstrues the basis upon which the market determines share prices for publicly traded firms. Second, it mistakenly presumes that managers have some disembodied duty to the corporations for which they work that is distinct from their fiduciary duty to maximize share value for the firms' residual claimants, whether or not they are "temporary owners."

40. Smale, *What About Shareowners' Responsibility?*, Wall St. J., Oct. 16, 1987, at 24, col. 2.

There is no real debate about the fundamental issue of how the market determines the price of publicly held shares. The price of such stock reflects the market's estimation of the present value of the net future earnings of the firm. This estimate, in turn, is based on the publicly available information about the firm's performance, and the market's estimate of the firm's future earnings prospects. This observation is virtually self-evident. After all, a share of stock is simply an asset and asset values are a function of discounted future flows.

The development and testing of the Efficient Capital Market Hypothesis (ECMH) has contributed substantially to our understanding of how share prices are determined.⁴¹ The theory posits that share prices fully reflect information about the earnings prospects of the firms to which they pertain. This is because information processors in search of profits quickly discover "undervalued" firms and purchase their shares, thereby driving share prices to their correct levels virtually instantaneously.⁴² Thus, according to the Hypothesis, "in an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value."⁴³

As Professor Michael Jensen has observed, "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis."⁴⁴ The Hypothesis

41. See J. LORIE & M. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 70-97 (1973); Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970); Comment, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1034 (1977).

42. Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

43. Fama, *Random Walks in Stock Market Prices*, FIN. ANALYSTS J., Sept.-Oct. 1965, at 55.

44. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 95 (1978). For discussions of the numerous tests supporting the hypothesis in its various forms, see Gilson & Kraakman, *supra* note 42, at 555.

Empirical studies have found several anomalies in stock returns that appear to be inconsistent with the Efficient Capital Market Hypothesis. Most notable among these are the price-earnings effect, the small-firm effect and the January effect. Initially it was thought that firms with higher price-earnings ratios (a price-earnings ratio is calculated by dividing a firm's stock price by its earnings per share) earned abnormally high returns on a risk-adjusted basis, a finding inconsistent with the Efficient Capital Market Hypothesis. Basu, *Investment Performance of Common Stocks in Relation to their Price Earnings Ratios: A Test of the Efficient Market Hypothesis*, 32 J. FIN. 663 (1977). A later study, however, by Professor Reinganum found the P/E effect to disappear when firm size was factored into the equation. Reinganum, *Misspecification of Capital Asset Pricing: Empirical Anomalies Based on Earnings' Yields and Market Values*, 9 J. FIN. ECON. 19 (1981). In essence, the P/E effect was seen to be a small-firm effect: small firms have been found to have higher risk-adjusted returns than larger firms. See Banz, *The Relationship Between Return and Market Value of Common Stocks*, 9 J. FIN. ECON. 3 (1981).

In addition to the small-firm effect, financial economists searching for market inefficiencies have discovered the "January effect." As the name implies, studies examining the January effect show that stock price returns are abnormally high in the month of January. Gultekin & Gultekin, *Stock Return Anomalies and the Tests of the APT*, 42 J. FIN. 1213 (1987); Tinic & West, *Risk and*

should inform our view of how the law of corporations, financial intermediaries and financial markets ought to evolve.⁴⁵

The basic lesson to be learned from the Efficient Capital Market Hypothesis is that what matters in the stock market is the future not the past, because past events have already become reflected in the firm's share price performance and therefore such information is worthless to investors. What matters is the market's perception about the firm's future income flows. The market's estimate about the size of these flows will be discounted back to present value and constitute the firm's share price.

The point, of course, is that the distinction between maximizing firm value for the present versus maximizing firm value for the future is wholly false. What matters in determining the value of a firm's shares is the present value of all flows—present and future. To argue that hostile takeovers force managers to focus on the short-term at the expense of the future is to ignore this reality. Earnings from investments in the future—even if such investments produce no immediate income to the firm—are reflected immediately in a firm's current share price.⁴⁶

For the same reason, characterizing some shareholders as “temporary” (only interested in the short run) and others as “permanent” (only interested in the long run) is fatuous. Temporary shareholders and permanent shareholders realize the same gain from future events. The temporary shareholder realizes the value of future events in the form of high current price/earnings multiples and high current prices for shares. The permanent shareholder realizes the value of future events in the form of long-term gains when the stock ultimately is sold and in the form of valuable collateral for current borrowing. Both groups have an interest in investing in firms whose managers invest in all projects with a positive present value.

The theoretical arguments presented above are bolstered substantially by the evidence of favorable stock market reaction to corporate

Return: January vs. the Rest of the Year, 13 J. FIN. ECON. 561 (1984); Keim, *Size-related Anomalies and Stock Return Seasonality: Further Empirical Evidence*, 12 J. FIN. ECON. 13 (1983); Gultekin & Gultekin, *Stock Market Seasonality: International Evidence*, 12 J. FIN. ECON. 469 (1983).

The presence of these aberrations is important but is likely due to a combination of insider trading in small firms and to tax-loss selling. See Woodward & Alexander, *Insider Trading and the Small Firm Effect* (April, 1987) (manuscript on file with author). In any event, such anomalies in no way affect the analysis in the text concerning the implications of the Efficient Capital Market Hypothesis for a policy analysis of state anti-takeover legislation.

45. See Gilson & Kraakman, *supra* note 42, at 549-50.

46. Some have argued that the market systematically undervalues future events, although there is no evidence that this is the case. If this is so, then current share prices will not accurately reflect future prospects. Of course, if share prices systematically undervalue future events then massive arbitrage possibilities are available in the market. This proposition is highly improbable.

announcements of new research and development projects.⁴⁷ Such projects produce no current income to the firms that embark upon them. The single explanation for the favorable stock market reaction is that the anticipated future earnings expected to result from such projects are reflected in the firm's current share price. In addition, a recent study shows that firms involved in takeovers show no difference in their pre- and post-merger research and development performance relative to their competitors.⁴⁸

Similarly, if takeovers forced managers to focus excessively on the short term in order to avoid being taken over, then firms with high research and development expenditures would be more likely to be taken over than other firms. But this is not the case. A recent study of 324 high research and development firms and 177 takeover targets during 1981-1984 shows that firms with high research and development expenditures are not more vulnerable to takeovers.⁴⁹ Indeed, a study by Bronwyn H. Hall on the effect of takeover activity on corporate research and development demonstrated that acquisition activity has been directed toward firms and industries which are involved in lower levels of research and development activity.⁵⁰

Managers owe a fiduciary duty to maximize value for shareholders. The claim that the long-term interests of a corporation permit a firm's managers to ignore the current value of the firm's share prices does not stand up to scrutiny. A firm's share price reflects all events, past, present, and future, that bear on the firm's present value. Thus, the argument that managers should be free to ignore current share prices in favor of vaguely stated goals, such as serving other long-term corporate interests, is really an argument to permit managers to ignore their fiduciary duties of care and loyalty to shareholders. If such a change in American law were permitted to occur through state anti-takeover statutes, it would represent a massive expropriation of shareholder wealth.

D. The Returns to Acquiring Firms

Just as there is a plethora of data on returns to shareholders of target companies, so too is there an abundance of data on returns to

47. THE OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, Institutional Ownership, Tender Offers, and Long-Term Investments (Apr. 19, 1985); McConnell & Muscarella, *Corporate Capital Expenditure Decisions and Market Value of the Firm*, 14 J. FIN. ECON. 399 (1985) (finding favorable share price reactions to increased investments in research and development except in the oil industry).

48. B. HALL, THE EFFECT OF TAKEOVER ACTIVITY ON CORPORATE RESEARCH AND DEVELOPMENT (National Bureau of Economic Research Working Paper 1987).

49. *Id.* at 28-29.

50. *Id.*

shareholders of acquiring firms. Some of these studies show that acquiring firms enjoy positive abnormal returns (that is, returns in excess of market expectations) during the time period immediately preceding the takeover.⁵¹ Other studies, however, report significant losses to bidding firms on or around the announcement date of a takeover.⁵²

These studies must be explained by those who subscribe to the theory that takeovers are unambiguously good for the economy. If it can be established that takeovers do not produce net gains to shareholders, then state anti-takeover legislation can be justified on the grounds that such legislation prevents the diversion of society's resources toward the consummation of transactions that produce no net social gains.⁵³ On the basis of these studies it has been suggested that takeovers are consummated to benefit the managers of the acquiring firm rather than the shareholders of the acquiring firm. Specifically, it has been suggested that managers of acquiring firms have an incentive to engage in acquisitions either: (1) because their compensation is linked to firm size,⁵⁴ or (2) because they prefer to control large amounts of corporate assets,⁵⁵ or (3) because controlling a large firm provides them with greater job security.⁵⁶

At the outset, it must be emphasized that no one has even suggested that a single state anti-takeover statute has been passed for the express or implied purpose of controlling opportunistic behavior on the part of managers of bidding firms. After all, a statute designed to impede opportunistic takeovers by managers would impede friendly as well as hostile takeovers. But no state anti-takeover statute even attempts to impede friendly acquisitions. Thus, these statutes cannot even

51. Asquith, Bruner & Mullins, *The Gains to Bidding Firms from Merger*, 11 J. FIN. ECON. 121, 128 (1983) (finding a .9% positive cumulative abnormal return to bidders on the announcement of the transaction); Dodd & Ruback, *Tender Offers and Stockholders Returns: An Empirical Analysis*, 5 J. FIN. ECON. 351, 368 (1977); (finding a 2.83% positive cumulative abnormal return to bidders in the period from one month before to one month after the announcement of the transaction).

52. Malatesta, *The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155 (1983) (finding a 5.4% negative cumulative abnormal return to bidders in the period from one to six months following the announcement of the transaction); Dodd, *Merger Proposals, Management Discretion and Stockholder Wealth*, 8 J. FIN. ECON. 105, 112 (1980) (finding a .62% negative cumulative abnormal return to bidders on the announcement date of the transaction); Eger, *An Empirical Test of the Redistribution Effect in Pure Exchange Mergers*, 18 J. FIN. & QUANT. ANALYSIS 547 (1983) (finding a negative cumulative abnormal return to bidders of 4% in the period beginning five days after the announcement).

53. Put another way, if takeovers produce no social welfare gains, then the resources spent in carrying out such transactions are real wealth losses to the economy.

54. W. J. BAUMOL, *BUSINESS BEHAVIOR, VALUE, AND GROWTH* (1969); Mueller, *A Theory of Conglomerate Mergers*, 1969 Q.J. ECON. 643.

55. Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197, 203 (1986).

56. Amihud & Lev, *Risk Reduction as a Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981).

be rationalized ex post on the ground that they mitigate the problem of opportunistic acquisitions by managers. If such acquisitions are currently taking place, state anti-takeover statutes will simply shift the focus of such acquirers from hostile to friendly targets.

More importantly, upon close inspection, it appears that any ambiguities in the empirical evidence on share price reactions to acquirers may be due to problems with statistical modeling rather than to a lack of real benefit to successful acquirers. As Paul H. Malatesta has pointed out, in an efficient capital market, the expected gains or losses to bidding firms will be incorporated rather quickly into the price of such firms' stock.⁵⁷ Thus, gains to bidders will begin to be reflected in acquirers' share prices at the moment such acquirers announce their intention to engage in an acquisition program. Thus, as one would expect, several studies show that acquiring firms enjoy positive abnormal returns (that is, returns in excess of market expectations) for an extended period prior to the actual announcement of a takeover transaction.⁵⁸ These positive abnormal returns should be attributed to the market's expectations of the gains to be realized from the firm's acquisition program. If the actual acquisitions turn out to disappoint these expectations, then the firm's share prices will react negatively around the time of the announcement.

Obviously, from the perspective of the acquiring firms' shareholders, the relevant inquiry is whether the total gains to the bidding firms' shareholders are positive or negative. If the losses that occur around the acquisition date are offset by the gains experienced in preceding months, then bidding firms' shareholders benefit by the process. Unfortunately, there is very little data available on this issue, but it appears likely that overall returns to bidders are positive. Three separate studies show that total returns to acquirers are positive.⁵⁹

57. Malatesta, *supra* note 52, at 168.

58. Asquith, *Merger Bids, Uncertainty, and Stockholder Returns*, 11 J. FIN. ECON. 51, 59 (1983) (finding a 14.3% positive cumulative abnormal return to bidders in the period from 480 to 20 days prior to the announcement of the transaction); Malatesta, *supra* note 52 (finding a 4.3% positive cumulative abnormal return to bidders in the period from 60 days prior to the announcement of the transaction to the announcement of the transaction); Asquith, Bruner & Mullins, *supra* note 50, at 128-30 (finding a 2.8% positive cumulative abnormal return to bidders in the period from 20 days prior to the announcement of the transaction to the transaction date itself); Dodd, *supra* note 52 (finding a 5.37% positive cumulative abnormal return to bidders in the period from 40 days prior to the announcement of the transaction); Dodd & Ruback, *supra* note 51, at 368 (finding an 11.66% cumulative positive abnormal return to bidders in the period from 12 months to one month prior to the announcement of the transaction to the date of the announcement); Mandelker, *Risk and Return: The Case of Merging Firms*, 1 J. FIN. ECON. 312 (1974) (finding a 5.1% positive cumulative abnormal return to bidders in the period from 40 months to one month prior to the announcement of the transaction).

59. See Asquith, *supra* note 58, at 59 (showing returns to bidders in the preannouncement period to be positive 14.3%, as against a statistically insignificant return on the announcement date of .2%); Dodd, *supra* note 52, at 112 (showing returns to bidders in the preannouncement

From a societal perspective, the pivotal question is whether the aggregate returns of takeovers are positive or negative. That is, even assuming that bidders suffer aggregate welfare losses, takeovers are still desirable from a societal perspective if the gains to the targets outweigh the losses to the bidders. Once again, the available evidence suggests that the gains from takeovers are positive.⁶⁰ This is not surprising given the ability of acquiring firm shareholders to draft compensation agreements with managers that align the interests of such managers with those of the shareholders.⁶¹ In light of the ability of shareholders to draft such contracts, it would be surprising if compensation arrangements did not eliminate the incentives of managers to consummate takeovers that harm acquiring firm shareholders. Indeed, the surprisingly large number of closely-held acquiring firms strongly suggests that corporate acquisitions are in acquiring firms' interests.

IV. THE NATIONAL ECONOMIC EFFECTS OF STATE ANTI-TAKEOVER LEGISLATION

The arguments presented above suggest that state statutes that impede the operation of the market for corporate control will harm the shareholders of all corporations. Such laws will result in less monitoring of managers of all firms, slower replacement of ineffective and corrupt incumbent management, less efficient deployment of society's resources, and a greater number of corporate bankruptcies and reorganizations.

ment period to be positive 5.37%, as against a negative return on the announcement date of .62%); Dodd & Ruback, *supra* note 51, at 368 (showing returns to bidders in the preannouncement period to be positive 11.66%, as against a negative return on the announcement date of 2.83%). Some of these studies continue to examine share prices long into the period after the announcement of the takeover. There are severe methodological problems with this approach because after the acquisition the resulting firm differs substantially from the acquiring firm.

60. Here studies examine average aggregate abnormal dollar returns instead of average abnormal rates of return because acquiring firms are generally larger than target firms. As a consequence of this size differential, if takeovers cause target firm shareholders to receive, on average, a five percent positive rate of return, and bidding firm shareholders to suffer a negative return of five percent, overall social welfare will decrease because the total dollar return from these transactions will be negative.

But most studies report that aggregate abnormal dollar returns from takeovers are positive even when the statistical methodology accounts for the differences in size between bidders and targets. See Roll, *supra* note 55 (citing 1983 study of Bradley, Desai & Kim) (reporting statistically insignificant average positive cumulative returns of \$33.9 million); Halpern, *Empirical Estimates of the Amount and Distribution of Gains to Companies in Mergers*, 46 J. Bus. 554, 569 (1973) (reporting statistically significant average positive cumulative returns of \$27.35 million); Malatesta, *supra* note 52, at 170 (reporting statistically significant average positive cumulative returns of \$.29 million); but see Firth, *Takeovers, Shareholder Returns, and the Theory of the Firm*, 1980 Q.J. Econ. 248 (reporting statistically significant average negative cumulative returns of \$36.6 million).

61. See Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 557-64 (1984).

These arguments are capable of empirical testing. By comparing the share prices of firms before the adoption of anti-takeover statutes with the share prices of such firms after the statutes are adopted, we can observe whether the statutes actually harm shareholders. If the statutes are, in fact, harmful to those who own shares in firms affected by the statutes, the value of those shares should decline. Unfortunately, measuring the effects of a particular anti-takeover statute is not as easy as it seems, because in an efficient market, where there is considerable advance warning of an impending rule change, share prices will adjust prior to the date on which the statute actually is adopted.

The Office of the Chief Economist at the Securities and Exchange Commission has conducted a study of the effects of the Ohio anti-takeover statute on shareholder wealth.⁶² This statute⁶³ seems particularly well suited for such a study due to the duration of only two weeks between the date on which the statute was proposed and the date upon which the statute was enacted.⁶⁴

The SEC study examined 37 firms which were incorporated in Ohio and were subject to hostile takeovers. In the three-day period during which the bill was debated and passed, these firms suffered an abnormal decline in share value of 1.68% (correcting for price fluctuation attributable to general market trends), which translates into a wealth loss to shareholders of \$754 million.⁶⁵ In fact, it is likely that the effect on Ohio firms was even more negative than this figure indicates. The study probably underestimates the losses to shareholders of firms incorporated in Ohio because information about the probability of the statute being enacted was available before the day prior to the passage of the statute and was reflected in the share prices of the relevant firms prior to the eve of passage. In fact, if one begins counting ten days prior to passage of the statute, to take account of the market's apprehensions about the probability of passage, one finds that Ohio firms experienced an average decline of 3.24% of their share value, which translates into

62. OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMMISSION, *supra* note 13.

63. OHIO REV. CODE ANN. § 1701.831 (Anderson 1985).

64. OFFICE OF THE CHIEF ECONOMIST, *supra* note 13, at 21. Other studies have found negligible shareholder losses, but these studies involved statutes that had been anticipated by the market for substantial periods of time. *See, e.g.*, SCHUMANN, STATE REGULATION OF TAKEOVERS AND SHAREHOLDER WEALTH: THE EFFECTS OF NEW YORK'S 1985 TAKEOVER STATUTES, Bureau of Economics Staff Report to the Federal Trade Commission 7 (Mar. 1987) (finding the negative stock price reaction to the passage of the New York anti-takeover legislation to be less than one percent, but with an eight-month period between the date of the proposal of an initial anti-takeover law and ultimate enactment of the final bill); Romano, *supra* note 8 (studying the effects on share prices of the statutes passed in Connecticut, Missouri and Pennsylvania, and finding statistically insignificant share price reactions where there was an average period of one month between the proposal of a statute and its adoption).

65. *See* OFFICE OF THE CHIEF ECONOMIST, *supra* note 13, at 17.

an aggregate wealth loss to shareholders of \$1.45 billion.⁶⁶ Thus, state anti-takeover statutes harm shareholders by deterring the probability of a profitable takeover for target firms' shares.⁶⁷

V. IMPLICATIONS FOR OUR UNDERSTANDING OF CORPORATE LAW

Perhaps the best thing that can be said for the current rash of state anti-takeover statutes is that they contribute mightily to our understanding of how corporate law is made. While commentators divide sharply on the issue of whether federal or state law should play the dominant role in the regulation of the large, publicly held corporation, both sides of the debate believe that there is robust competition among states in the jurisdictional rivalry for corporate charters.

One school depicts states as competing among one another to attract corporate charters by granting corporate officers and directors wide latitude to act in ways that are clearly contrary to shareholder interests.⁶⁸ This group favors placing the authority to grant charters to corporations in the hands of the federal government in order to prevent state legislatures from exploiting shareholders to benefit their own state budgets.⁶⁹

The competing camp posits that market forces prompt state legislators who desire to attract corporate charters to pass laws that enhance shareholder wealth.⁷⁰ This group favors leaving authority to regulate the internal affairs of the nation's corporations in the hands of the states.

Thus, while one school posits that state laws will benefit shareholders and the other posits that the laws will benefit managers, both schools embrace the premise that there exists a jurisdictional competition for corporate charters in which states compete for business. But if there is one clear lesson to be drawn from the state anti-takeover law experience, it is that the legislatures passing these laws care less about

66. *Id.*

67. This is not recent news. See Smiley, *The Effect of State Securities Statutes on Tender Offer Activity*, 19 *ECON. INQUIRY* 426 (1981).

68. R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* (1976); Folk, *Corporation Statutes 1959-1966*, 1966 *DUKE L.J.* 875; Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 *BUS. LAW.* 991 (1976); Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 *BUS. LAW.* 883 (1976); Young, *Federal Corporate Law, Federalism and the Federal Courts*, 41 *LAW & CONTEMP. PROBS.* 146 (1977); Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L.J.* 663 (1974).

69. See sources cited in *supra* note 68.

70. R. POSNER, *ECONOMIC ANALYSIS OF LAW* 306-07 (2d ed. 1977); R. WINTER, *GOVERNMENT AND THE CORPORATION* 28-42 (1978); Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 *J.L. & ECON.* 179, 181-82 (1985); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 *NW. U.L. REV.* 913, 919-20 (1982).

attracting chartering business than they care about maximizing political support from the interest groups lobbying for passage of the laws. In a rivalrous political world, it is virtually a tautology that successful politicians must place concern for political support above other concerns in order to continue to be re-elected. The fact that state politicians have been responding to the interests of politically powerful in-state incumbent management teams, at the expense of concerns about attracting chartering revenue, is not surprising.⁷¹ As such, these statutes appear less consistent with either of the existing theories of state corporate codes than with the economic theory of regulation, which posits that politicians will be more concerned with maximizing their own political support than with maximizing the chartering revenues of the state.⁷²

The emergence of the economic theory of regulation as the most promising candidate for a unified theory of corporate law has important implications for the current debate about whether state anti-takeover laws should be pre-empted by Congress through the passage of a more comprehensive law governing takeovers. The economic theory of regulation predicts that, like the current state laws, any law promulgated at the federal level will reflect the outcome of political maneuvering rather than the expression of public interest policy concerns.

Thus, one's preference for federal pre-emption in this area hinges upon whether one is more favorably disposed towards the interests likely to prevail at the federal level than towards the interests currently

71. Clearly, state anti-takeover statutes benefit incumbent management teams at the expense of shareholders and thus may, at first blush, appear consistent with the managerial exploitation theory of corporate law. That theory, however, posits that the reason state legislatures pass corporate laws such as anti-takeover measures is to attract corporate chartering business. This does not appear to be the case. These statutes are passed to garner political support from the existing firms, not to attract new firms.

72. The economic theory of regulation posits that legal rules are demanded and supplied like any other commodity. According to the theory, each law reflects a competitive equilibrium among the rival interest groups affected by the law. Thus, according to the theory, legal rules are demanded by relatively cohesive, well-organized special interest groups who successfully out bid competing groups in order to obtain the rules. The currency used in the bidding process consists of political support in election campaigns, speaking honoraria, campaign contributions, and other lobbying expenditures.

The costs associated with these rules sometimes are borne by rival groups but more often are shouldered by the relatively unorganized members of the population for whom the costs (1) of becoming informed about the relevant issues, and (2) of organizing with other, similarly situated people into an effective political coalition, are sufficiently high as to make "rational ignorance" (see *infra* note 73) their most effective political strategy. For articles which describe the economic theory of regulation, see Stigler, *The Theory of Economic Regulation*, 2 *BELL J. ECON. & MGMT. SCI.* 3 (1971); Posner, *Theories of Economic Regulation*, 5 *BELL J. ECON. & MGMT. SCI.* 335 (1974); Peltzman, *Towards a More General Theory of Economic Regulation*, 19 *J.L. & ECON.* 211 (1976); McChesney, *Rent Extraction and Rent Creation in the Economic Theory of Regulation*, 16 *J. LEGAL STUD.* 101 (1987). For a recent application of the economic theory of regulation to the corporate law of Delaware, see Macey & Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 *TEX. L. REV.* 469, 498-509 (1987).

prevailing at the state level. If bidder and shareholder interests⁷³ are likely to enjoy greater representation at the federal level than at the state level, then a federal statute will be better for the economy than the current state statutes. And, because bidder and shareholder interests appear to be peculiarly underrepresented in states with strong anti-takeover laws, it appears unlikely that a federal law would be worse than the current state laws.

Indeed, the current generation of state anti-takeover laws appears to be a paradigmatic example of the sort of jurisdictional exploitation that frequently serves to justify federal intervention. Specifically, "citizens of the legislating state may benefit from the law while citizens of another state bear the costs."⁷⁴ Shareholders do not appear to be particularly concentrated within any single state, a fact that suggests that their interests systematically will be underrepresented in the political process at both the state and federal levels.

VI. CONCLUSION

The current debate on whether state anti-takeover legislation should be pre-empted by federal regulation starts with the premise that regulation of the tender offer process is needed. The only question is whether the rules should be generated by Congress or at the state level. While the arguments in this Article are directed at the state anti-takeover laws, they apply with equal force to the Williams Act, which is the federal law that regulates takeovers.⁷⁵ Like the state anti-takeover statutes, the Williams Act—which places disclosure obligations on tender offerors—imposes significant delays in the tender offer process and raises the costs of mounting a tender offer. Thus it reduces the incentives for individuals and firms to make such offers.⁷⁶

73. Institutional investors are likely to be the only shareholding interests with sufficient size to overcome the rational ignorance and collective action problems that prevent individual shareholders from joining together to oppose anti-takeover legislation.

Rational ignorance refers to the situation in which the costs of becoming informed about a particular issue are sufficiently high as to dwarf the benefits of acquiring the relevant information. For example, if the effects of a measure on a person's wealth will be only \$100, it is rational for that person to decline to invest more than \$100 to find out if it is in his or her best interests to vote for the measure.

Similarly, a problem of collective action exists whenever a group of similarly situated people face high transaction costs and free-rider problems when they attempt to organize into an effective political coalition.

74. Romano, *supra* note 8, at 140.

75. Act of July 29, 1968, Pub. L. No. 90-439, 82 Stat. 454-57, adding 15 U.S.C. §§ 78m(d)-(e) & 78n(d)-(f).

76. See Fischel, *Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 13 (1978) ("the disclosure requirements of the Williams Act . . . dilute the value of the property right in privately produced information"); Carney, *Toward a More Perfect Market for Corporate Control*, 9 DEL. J. CORP. L. 593, 597-609

This Article has pointed out that, while state anti-takeover laws harm shareholders, shareholders may benefit from intra-firm rules that enable them to mitigate if not solve the collective action problem they face when confronted by a tender offer for their shares. It follows that the proper role of the legal system is to facilitate the intra-firm contracting process.

As this Article has shown, however, one of the primary impediments to the adoption of optimal intra-firm rules regarding takeovers is the fact that the interests of shareholders often conflict with the interests of managers and directors. Managers and directors are often primarily interested in ensuring their continued tenure in office, while the primary concern of shareholders is in obtaining the best possible price for their shares. Thus, it is ironic that the existing panoply of state and federal law is designed to make takeovers more difficult; existing management already has strong incentives to install devices that impede takeovers. Management does not need to be motivated to detect problems with a firm's array of defensive strategies. Indeed, if shareholders need protection at all, it is in ensuring that management is not overzealous in thwarting tender offers by outsiders. There are no statutes that provide such protection for shareholders. Rather, it seems that the regulations we observe at both the state and federal level are the result of interest group pressures and do not reflect the real needs of shareholders.

A public interest statute regulating takeovers might protect the shareholders of some firms from intra-firm defensive tactics that make hostile acquisitions too difficult. Such statutes would not protect shareholders from bidders offering to pay them a premium for their shares. This is what our current legal system does, despite the fact that in a world of efficient capital markets, the willingness of an outsider to pay shareholders a premium for their shares is hardly a sign of exploitation. Such outsiders should be applauded—not regulated.

Thus, the debate about federal pre-emption of state anti-takeover laws is a struggle over the lesser of two evils. The outcome will reflect a political compromise, with the benefit going to the interest group with the greatest political clout. It will not reflect an attempt by Congress to realize a legitimate public policy goal. This is particularly unfortunate in light of the vital importance that a robust market for corporate control plays in the development and restructuring of the national economy.

(1984) (regulatory delay caused by the Williams Act raises the price of tender offers and "will inevitably lead to fewer takeover bids."); Macey & Netter, *Regulation 13D and the Regulatory Process*, 65 WASH. U.L.Q. 131 (1987) (discussing costs associated with one aspect of the Williams Act, the requirement that the bidder's identity and intentions be disclosed within ten days of the acquisition of five percent of a target firm's shares).