

# AUCTION THEORY, MBOs AND PROPERTY RIGHTS IN CORPORATE ASSETS

*Jonathan R. Macey\**

## INTRODUCTION

From as early as the fifth century B.C. when Herodotus described the auctioning of women for service as wives in Babylonia, scholars have evinced a keen interest in the conduct of auctions.<sup>1</sup> Although auctions are no longer a vehicle for exploiting women, the auction process remains of particular interest to economists.<sup>2</sup> Economists are interested in the efficient allocation of resources, and auctions are widely, if erroneously, viewed as the optimal means of allocating resources.

In the world of commerce and industry, owners utilize an incredibly diverse range of sales techniques when they wish to dispose of their assets. While purchasers and sellers may haggle, bargain, and negotiate about asset prices in flea markets and European bazaars, at grocery stores one does not expect to bargain over price. Similarly, while certain goods are sold to distributors on consignment, other goods are transferred on an "as is" basis. And, of course, certain items such as mineral rights, fine art, and certain government securities are sold at auctions. These auctions vary a great deal depending on the type of asset being sold.

Upon reflection, the existence of such a rich array of trading mechanisms should be unsurprising. Asset owners have a clear incentive to maximize the price of the goods they are selling. Buyers, on the other hand, wish to pay as little as possible, and in no case will they pay more than the value of the goods to them. Furthermore, the value of any good to a potential buyer will be reduced by an amount sufficient to compensate a buyer for the costs associated with consummating the transaction. These costs include the risk that a product will be unsuitable for the buyer's needs, the costs of obtaining and verifying information about the product, and all other costs associated with the transaction, including the actual costs of bid preparation.

In a world of high information, signalling, and transactions costs, asset owners will try to devise ways to lower costs to buyers in order to

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\* Professor of Law, Cornell University. B.A. Harvard, 1977; J.D. Yale, 1982.

1. Milgrom & Weber, *A Theory of Auctions and Competitive Bidding*, 50 *ECONOMETRICA* 1089 (1982). See also R. CASSADY, *AUCTIONS AND AUCTIONEERING* (1967) (describing other historical uses for auctions).

2. Literature surveys and bibliographies have turned up hundreds upon hundreds of articles from economics journals on this topic. See, e.g., Engelbrecht-Wiggans, *Auctions and Bidding Models: A Survey*, 26 *MGMT. SCI.* 119 (1980); Stark & Rothkopf, *Competitive Bidding: A Comprehensive Bibliography*, 27 *OPERATIONS RES.* 364 (1979).

obtain higher prices for themselves. And, because the cost to purchasers of acquiring an asset varies widely depending on the particular characteristics of the asset being sold, it is not surprising that the market has generated such a rich array of sales devices. The point of this article is that these observations apply with the same force to the sale of firms in the market for corporate control as they do to the sale of other assets.

Despite the seemingly obvious nature of this observation, a recent spate of important Delaware decisions has established that corporate boards for directors have a duty to conduct an auction or its equivalent whenever they wish to effectuate a change in control of their firm.<sup>3</sup> In addition, the precise way in which this auction is structured is strictly regulated by the Delaware courts. Thus, in management buyout transactions for example, it generally will be necessary for a company to conduct an auction before consummating the transaction.

Perhaps even more surprising, the rich literature from the field of economics on auction models has not permeated into the legal literature. This is especially peculiar in light of the number of law and economics scholars writing on this topic in law reviews, and the recognition by these scholars that auctions are being used in the market for corporate control.

The purpose of this article is to show that Delaware's forced auction rule is harmful to shareholders because it requires directors to effectuate changes in control through a particular sort of auction process when other means for disposing of corporate assets may realize higher prices. Thus, the Delaware forced open-auction makes only slightly more sense than a state law requiring supermarkets to sell bagels by auction rather than by affixing preset, "take them or leave them" prices to the products.

The only justification imaginable for the Delaware forced auction rule is to mitigate the conflict of interest that exists between management and shareholders in changes of control. Since this conflict of interest exists in the sale of corporations but not in the sale of bagels, the forced auction rule has a surface appeal. But even this justification disappears upon closer examination, because there are alternative methods for mitigating such conflicts that do not force corporate assets to be reallocated in an inefficient manner. Thus, while potential conflicts are particularly acute in the context of management buyouts, this article concludes that management should not be compelled to conduct an auction for a company being sold even in this context.

Part I of this article provides an introduction to the economics of auction theory, and offers examples of situations in which auctions of various types are particularly appropriate or particularly inappropriate. The purpose of part I is to show that, while conducting an auction of some sort may be the best way to dispose of corporate assets under certain conditions, under other conditions it clearly is not. Corporate boards of directors—rather than courts—should be able to determine the best

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3. For a discussion of Delaware decisions, see *infra* notes 122-41 and accompanying text.

method for disposing of or transferring corporate control. Part II of the article reviews the work of the dominant contributors to the legal literature on auctions in the market for corporate control. This literature, which has had a great influence on the shape of Delaware court decisions, does not appear to have been influenced by the economists working in the general field of auctions.

Part III examines the law on auctions generated by the Delaware courts and shows that they are ignoring economic theory and forcing management to comply with auction rules that reduce shareholder wealth. Part IV examines the possible justifications for requiring management to conduct an auction, and concludes that there are less intrusive means for solving the conflicts of interest that plague the modern publicly held firm. The phenomenon of leveraged buyouts by management is then used to illustrate various points made in the article.

### I. THE EFFICIENT DISPOSITION OF ASSETS AND THE COST OF AUCTIONS

There exists a huge array of methods for disposing of an asset—holding an auction is only one of them. In addition, there are many different sorts of auctions.

Perhaps the most well known types of auctions are the English, or ascending bid auction, in which the asset is allocated to the buyer who makes the final and highest bid,<sup>4</sup> and the Dutch auction, in which the sale price of a good is set at an initial, high level and then lowered until a bid is made.<sup>5</sup> Other types of auctions include those in which prospective purchasers submit sealed bids, and so-called Vickrey auctions, in which each potential buyer submits a bid, and the asset is allocated to the highest bidder, but that bidder pays only the *second* highest priced bid.<sup>6</sup> In addition, some auctions require all bidders to pay an initial entry fee in order to be permitted to bid.<sup>7</sup> These auction strategies are not selected by asset owners at random. Rather, asset owners will choose the sales technique that is most likely to yield the highest price for the goods being sold.

For asset owners, the critical questions are: (1) under what circumstances is it appropriate for an asset owner to conduct an auction instead of a privately negotiated sale; and (2) what sorts of auctions are optimal under various circumstances? As will be seen, the principal insight of this paper as derived directly from the economics literature of auctions, is that different sorts of assets should be sold in different ways.

The application of this insight to the market for corporate control is straightforward but heretofore unrecognized. While an unfettered, English style, come-one-come-all auction may be the optimal way to transfer control of certain firms, for other companies, shareholders will maximize the value of their shares by utilizing some other selling strategy. While

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4. Riley & Samuelson, *Optimal Auctions*, 71 AM. ECON. REV. 381, 382 (1981).

5. *Id.* at 382 n.4.

6. *Id.* at 382.

7. *Id.*

this conclusion may appear obvious, the judges<sup>8</sup> and legal scholars<sup>9</sup> writing in this area uniformly have concluded that a single sales strategy should control the sale of public corporations. This conclusion is clearly wrong.

In a seminal article, Professors French and McCormick made a major contribution to auction literature by showing that, where auction participants face sunk costs, each buyer will bid less for the asset than he thinks it is worth in order to recover his sunk costs.<sup>10</sup> In equilibrium, the winning bidder pays a sum equal to his expected profit plus the sum of his competitor's sunk costs.<sup>11</sup> Asset owners therefore have a strong incentive to devise auction rules that minimize bidders' sunk costs because these costs are transferred from the bidders to the asset owners. Bidders' estimation costs<sup>12</sup> are transferred from bidders to asset owners because potential buyers will offer sellers less than they think an asset is worth in order to recoup the costs they have incurred in preparing their bids. Thus, asset owners will want to design auction systems that minimize bidders' bid preparation costs in order to increase the amount buyers are willing to bid.

The French and McCormick analysis may be summarized succinctly. Firms involved in bidding for assets must incur precontract costs to estimate the value of the object on which they are bidding and to prepare their bids. As French and McCormick observe, these costs are not marginal; they are sunk.<sup>13</sup> In order for bidding firms to survive, they must recover these sunk bid preparation costs as well as their marginal costs.<sup>14</sup> Thus, "the textbook prediction that price equals marginal cost cannot always be accurate."<sup>15</sup>

Based on these observations, French and McCormick developed a model which posits two competitive equilibria, one before bidders' costs are sunk and one after. Before costs are sunk, there are an infinite number of potential bidders, and all marginal conditions obtain, including the expectation of zero profits to bidders. After bidders' costs are sunk, however, only a finite number of competitors exist.<sup>16</sup>

The game changes when this finite number of competitors emerges. Each of these bidders adjusts its bid in anticipation of the expected number of rival bidders: "Depending on the number of competitors, the firm reduces its bid below its estimate of the asset's value to the point where the expected cost of reducing the bid 1 more dollar equals the expected

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8. For a discussion of the pertinent judicial decisions, see *infra* notes 122-41 and accompanying text.

9. For a discussion of these works, see *infra* notes 47-121 and accompanying text.

10. French & McCormick, *Sealed Bids, Sunk Costs, and the Process of Competition*, 57 J. Bus. 417, 424 (1984).

11. *Id.*

12. Estimation costs are the search costs of determining the value of the asset.

13. French & McCormick, *supra* note 10, at 417-18.

14. *Id.*

15. *Id.*

16. *Id.* at 438-39.

revenue.”<sup>17</sup> In other words, as the number of bidders goes up, each bidder’s expected profit from bidding decreases. Firms will enter or leave the auction until the expected gains from bidding equal the expected costs.

Thus, under any given set of auction rules, bidders will recover their prebid estimation costs by bidding an amount that reflects these costs. Ignoring sunk costs, bids for assets will equal their present value. In the face of sunk bidding costs, however, bids will equal the present value of the assets being sold *minus* industry bid preparation costs.<sup>18</sup> This is an important insight for asset owners. Asset owners must expect to recover the value of the asset “minus *all* the bid preparation costs, . . . [since] the estimation costs are transferred from the bidders to the asset owner.”<sup>19</sup>

Since bidders are internalizing all of the bidders’ prebid sunk costs, they have a strong incentive to adopt auction rules that minimize those costs. Bidders’ sunk costs will be of particular concern in the market for corporate control because of the magnitude of those costs. In the takeover context, bidders’ sunk costs include the costs of search in that market, of compliance with the securities laws, of performing due diligence, and of estimating the market value of the assets to be purchased. But in order for asset owners (or their agents) to maximize the value of the asset they are selling, they must be able to control the rules governing the sale of such assets.

In light of the heavy sunk costs borne by bidders engaged in a contested takeover, sellers and bidders are likely to prefer a sealed bid auction over an open-ended, English auction in which bidders have the opportunity to increase their bids during the course of the auction. This is because, unlike the situation in a sealed-bid auction where no rebidding is allowed, bidders risk losing their sunk investments in estimation costs in an open-ended auction. A simple example illustrates this point.

Suppose that two bidding firms, X and Y, are considering bidding on a target firm. Before incurring any sunk estimation costs, X and Y calculate that the asset is worth somewhere in the range of \$70-\$150. They also predict that they will have to pay estimation costs of \$20 in order to comply with applicable disclosure and due diligence rules and in order to

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17. *Id.* at 423. As the number of expected bidders increases, the expected profit of each bidder goes down. As French and McCormick point out, this is due to two factors. First, increasing the number of bidders decreases the probability that any particular bidder will succeed. As a bidder’s probability of success goes down, so too does its expected profit from bidding, since expected profits will be multiplied by this probability estimate. Second, the winner’s payoff decreases as the number of bidding firms increases because each bidder will narrow the gap between its bid and its adjusted estimate of the asset’s value when the number of bidders goes up. This is because the expected difference between each bidder’s estimate of the value of the firm and the other bidders’ estimate of the value of the asset decreases as the number of bidders goes up. When this happens, bidders must increase their bids in order to prevail in the auction. As the number of bidders increases, bidders’ estimation costs go up, and the returns to asset owners goes down. *Id.* at 423-24.

18. *Id.* at 417.

19. *Id.* at 425 (emphasis added).

make an informed bid. Further, suppose that after incurring the sunk estimation costs, the parties discover that the asset is worth \$100.

Under these assumptions, the parties recognize that they cannot pay more than \$80 for the asset without making the auction a losing proposition once their sunk costs are taken into account. If they pay \$81, they will have invested a total of \$101 (\$20 in sunk estimation costs, plus \$81 to purchase the asset). But once the firms have entered an open-outcry auction, they have an incentive to bid up to the market value of the asset (\$100). For example, once Firm X has bid \$80, Firm Y's choices are: (1) stop bidding and lose its \$20 sunk cost; or (2) bid \$81, thereby reducing its total losses to only \$19. Of course, once Firm Y has bid \$81, Firm X must either keep raising its bid, or lose its sunk estimation costs. Only when one party has bid the full \$100 will bidding finally stop.<sup>20</sup> Rational bidders will decline to enter auctions of this type, knowing that, unless they collude with other bidders, they inevitably will lose money.

The implication of this analysis is clear. In certain takeover situations, it may be in the asset owner's interest to be able to restrict bidders to only one bid in order to encourage bidders to enter the auction process. This will be particularly true where bidders have high sunk costs. As will be seen,<sup>21</sup> the rules of prominent takeover commentators such as Frank Easterbrook, Dan Fischel, and Lucian Bebchuk fail to take the problem of prebid sunk estimation costs into account. Consequently, their policy prescriptions for takeovers, by failing to give target firms the ability to structure sealed bid auctions, reduce shareholder wealth.

Just as conducting a sealed bid auction will be the best way to maximize shareholder wealth in some contexts, limiting the number of bidders will maximize shareholder wealth in other contexts. Similarly, sometimes negotiated sales will be preferred to auctions. Any rules that deprive selling firms of the flexibility needed to craft their own auction rules will harm shareholders.

It is also important for asset owners to be able both to control the timing of the auction and to restrict the number of bidders. As the number of bidders increases, bidders' expected profits fall. Once a certain number of firms are competing in an auction, "no other firm has an incentive to enter because its expected profit will not cover its estimation costs. In fact, if a new firm did enter the auction, it would also drive everyone else's expected profit below its (now sunk) estimation costs."<sup>22</sup> Thus, uncertainty about the number of firms involved in an auction can disrupt the plans of firms already committed to bidding and reduce the incentive of those firms to commit to preparing bids in the first place. This is so because risk-averse bidding firms may overestimate the number

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20. A bid of \$101 will cause the parties to lose one dollar more than the amount of their sunk costs. At this point, the parties will decline to bid because not bidding will allow them to lose only the amount of their sunk costs.

21. For a discussion of these commentators' analysis, see *infra* notes 50-86 and accompanying text.

22. French & McCormick, *supra* note 10, at 424.

of firms bidding, and therefore, underestimate their own potential profits.

An interesting empirical implication emerges from this analysis. In an efficient auction market in which the bidding firms make reasonable assumptions about the number of competitors, the expected value of the winning bid will increase as the number of bidders increases.<sup>23</sup> This is because bid preparation costs increase with the number of bidders.<sup>24</sup> Thus, when prebid costs are taken into account, there will be a divergence between the value of the asset and the value of the winning bid. This divergence is not evidence of lack of competition; nor is it evidence that bidders are obtaining economic rents or exploiting target firm shareholders. Rather, the divergence "simply reflects the fact that the winning bidder must, on average, recover the industry's estimation costs."<sup>25</sup>

Interestingly, however, gains to bidders in takeover contests have been steadily declining in recent years.<sup>26</sup> Studies show that bidders made statistically significant gains of 4.4% in the 1960's.<sup>27</sup> During the 1970's, bidder returns declined to 2.2%; studies from the 1980's show that bidder returns have turned negative.<sup>28</sup> In light of the above analysis, it seems likely that these declining returns to bidders are consistent with imperfections in the bidding process. In particular, as will be seen below, judicial decisions regulating the takeover process make it increasingly difficult for target firms to control the bidding process.<sup>29</sup> One consequence of this inability to control the bidding process is that bidders are unable to capture the industry's sunk bid costs. If this is the case, in the long run we will observe bidders leaving the industry, and the remaining bidders making fewer bids. A new equilibrium may be reached, but shareholders will suffer as fewer bids are made for their firms.

In other words, the lack of gains to bidding firms in takeover contests suggests that one of two phenomena is occurring. First, it is possible that bidders are not incurring any sunk costs associated with making bids. If this were the case, bidding firms' bids would equal the expected value of the assets on which they are bidding. It is, however, highly unlikely that this is the case. Bidders must incur significant costs in the form of research, bid preparation, due diligence, and legal fees. These costs are all specific to the particular auction in question.

Alternatively, it is possible that bidders are not recovering their prebid sunk costs and the takeover market is in disequilibrium because of target firms' inability to control the auction process for their firms. If the industry were in equilibrium, bidders would be recovering their sunk

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23. *Id.* at 439. See also Reece, *Competitive Bidding For Offshore Petroleum Leases*, 9 *BELL J. ECON.* 369, 383 (1978).

24. French & McCormick, *supra* note 10, at 439.

25. *Id.*

26. Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 *J. ECON. PERSPECTIVES* 49, 53 (1988).

27. *Id.*

28. *Id.*

29. For a discussion of the relevant court decisions, see *infra* notes 122-41 and accompanying text.

costs. Additionally, anecdotal evidence that the industry is not in equilibrium is suggested by the fact that the vast majority of potential acquirers refuse to enter into contested takeover contests. Realizing that they will be unable to recover their sunk prebid estimation costs, it is common for acquirers to insist that any acquisition they make be on a friendly basis.

Unfortunately, the costs of this phenomenon, which come in the form of a decreased number of tender offers, are exceedingly hard to measure. While target firms' premiums have been rising dramatically,<sup>30</sup> there is no way to determine how many more bids would have been made if bidders could be more certain about whether they would be able to recover the value of their prebid estimation costs.

But clearly constructed rules do not insure that shareholders and their agents will get the highest price for their firm in a takeover. Once we assume that bidders must invest resources to value target firms and to prepare bids, it is clear that auction strategy and design will play a large role in determining the price that shareholders are able to obtain for their firms in the takeover context. And, the traditional auction format will not always be the optimal method by which assets owners can dispose of their assets. Factors to be considered will be the *sources* of the bidders' information, whether the information being produced is productive or unproductive, the reputation of the seller, and above all, the nature of the assets being sold.

Asset owners have devised a number of strategies to reduce bidders' investment in information in order to increase their returns in an auction. Obviously, sellers will produce information about themselves whenever possible so that bidders will not have to do so. Asset owners also will increase returns to themselves by actively preventing bidders from investing in search costs. Two well known examples of this phenomenon are auctions for U.S. Treasury bills and sales of diamonds by DeBeers.<sup>31</sup> Small purchasers of Treasury bills indicate the quantity of U.S. government debt they wish to purchase, but are not permitted to submit price bids. Rather, the price they pay will be the average of the accepted competitive bids. This reduces the incentives of both small and large bidders to engage in a costly search regarding price.<sup>32</sup>

DeBeers has devised an ingenious mechanism for preventing its customers from incurring bid preparation costs. DeBeers customers submit orders to the company specifying the number, weight, and quality of the raw diamonds they would like. DeBeers prepares a package of diamonds meeting these specifications (called a "sight"), and presents it to the customer on a take-it-or-leave-it basis. Customers who reject the sight are

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30. Jarrell, Brickley & Netter, *supra* note 26, at 53.

31. See, e.g., French & McCormick, *supra* note 10, at 431-32; Barzel, *Measurement Cost and the Organization of Markets*, 25 J. L. & ECON. 27, 32 (1982).

32. Small bidders have no incentive to engage in bid preparation because they are not permitted to submit priced bids. Large bidders' incentive to conduct search is diminished by the fact that small bidders are free riding on their investments in information. French & McCormick, *supra* note 10, at 431.

not permitted to submit orders in the future. As French and McCormick observe, "[t]his . . . arrangement virtually eliminates the acquisition of information, save for the initial one by DeBeers themselves. Presumably it is their longstanding reputation that warrants the quality of the information and prevents the duplication of information."<sup>33</sup>

While the mechanisms used for selling diamonds and Treasury bills may appear a bit exotic, they illustrate the point that sellers have incentives to go to extraordinary lengths to reduce buyers' information costs. In particular, at times it will be in the sellers' interest to reduce competition among buyers by providing them with information, limiting the number of bidders, or, in some instances, by abandoning auctions altogether in favor of negotiated sales.

Negotiated sales, which allow buyers to avoid bid preparation costs, will replace auctions where sellers have good reputations. In addition, where the particular identity of the buyer has little to do with the price offered for the goods being sold, negotiated sales are likely to replace auctions. Where different buyers are likely to place the same value on the asset, the identity of the buyer will not affect price, and the cost of holding an auction can be avoided. But where there is a dispersion in the value that buyers place on the asset, either because they have differing amounts of information about the asset, or because the subjective value of the asset varies with the identity of the buyer, then a negotiated sale is unlikely.<sup>34</sup>

The problems associated with auctions for oil, gas, and mineral rights have been closely studied by economists and appear to be quite similar to the problems faced by bidders in an acquisition for a publicly held corporation. The sale price of the minerals (or the target firm) will depend on the bidders' estimation of the future value of the assets.<sup>35</sup> While the value of the firm may be the same to all bidders in a world of perfect information, given that bidders will have different estimates of the market value of the asset, the bidders are likely to have different bid prices.<sup>36</sup> Sellers have an obvious incentive to avoid wasteful duplication in the production of information by bidders. To avoid this duplication, sellers will attempt to lower bidders' bid preparation costs by supplying them with information.<sup>37</sup> But, as Ronald Johnson has shown in an important article on bid preparation costs in auctions, even with the advised provision of data to bidders by the seller, each bidder can be expected to undertake an expense to determine the cost of altering the asset to his own needs, as well as the costs associated with interpreting and verifying the data supplied

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33. *Id.* at 432.

34. *Id.* In particular, negotiations with buyers are likely to be preferred to auctions where, "there is not much dispersion in the true value of the asset across the potential buyers, . . . (or if the owner can determine the highest valued user ex ante)."

35. Milgrom & Weber, *supra* note 1, at 1093-94.

36. *Id.*

37. Hughart, *Informational Asymmetry, Bidding Strategies, and the Marketing of Offshore Petroleum Leases*, 83 J. POL. ECON. 969 (1975).

by the seller.<sup>38</sup>

In oil exploration, the bidders' costs will take the form of estimating the cost of developing the site for drilling and interpreting the relevant geological survey evidence.<sup>39</sup> In the market for corporate control, the costs will be associated with developing a strategic plan for redeploying the target firm's strategic assets, negotiating the necessary financing arrangements, preparing a bid package in compliance with the relevant securities laws, and conducting a due diligence investigation of the seller (all of which include the expense of paying lawyers, accountants, and investment bankers). These costs are far from trivial.

Thus, the economic and social gains accruing from exploitation of the resource (or the acquisition of the target firm) can be dissipated by the costs of bid development.<sup>40</sup> Nevertheless, as Johnson observes:

[t]he expenditure undertaken to determine the cost of exploitation [of a target firm, for example] does have social value as it aids in establishing the highest user value via the bidding process. This gain, however, is offset by the resources involved in each bidder determining an estimate of development costs . . . . The major conclusion is that an entrance fee or charge can reduce the amount dissipated and provide an increase in net returns to the seller.<sup>41</sup>

Based on these observations, under certain conditions, sellers will find it in their best interests to impose entry fees in order to restrict the number of bidders. In particular, where the aggregate savings to bidders in the form of reduced estimation costs is greater than the expected increase in price from adding additional bidders, we will expect sellers to restrict entry. Thus, even though the imposition of an entry fee will discourage entry into bidding, "an entrance fee or charge can reduce the amount dissipated and provide an increase in net returns to the seller."<sup>42</sup> By reducing the total costs associated with the bidding process, the increase in net returns to the seller brought about by restricting bidding through entry fees is not only consistent with a strategy of private wealth maximization, but the policy of maximization of social welfare as well. Thus, absent legal impediments to the contrary, we might expect sellers to impose restrictions on the number of bidders in the form of entry fees where bid preparation costs are high.

Interestingly, the merger and acquisition departments of major United States investment banks do not require bid preparation fees. This is particularly surprising in light of the similarities between auctions for firms and government auctions for oil leases, where it seems clear that bid preparation fees are desirable. Both situations often involve the receipt of

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38. Johnson, *Auction Markets, Bid Preparation Costs and Entrance Fees*, 55 *LAND ECON.* 313 (1979).

39. *Id.*

40. Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 *AMER. ECON. REV.* 561 (1971).

41. Johnson, *supra* note 38, at 314.

42. *Id.* See also Hughart, *supra* note 37 (discussing over-investment problem).

information about the target firm by potential bidders, which is analogous to the survey information given to bidders for oil leases. After receipt of the information, however, bidders for corporations—like bidders for oil leases—are expected to engage in a costly process of ascertaining the value of the assets of the firm to be acquired, including the preparation of legal documents and the conduct of due diligence. It would seem that having prospective bidders submit entry fees in order to be able to bid would be desirable.

One possible explanation for the absence of entry fees is that target firms' investment bankers are able to narrow down the number of potential bidders *ex ante* in ways that accomplish the same result as bid preparation fees. For example, investment bankers often require potential bidders to submit preliminary indications of interest in a target firm. These preliminary indications of interest reflect bidders' first approximations of their estimates of the value of the target. Only the top bidders on their list are permitted to go forward with the costly process of preparing legal documents and conducting the due diligence necessary to submit a final bid. These preliminary indications of interest serve as a direct substitute for the entry fees required in oil exploration bidding by reducing bidders' investment in search.

An additional reason why corporations being auctioned do not require bidders to submit entrance fees is that these sellers have far less control over the conduct of the auction process than the sellers of other assets. In particular, selling firms often cannot control the timing of the start of an auction, since it may be triggered by a buyer's public announcement of a tender offer for a controlling interest in the target firm. The sellers are the firm's widely dispersed public shareholders. In such situations, the target firm itself is simply unable to control the bidding process sufficiently to be able to impose an entrance fee on potential bidders. And courts, which are mesmerized by the conflict of interest problem presented by entrenched incumbent management rejecting good bids in order to retain control, are likely to look askance on any attempt by target firm management to impose an entrance fee on potential bidders.

A final factor militating against the imposition of entry fees is that, unlike the situation with oil leases, the value of a target firm is productive in the sense that the actual value of the target firm may be affected by the information obtained by the bidder. In such cases, entry fees are inappropriate because the fees discourage the production of information that can increase the price that bidders are willing to offer to sellers.<sup>43</sup> Thus, for example, where different bidding firms are likely to value a target firm differently, encouraging bidder search by declining to impose entry fees "may improve the allocation of the asset so that the highest valued user receives it."<sup>44</sup> Similarly, increasing the number of bidders increases the probability that some bidder will find a particularly efficient

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43. French & McCormick, *supra* note 10, at 426.

44. *Id.* at 428.

plan for using the asset.<sup>45</sup> As French and McCormick have observed:

The value of products which are complicated or unique, such as rare art objects, may vary considerably across bidders. In this case, increasing [the number of bidders] increases the probability that a user for whom the true value of the asset is particularly high will bear the cost of preparing and submitting a bid. When the asset is simple or its value is easily estimated, the seller stands to gain little from having many buyers invest in information. This allows us to make some predictions about the type of auctions which are likely to have entry fees. For example, ongoing auctions, where the product is standardized and the seller has a well-established brand name, are likely candidates for [entry] fees. In this case, the cost of information acquired by prospective buyers is borne by the seller with little concomitant gain in revenues. On the other hand, auctions for unusual products are less likely to involve entry fees. By this reasoning, estate or land auctions are not likely to impose a fee for bidding.<sup>46</sup>

Target firms are complicated, unique and unusual products; consequently, it is not surprising that we do not observe sellers charging entry fees to prospective bidders. On the other hand, investment bankers, as agents for selling firms, often will employ strategies such as requiring prospective purchasers to submit preliminary, nonbinding indications of interest as a method of winnowing down the field of prospective bidders in order to reduce aggregate bid preparation costs.

The following section applies these theoretical insights about the conduct of auctions to existing literature on the market for corporate control. As will be seen, there is a wide gulf between these insights and currently fashionable policy prescriptions.

## II. THE CURRENT STATE OF THE LEGAL LITERATURE

The seminal article on the issue of auctions in the market for corporate control argues for a rule that would prohibit management of a public corporation from organizing an auction for the firm in the event of a bid for control.<sup>47</sup> Their preferred legal regime would require officers and directors to remain passive in the face of a tender offer.<sup>48</sup> Professor Lucian Bebchuk has devoted considerable time to refuting Easterbrook and Fischel's arguments. The debate has been joined by other important commentators, notably Ronald Gilson and Alan Schwartz.<sup>49</sup>

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45. *Id.*

46. *Id.* at 429-30.

47. Easterbrook & Fischel, *The Proper Role of a Target's Management In Responding to A Tender Offer*, 94 HARV. L. REV. 1161 (1981).

48. *Id.* at 1164, 1201-04.

49. For a discussion of these commentators' works, see *infra* notes 87-121 and accompanying text.

### A. *Easterbrook & Fischel's Passivity Rule*

Easterbrook and Fischel provide two reasons why auctions are inconsistent with the goal of shareholder wealth maximization. First, they argue that subsequent bidders who follow on the coattails of the initial bidder are free-riding on the information generated by the first bidder.<sup>50</sup> Because it is costly to locate undervalued target firms and to prepare bids for them, potential bidders will steer clear of the bidding process if they think that other firms can steal the information they have generated through costly search simply by observing their actions. Because subsequent bidders have incurred no costs to acquire information, they can offer a higher price to target-firm shareholders, forcing the initial bidder to increase his offer or else lose the opportunity to acquire the target firm.

The second problem with auctions that Easterbrook and Fischel identify involves the consumption of real resources on the part of the firm being acquired.<sup>51</sup> Resisting takeovers consumes resources in the form of wasted managerial time, legal fees, court costs, etc. Bidders, according to Easterbrook and Fischel, would be willing to pay more to acquire assets if they did not have to incur resistance costs, which ultimately reduce the value of the target. Consequently, in the absence of resistance, more bids would be made.

The problem with the Easterbrook and Fischel argument is that it focuses exclusively on the costs involved in holding auctions and ignores the benefits of the procedure. In particular, the auction literature indicates that, while having an auction may reduce the number of bidders, it may increase the amount that the winning bidder is willing to pay.<sup>52</sup>

Easterbrook and Fischel's conclusions are strongly motivated by their prior assumptions about the nature of the market for corporate control. They view the market for corporate control primarily as an arena in which market forces monitor and discipline incumbent managers of target firms.<sup>53</sup> These managers have an incentive to shirk their duties and consume a disproportionate share of corporate resources because widely dispersed shareholders are incapable of monitoring their activities at reasonable cost.<sup>54</sup> Outside bidders can achieve arbitrage profits by locating and buying controlling interests in poorly managed target firms in order to displace the old, inefficient management with a more productive group.<sup>55</sup>

From the standpoint of auction theory, the problem with Easterbrook and Fischel's analysis is that it ignores the fact that in certain take-

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50. Easterbrook & Fischel, *supra* note 47, at 1178-79.

51. *Id.* at 1175.

52. *E.g.*, Haddock, Macey & McChesney, *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987).

53. Easterbrook & Fischel, *supra* note 47, at 1169-73.

54. *See* Hensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

55. For a more complete discussion and refutation of Easterbrook and Fischel's arguments, see Haddock, Macey & McChesney, *supra* note 52.

over situations there are likely to be particular bidders who value control of the target more highly than others. It also ignores the fact that subsequent resales to such rights valuing bidders will be costly, and that there are ways that targets can compensate bidders for their search costs. For example, where a firm is quite unusual in terms of the products or services it provides, or where corporate control carries with it certain subjective pleasures (as in the case of a professional sports team), open auctions are likely to be preferred by potential bidders because the seller will not be able to ascertain the identity of these potential purchasers.<sup>56</sup> Similarly, auction literature suggests that where bidders' costs are nonduplicative, in the sense that the information that one bidder finds to be useful is different from information another bidder may find useful, asset owners will find it in their interest to conduct an auction.

To simplify somewhat, Easterbrook and Fischel argue that auctions are undesirable in the contests for corporate control because they cause initial bidders to lose the sunk costs in information that they have incurred.<sup>57</sup> But, as French and McCormick show, the mere presence of sunk costs does not preclude the desirability of holding auctions under certain circumstances.<sup>58</sup> In particular, in situations where subsequent bidders actually generate new information, where buyers may have information about the target that is not available to sellers, where different buyers place different values on the assets, and where bid preparation costs are low, it will be to the advantage of sellers to conduct an auction.

The point here is not to suggest that Easterbrook and Fischel are wrong in pointing to the existence of sunk costs for target firm shares. Their identification of the presence of such costs is a major contribution to the literature on corporate control. Similarly, I wish to emphasize that I am not arguing that auctions for target shares ought to be required. Rather, the point is that every takeover situation is different. And, while Easterbrook and Fischel are correct to point to the existence of sunk costs as representing an important cost of using auctions in the market for corporate control, they are wrong to suppose that the benefits of using auctions never outweigh these costs.

### B. *Bebchuk's Response*

In an interesting article responding to Easterbrook and Fischel, Professor Lucian Bebchuk advanced a rule of auctioneering that would require that auctions be held open sufficiently long to allow time for rival bidders to make competing bids.<sup>59</sup> Bebchuk's approach also allows the

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56. French & McCormick, *supra* note 10, at 430.

57. This succinct formulation of Easterbrook & Fischel's argument may be found in Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982).

58. For a discussion of French & McCormick's views on this point, see *supra* notes 13-25 and accompanying text.

59. Bebchuk, *The Case For Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1030 (1982).

officers and directors of the target firm to solicit these rival bids by providing information about the target to potential bidders.<sup>60</sup> Bebchuk noted that, while the expectation of arbitrage profits from increasing managerial productivity “may explain some or even many takeovers, there is no basis for denying the significance of other motives.”<sup>61</sup> In particular, synergistic gains from a number of sources, including economies of scale in production, marketing, and capital costs may account for the gains from a takeover.<sup>62</sup> Other synergistic gains will arise if the acquirer has “skills or nonpatentable information that are useful to the target. Finally, the takeover may yield tax savings or an increase in . . . market power.”<sup>63</sup>

In addition to synergistic gains, Bebchuk argued that a firm might also be motivated to make an acquisition if the target’s stock were undervalued in the market. In such cases, “the takeover does not increase the target’s true value; it only makes the market aware of an already existing value.”<sup>64</sup> Lastly, on the theory that bidding firms, as well as target firms, suffer from the costs associated with the separation of ownership and management, Bebchuk argued that bidding firm managers might make acquisitions simply to expand the size of the enterprise under their control.<sup>65</sup>

Bebchuk concedes that Easterbrook and Fischel are correct in their observation that auctions will “have some adverse effect on the amount of search done by prospective offerors.”<sup>66</sup> These offerors will refrain from searching for potential targets since they cannot always recoup the costs associated with this activity unless they are successful in acquiring the target firm. Since auctions reduce the probability of success in acquiring the target, search is reduced.

Bebchuk notes, however, that bidders can recoup their search costs in some instances even if they are unsuccessful in acquiring the target. First, he argues, potential bidders can invest in the target’s stock, and later resell it to the ultimate purchaser at a healthy premium.<sup>67</sup> While Bebchuk’s point is true as far as it goes, the argument ignores certain basic principles of economics, and is wrong as a matter of social policy. The question is not whether initial bidders who are unsuccessful can resell the stock they have acquired to the successful bidder; rather, the issue is whether the gains to bidders from these resales are greater than the gains from a successful acquisition. Clearly they are not. Indeed, Bebchuk does not even suggest that they might be. Consequently, a potential bidder who wants to acquire control of a target is worse off if he must sell out to a subsequent bidder. Any gains from the sale only mitigate his

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60. *Id.*

61. *Id.* at 1031.

62. *Id.*

63. *Id.* at 1031-32.

64. *Id.* at 1033.

65. *Id.*

66. *Id.* at 1035.

67. *Id.*

damages; they do not eliminate them. Thus, Bebchuk's response does not refute the fundamental economic logic behind Easterbrook and Fischel's point: Auctions reduce the gains to bidders and hence the incidence of bids.

Second, Bebchuk argues that "a searcher may discover a target whose acquisition will bring greater synergistic or managerial gains to the searcher than to any other potential acquirers."<sup>68</sup> Bebchuk argues that these searchers will acquire the target firms for which they bid regardless of when they appear in the bidding process.<sup>69</sup> But Bebchuk's analysis ignores the process by which bidders obtain the information about the synergistic gains associated with a particular acquisition. If a bidder only obtains this information by free-riding on the search of others, then Bebchuk's argument crumbles once we recognize that *initial* bidders will not engage in search if the only consequence of the search will be to signal *other* firms that they can enjoy synergistic gains by acquiring the target. In other words, here Bebchuk's analysis assumes the existence of an initial bidder whose search supplies subsequent auction participants with information about the value of the target. His analysis is flawed because it deprives these initial bidders of any incentive to provide this service.<sup>70</sup>

Next, Professor Bebchuk argues that search costs are not particularly high.<sup>71</sup> He offers no evidence for this assertion, other than the unique suggestion that investment bankers conduct much of the search for prospective targets, and charge low fees for this service.<sup>72</sup>

As the discussion of the auction literature in part I illustrates, Professor Bebchuk is on no firmer ground when he shifts his analysis from bidders' incentives to premiums for target firm shareholders. He asserts that "[c]ompetition among potential bidders generally raises the price a seller will receive."<sup>73</sup> The economists who have studied auctions have demonstrated that this is not always the case. As discussed in part I, for certain types of assets, reducing the competition among bidders will *raise* the price the seller will receive. In particular, as McCormick and French show, asset owners must always "pay all of the potential buyers' precontract costs."<sup>74</sup> For this reason, we observe owners imposing entry fees on

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68. *Id.* at 1036.

69. *Id.*

70. Professor Bebchuk also argues that bidders can obtain suitable rewards for search without abandoning the auction process by raising the percentage of target firm stock that bidders can purchase without disclosure. *Id.* at 1038. This argument suffers from the same flaw as the argument addressed in the text, namely that it ignores the economics of behavior at the margin. The issue is not whether bidders can obtain "suitable awards" for their search, but whether the incremental gains from a particular search will outweigh the cost. Bebchuk has conceded that requiring auctions will result in higher costs to bidders. *Id.* at 1035. Having done so, he cannot then argue that these higher costs will have no consequences.

71. *Id.* at 1036-37.

72. *Cf.* Gilson, *supra* note 57, at 58 n.17 (noting "seemingly very high fees charged by merger and acquisition departments of investment banking firms").

73. Bebchuk, *supra* note 59, at 1041.

74. French & McCormick, *supra* note 10, at 425.

potential bidders in order to restrict the number of bidders, where such bidders must incur high search and information costs (estimation costs) in connection with their bids. As the estimation costs go up, it becomes more and more desirable for asset owners to reduce the estimation costs they charge for their firms. Suppose, for example, that it is costly to estimate the value of a firm, but that the value of the firm, once determined, is unlikely to vary much from bidder to bidder. In such cases, sellers have "little to gain from having many buyers invest in information."<sup>75</sup> This is a straightforward application of the principle that sellers have an incentive to reduce bidders' costs. Where a buyer can identify the highest-valued user, or where the dispersion in the value of the asset across potential buyers is small, then, absent legal constraints, asset owners will avoid the use of an auction.<sup>76</sup> In such situations, a negotiated sale to a single bidder will maximize the returns to the seller.<sup>77</sup>

Ignoring the economics literature on auctions, Bebchuk asserts that auctions would benefit sellers "in all acquisitions, unfriendly or negotiated, through merger or takeover, whether management is loyal or self-serving."<sup>78</sup> This is as absurd as declaring that all grocery store owners should conduct auctions for fruits and vegetables in order to maximize their profits.

For example, Bebchuk recognizes that some takeovers occur because of the possibility of tax savings. These tax savings may be equally available to many firms. There is no reason to conduct an open auction where this is the case; adding more bidders will not increase the price being offered, since there is no dispersion of values among bidders. Adding bidders will only reduce the amount of the winning bid by the estimated amount of the bidders' sunk costs.

Bebchuk argues that, while forcing firms to conduct auctions reduces the incentives for search by bidders, it encourages search by target management.<sup>79</sup> This will be true in some cases, but not all. Some target firms may be equally valuable to a wide range of potential bidders. Where this is the case, there is no reason for targets to engage in costly search.

In other words, Bebchuk's error is that he only identifies one cost of auctions: "The only possible objection to a rule of auctioneering is that it reduces the number of acquisitions by decreasing the incentives for search."<sup>80</sup> But an additional objection to a rule of auctioneering exists; namely, it involves the waste of real resources.<sup>81</sup> The economics literature on auctions discussed in the article shows that for certain types of target firms this waste can be avoided by not holding an auction.

Ironically, Bebchuk appears to recognize the point first made by

75. *Id.* at 430.

76. *Id.* at 432-33.

77. *Id.*

78. Bebchuk, *supra* note 59, at 1045.

79. *Id.* at 1045-46.

80. *Id.* at 1046.

81. Easterbrook & Fischel, *supra* note 47, at 1174-75.

Yoram Barzel that one pitfall associated with the market for corporate control is the danger that excessive resources will be expended on search.<sup>82</sup> But he erroneously concludes that this pitfall can be avoided by holding unlimited auctions.<sup>83</sup> In fact, the auction literature shows that in many situations it will be possible to avoid the waste of excessive resources only by restricting the number of bidders.<sup>84</sup>

Finally, Professor Bebchuk's principal policy prescription is to impose a mandatory delay period.<sup>85</sup> The problem with Bebchuk's analysis is that it ignores the fact that a mandatory delay period allows bidders to rebid. As noted in section I, this will be disastrous both to bidders and to asset owners in any acquisition in which bidders must incur sunk costs.<sup>86</sup> This is because bidders will decline to enter a bidding contest unless they can be assured that they can recover these sunk costs. While bidders can recover sunk costs in sealed bid auctions, in open-bidding situations of the kind Bebchuk proposes, once bidding is underway, bidders will have an incentive to ignore their sunk costs and bid up to the market value for the firm being auctioned. Since they lose money doing this, they will be discouraged from entering a bidding situation that will lead them into this trap.

### C. Additions and Extensions to the Literature

In addition to the articles by Bebchuk and by Easterbrook and Fischel, other commentators, particularly Ron Gilson and Alan Schwartz, have contributed seminal articles to the theoretical literature on the ideal corporate auction rule.

In an article that appeared contemporaneously with Bebchuk's,<sup>87</sup> Professor Ronald Gilson also argued that a first bidder could recoup sunk estimation costs by buying a block of stock in the target that could be sold at a profit to subsequent bidders.<sup>88</sup> In addition, he stressed the point that any societal losses resulting from the fact that bidders are unable to recoup their sunk estimation costs will be offset by the fact that target assets are being allocated to their most efficient users.<sup>89</sup> In a later article, Professor Gilson argued that competitive bidding might actually increase bidders' return on their investment in search costs due to increased profits in subsequent sales.<sup>90</sup>

Gilson's argument is based on the observation that a successful ac-

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82. Bebchuk, *supra* note 59, at 1045.

83. *Id.*

84. *Id.*

85. Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEG. STUD. 197, 221 (1988).

86. For a discussion of the effects of rebidding, see *supra* notes 20-21 and accompanying text.

87. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981).

88. *Id.* at 870.

89. *Id.* at 872.

90. Gilson, *supra* note 57, at 66.

quisition requires two distinct attributes: (1) information production about the target, and (2) the actual skills necessary to operate the target.<sup>91</sup> From this observation, Gilson concludes that those firms who produce information will “prefer a rule allowing target management to facilitate competitive bidding, since competitive bidding would increase the return on their investment in information.”<sup>92</sup> He also argues that those with the skills necessary to operate the target (“implementers”) will prefer a rule of pure passivity, since a passivity rule will reduce takeover prices and enable implementers to capture some of the returns associated with information production.<sup>93</sup>

Professor Gilson makes an important contribution to takeover literature by recognizing that not all bidding firms involved in the takeover game have identical skills. Some bidders may prefer auctions, while others will prefer negotiated sales. But Gilson’s argument that those firms who are best at producing information about targets will inevitably prefer auctions is unconvincing. As Easterbrook and Fischel point out in defense of their no auction rule, an information producer often will benefit most by acquiring the firm about which it has developed the information and then reselling it later to a higher bidder.<sup>94</sup>

Similarly, it is not clear that “implementers,” those best able to implement the plans of the information producers, will uniformly prefer a rule of pure passivity. It seems clear that the implementers will prefer whatever rule the information producers prefer. After all, it does no good for a firm to have good management skills unless it has a target firm on which to implement them. Any rule that discourages information gatherers will therefore harm implementers as well.<sup>95</sup>

Professor Gilson’s analysis is valuable because it recognizes the contracting problems that exist between the various institutions involved in the market for corporate control, and because he recognizes that there are gains to be had from specializing in the different aspects of the takeover process. In particular, he observes that firms who acquire information about a target, but are unable to actually run the target firm, may have contracting problems in trying to sell the information due to the difficulties of obtaining a defensible property right in information.<sup>96</sup>

Based on these observations, Professor Gilson concludes that a rule that would prohibit defensive tactics but allow management to solicit competitive bids would be the optimal mechanism for disposing of

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91. *Id.* at 54.

92. *Id.*

93. *Id.* at 55.

94. Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 20 (1982).

95. *Id.* at 18.

96. It is hard to understand the difference between Professor Gilson’s information producer and the average market professionals who routinely acquire information about undervalued firms and recoup their investments in information by buying shares. See Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 571 (1984).

firms.<sup>97</sup> His policy prescription is based on the conclusion that his proposed rule would best balance the conflicting interests of information acquirers and implementers. Unfortunately, like Professor Bebchuk and Professors Easterbrook and Fischel, Professor Gilson's analysis ignores the fact that firms—both bidders and targets—differ dramatically from one to the other. As such, no single rule will be best for all firms, and sometimes defensive tactics will benefit target shareholders precisely because they encourage auctions.

Auction theory makes it clear that all information producers are not going to prefer auctions to negotiations in every case. Some information producers have sufficient reputational capital that their reputation serves to bond the veracity of their information. In other words, the diminution in reputational value from lying about the nature of their information is likely to outweigh any gains from a one-shot fraud. Professor Gilson recognizes this.<sup>98</sup> Where this is the case, the costs to the seller of negotiating are greatly reduced. The auction process, which permits buyers to verify the information about the target, is unnecessary where the buyers trust the seller.<sup>99</sup>

If all potential bidders have to expend resources in bid preparation, the information seller may lose by having an auction since the money spent to prepare bids will be subtracted from the amount that implementers are willing to bid. And, if Professor Gilson's dichotomy is correct, and implementers are not very good at information production and assimilation, it is likely that they will have to spend considerable resources preparing a bid. As French and McCormick point out, the paradigm case for negotiating instead of auctioning is where a seller with a long-standing reputation can prevent potential buyers from collecting information by supplying them with all of the information they need.<sup>100</sup> DeBeers refuses to offer its diamonds for sale at auction because it has a long-standing reputation in the trade. Negotiating, rather than auctioning, allows the company to obtain higher prices for its diamonds because bidders do not subtract their sunk estimation costs from their bids.<sup>101</sup>

In sum, it appears clear that Gilson's general rule prohibiting defensive tactics will disadvantage shareholders by preventing target firms from choosing to dispose of their firms in a negotiated sale. In this regard,

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97. Gilson, *supra* note 57, at 64.

98. *Id.* at 58.

99. *Id.* at 58-59.

100. French & McCormick, *supra* note 10, at 431-33.

101. Interestingly, Professor Gilson is aware of the DeBeers method of selling diamonds as a response to problems of collecting information. He even quotes Professor Barzel's observation that DeBeers employs its unique sales mechanism in order to place buyers "in a position to spend on the actual purchase of diamonds the amount they otherwise might have spent on collecting information." See Gilson, *supra* note 57, at 58 n.15 (quoting Barzel, *Some Fallacies in the Interpretation of Information Costs*, 20 J. L. & Econ. 291, 304 (1977)). He fails to see, however, that these insights suggest that auctions are inappropriate in circumstances that seem quite similar to those he is describing in the market for corporate control.

Gilson's proposed rule is no different from the other proposed rules previously described. It is too rigid for the complex world it seeks to regulate.

Professor Alan Schwartz also made an important contribution to the literature on takeover auctions.<sup>102</sup> He argues that minimum offer periods such as those contained in the Williams Act, along with other rules requiring auctions, reduce the incidence of search for welfare increasing acquisitions, without producing any countervailing benefits.<sup>103</sup> It seems that a complete answer to this assertion has been made in the economics literature and echoed by Professor Bebchuk.<sup>104</sup> In particular, if auctions are rendered impermissible, there may be socially excessive incentives to search.<sup>105</sup> As Haddock, Macey and McChesney explained in an earlier article:

The search for undervalued targets, like the search for new ideas, is costly. When several different claimants to a profitable idea or asset emerge, some scheme for allocating the property right must also emerge . . . .

[E]stablishing property rights by first possession ordinarily results in premature capture. Moving resources to higher-valued uses as fast as possible is undesirable . . . .

The search for targets consumes resources which have valuable alternative uses. Resources will be diverted too soon if title to the entire increase in a corporation's value arising from reallocating control can be established only by racing to the firm before a competitor reaches it. Well-defined property rights control the race by forcing contenders to deal with an owner or agent capable of implementing an internally consistent plan of action . . . . Facing no resistance, first bidders would be more likely to be the only bidders, since no defense could be used to elicit competing bids.<sup>106</sup>

Thus, Professor Schwartz erroneously presumes that additional increments of search will be made at zero cost to searchers. This is false. An additional problem with Schwartz's analysis is that it ignores the ability of target firms to save on bidders' aggregate search costs by conducting search themselves. Sometimes there are only a few potential buyers for target firms. As George Stigler has observed, in such thin markets, "sellers can also engage in search . . . in the literal fashion that buyers do."<sup>107</sup>

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102. Schwartz, *Search Theory & the Tender Offer Auction*, 2 J. L. ECON. & ORG. 229 (1986).

103. See *id.* at 230.

104. Barzel, *Optimal Timing of Innovations*, 50 REV. ECON. & STATS. 348 (1969); Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1047 (1982); Dasgupta & Stiglitz, *Uncertainty, Industrial Structure and the Speed of R&D*, 11 BELL J. ECON. 1 (1980); Mortensen, *Property Rights and Efficiency in Mating, Racing, and Related Games*, 72 AM. ECON. REV. 968 (1982).

105. Bebchuk, *supra* note 59, at 1047.

106. Haddock, Macey & McChesney, *supra* note 52, at 717-19.

107. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213, 216 (1961). See also Bebchuk, *The Case For Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1049 (1982); Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1776 (1985); Haddock, Macey & McChesney, *Property Rights*

Similarly, as the auction literature emphasizes, where search and bid preparation costs are low, conducting an auction will not be very costly for target firms, and will be the sales strategy most likely to fetch the highest price for the sellers. This is because bidders will be bidding close to their estimate of the true value of the asset being sold, since they will have few estimation costs to deduct.<sup>108</sup>

A final reason why Professor Schwartz's pro-auction rule seems debatable is that it can dampen productivity and skew incentives in the internal management of target firms. Suppose that a firm's shares are trading at \$50 per share. The firm has made a discovery of a huge store of minerals beneath some land in the West. The firm has not disclosed its discovery because it has not yet obtained mineral rights to all of the land in question. A rule that prohibits defensive tactics by the target would make the company prey to a takeover the moment rumors of the mineral discovery leaked out. This would prevent the firm's shareholders from obtaining the benefit of their firm's initial discovery, and dampen their incentives to search in the first place.

More recently, Professor Schwartz has defended a pure passivity rule from the perspective of utilitarian theory.<sup>109</sup> Like Professors Easterbrook and Fischel, Schwartz argues that any offer above the target's prebid offer price should be accepted, and therefore target managers should remain passive (*i.e.* refuse to hold an auction or engage in defensive tactics) when an outside bid is made for their firm.<sup>110</sup>

Professor Schwartz claims that the efficiency question in takeovers is "whether a transfer has moved assets from a lower- to a higher-valuing user."<sup>111</sup> Professor Schwartz points out that there is no "aesthetic, sentimental or other noneconomic value" associated with stock ownership, and that, in efficient markets, "the prebid price of a target's shares reflects the target's earnings prospects under current management."<sup>112</sup> These attributes cause stock to represent "financial assets whose values largely are reflected in their market price."<sup>113</sup> Consequently, "any transfer of corporate assets at a nontrivial premium above the market price is efficient *ex ante*, in the same sense that any voluntary contract is efficient *ex ante* (*i.e.* in the sense that the transaction makes both parties better off than they were before)."<sup>114</sup>

Professor Schwartz's analysis does not appear to be confined to takeovers. His arguments would appear to apply with equal force to any asset that trades in a thick market to which owners attach no sentimental value. Under Professor Schwartz's analysis, such asset owners should

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in *Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 709-10 (1987).

108. See French & McCormick, *supra* note 10, at 438-40.

109. Schwartz, *The Fairness of Tender Offer Prices in Utilitarian Theory*, 17 J. LEGAL STUD. 165 (1988).

110. *Id.* at 168-69.

111. *Id.* at 186.

112. *Id.* at 188-89.

113. *Id.* at 170.

114. *Id.* (emphasis in original).

never be able to decline to sell their assets to anyone who wants to buy them for a nontrivial premium above their current market price.

Professor Schwartz's arguments about the implications of market efficiency do not support his conclusions. Market prices of publicly traded shares reflect all publicly available information about those shares. Thus, share prices at any given time reflect the market's best guess about the future earnings of a particular firm. But some investors, particularly market professionals, will value share ownership in a particular firm more highly than other investors because they believe that the market price is inaccurate. By buying these shares, such market professionals can capitalize on new information they have uncovered and on the implications of their analysis of the firm whose shares are being traded. Competition among these market professionals is what drives securities prices to their efficient levels. Professor Schwartz's analysis would deprive these market professionals of incentives to locate undervalued firms, since they would be unable to capitalize fully on their investments in search.<sup>115</sup>

Put another way, the supply curve for shares is not perfectly inelastic, as Professor Schwartz presumes. Some investors believe that the market's price evaluation is wrong, and that their shares are worth considerably more than the price that the market has assigned. These investors will be the highest valuing users for a firm's shares. Professor Schwartz's proposed passivity standard would be inefficient because it would deprive these people of the incentive to engage in search.

The peculiar thing about the current legal literature on takeovers is that its policy prescriptions are so inflexible. Easterbrook, Fischel, and Schwartz argue that pure passivity ought to be the governing principle.<sup>116</sup> Bebchuk and Gilson argue that defensive tactics ought to be forbidden. But even cursory reference to the literature specifically devoted to the economics of auctions shows that neither side can be right. If target firms differ from one another, or if bidder firms differ from one another, then some are likely to flourish under a rule of pure passivity, some under a rule encouraging auctions, and some under some intermediate sales strategies. To conclude that all firms should be constrained by one sales strategy will force some shareholders to transfer ownership of their firms in suboptimal ways. This will depress share values generally, and provide a disincentive to investment.

For example, suppose that a publicly traded firm wishes to be acquired. It is involved in a highly specialized, high-tech industry which requires a heavy research and development budget and can only be managed by highly specialized acquirers. It has recently made a valuable discovery and wishes to merge with a partner who has both able technical skills to manage the ongoing operations of the firm and the marketing

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115. Bebchuk, *supra* note 85, at 205-16.

116. In fact, Alan Schwartz does not specifically address the issue of whether the state should permit shareholders of particular companies to adopt pure passivity by amendment to their firms' charter or bylaws. He treats that issue as a "separate question" which is "beyond the scope" of his analysis. Schwartz, *supra* note 109, at 169 n.13.

skills to exploit the new product successfully. Suppose further that for potential acquirers to make a bid they must make a sizable, non-transferable investment in firm-specific information about the target firm. If an open auction is conducted, and sale of the firm is thrown open to all comers, the price that the seller receives will be reduced by the aggregate sunk prebid costs of the bidders. To the extent that these bidders have duplicated efforts investigating the target, requiring an auction will simply waste bidder resources and result in a net lower price for selling shareholders.<sup>117</sup>

On the other hand, suppose there is another firm that makes a standardized product in a traditional way and could be managed by any number of acquiring firms using generic management skills. Suppose further that the company is quite simple in terms of its organizational and operational form so that prebid estimation costs are low. In such cases, holding open auctions is likely to be the optimal method of selling the firm.<sup>118</sup>

These examples are only meant to be illustrative. In the real world, firms are far too complex to support such sweeping generalizations. The high-tech firm might prefer to introduce some elements of an auction to draw an acquirer who values the target more than any other buyer because of some particular insight or skill he brings to bear in managing the target's assets.<sup>119</sup> Similarly, the simple, generic firm might be better off with a negotiated sale rather than an acquisition if it turns out that potential buyers are unexpectedly investing large amounts of resources collecting information about the target in the mistaken belief that there is more to the target than meets the eye. Under these circumstances, a negotiated sale can save these estimation costs and result in a higher price for selling shareholders.<sup>120</sup>

Again, the point here is that a general rule favoring or disfavoring auctions is likely to be harmful to large groups of shareholders. Two other points need to be made. First, current literature suggests that sellers of assets have only two choices, auction or forced sale. The reality, as the auction literature shows, is that there exists a huge array of sales techniques. There are dozens of types of auctions and a multitude of different mechanisms available to handle the negotiations for a particular firm. Each of these different sales techniques may be optimal for certain firms, but disastrous for others. Thus, it is not particularly illuminating to speak in vague terms about requiring "auctions" unless one specifies in some detail the particular sort of auction one favors.

A second related point concerns innovation by sellers. Since bidders' costs are passed along to asset owners in the form of lower bids, asset owners have an incentive to invest in developing innovative techniques to sell their assets. Asset owners have developed a variety of ingenious auction mechanisms to respond to the particular problems facing bidders for

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117. This analysis is an application of French and McCormick's theory.

118. *Id.*

119. *Id.* at 428.

120. *Id.* at 422-23.

their goods. These sales techniques involve everything from imposing submission fees on potential bidders to refusing to negotiate with some purchasers at all. The common feature of this wealth of disparate sales strategies is that each of them maximizes the value of the particular type of asset being sold. To dictate by uniform rule the type of sales process that can be used by asset owners would needlessly stifle this innovation process.

As we will see, many of these same criticisms apply to the dominant state and federal law on auctions. State law, as reflected in the recent decisions of the Delaware judiciary, appears to require auctions by target firm shareholders at least in certain contexts. Similarly, it is well known that the Williams Act,<sup>121</sup> the principal federal law regulating the market for corporate control, makes it difficult for target firms to prevent auctions from occurring. This is primarily because the Securities and Exchange Commission (SEC) has construed the law to require that initial tender offerors keep their offers open for at least twenty business days. An additional ten business days must be added after any increase in the price offered, the percentage of shares being bid for, or the dealer's solicitation fee.<sup>122</sup> These federal regulations impede firms' ability to decide for themselves what sales strategy will best maximize share value and diminish firms' incentives to become acquirers, since they create bidding environments in which bidders cannot recover their sunk estimation costs. The process is further impeded by recent decisions of the Delaware Supreme Court.

### III. THE DELAWARE JUDICIARY'S PREFERENCE FOR AUCTIONS

The starting point for any analysis of the Delaware judiciary's views on auction theory is the decision of the Delaware Supreme Court in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*<sup>123</sup> This case involved what began as a friendly takeover bid by Pantry Pride, which offered to pay between \$40 and \$50 per share for Revlon. The board of directors of Revlon responded to Pantry Pride's offer by undergoing a restructuring of the corporation, which significantly increased the firm's leverage. Pantry Pride's response to this corporate restructuring was to make a series of hostile tender offers for Revlon at a range from \$42 to \$56 ¼ per share. In the midst of this process, Revlon began to consider proposals from two other potential outside acquirers. As the Delaware court noted, both of these acquirers intended to finance their acquisition through the issuance of high yield (junk) bonds, and to repay the principal and interest on these securities, at least in part, through the sale of Revlon assets.<sup>124</sup>

Once the sale of the company became inevitable, the court held that

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121. 15 U.S.C. §§ 78m-78n (1982).

122. 17 C.F.R. § 240.14e-1 (1988). See L. LOSS, FUNDAMENTALS OF SECURITIES REGULATION 576 (2d ed. 1988) (noting that it "startles a bit" to see the SEC use its power to promulgate time periods in this way).

123. 506 A.2d 173 (Del. 1986).

124. *Id.* at 177, 180.

“[t]he whole question of defensive measures became moot. The directors’ role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.”<sup>125</sup> It has been argued that *Revlon* should be read to apply only in the context of a bust-up takeover.<sup>126</sup> This reading of the case is somewhat implausible, however, because it does not provide any guidance as to how much restructuring leads to a “bust-up.” Thus, in the absence of any sound theoretical justification for distinguishing bust-up takeovers from other takeovers from the shareholders’ perspective, it is unclear precisely when the obligation to conduct an auction is triggered.

More plausibly, it has been argued that *Revlon* requires that an auction be conducted only when the target board of directors has a conflict of interest in deciding whether to accept or reject a particular merger proposal.<sup>127</sup> In *Revlon*, it was thought that the ability of the board to consider outside bids was compromised because some board members were to participate in the buyout.<sup>128</sup> Later, the board was considered compromised because of a buyer agreement to protect the board against civil liability in any future suit brought by certain note holders.<sup>129</sup>

Regardless of possible readings of *Revlon*, it is clear that some lawyers and investment bankers are of the opinion that *Revlon* imposes a general duty on corporate directors to engage in an open-ended auction once a target company is “in play.” *Revlon*’s progeny provide some support for this conclusion. In *Freedman v. Restaurant Associates Industries*,<sup>130</sup> for example, the Delaware Court of Chancery interpreted *Revlon* as imposing “an obligation on the part of the board of directors, once it is clear to the board that the corporation is to be subject to a change in control, to attempt to maximize the amount to be received by shareholders.”<sup>131</sup> This language would pose no difficulties except for the fact that the court erroneously assumed that “maximizing the amount to be received by shareholders” is synonymous with holding an open auction. But, as previously established, this is not the case because holding an open auction may decrease, rather than increase, the value shareholders can receive when the sale of a firm is viewed from an ex ante perspective.

In *Ivanhoe Partners v. Newmont Mining Corp.*,<sup>132</sup> the Delaware Supreme Court repeated its conclusion that directors should serve as auctioneers whenever it becomes “apparent” that the sale of the target

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125. *Id.* at 182.

126. Reder, *The Obligation of a Director of a Delaware Corporation to Act as Auctioneer*, 44 BUS. LAW. 275, 278-79 (1989).

127. Herzel & Shepro, *Negotiated Acquisitions: The Impact of Competition in the United States*, 44 BUS. LAW. 301, 314 (1989).

128. *Id.* at 313.

129. *Id.*

130. [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,502 at 97,218 (Del. Ch. Oct. 16, 1987).

131. *Id.*

132. 535 A.2d 1334 (Del. Ch. 1987).

company is "inevitable."<sup>133</sup> The bottom line is that the law is quite unclear. *Revlon* establishes that auctions are required, at least in certain circumstances. However, they are not required in all circumstances. In particular, where there is no conflict of interest between the bidder and the target board of directors, "Revlon does not . . . require . . . that before every corporate merger agreement can validly be entered into, the constituent corporations must be 'shopped' or, more radically, an auction process undertaken."<sup>134</sup>

Regardless of the nuances in the law, it appears clear that the presence or absence of conflicts of interest and favoritism will be important factors in a determination of whether an open auction will be deemed mandatory. Another important factor will be whether target management actually has decided to sell the firm or not. Thus, the target's board does not appear to be able to invoke a poison pill to stop an auction once it is in progress,<sup>135</sup> or to favor one bidder over another in the context of an ongoing auction.<sup>136</sup> To evaluate the auction process within the context of a management buyout, the controversy surrounding Black and Decker's hostile bid for American Standard is particularly instructive.<sup>137</sup>

In the wake of Black and Decker's unfriendly bid, American Standard proposed a corporate restructuring that was the functional equivalent of a management buyout because it would have given control of the company to management and to an employee stock ownership plan (ESOP).<sup>138</sup> In addition, the restructuring would have cashed out virtually all of American Standard's public shareholders. This restructuring would have been triggered by a change of control, such as a hostile takeover bid.<sup>139</sup> The court essentially found that management's recapitalization plan would have been the functional equivalent of a management buyout and invalidated the plan because it was held to unfairly favor management's bid.<sup>140</sup> Thus, regardless of whether a corporation can avoid a general obligation to hold an auction in a struggle for control, it seems clear that an auction must be held if the firm is contemplating any corporate restructuring, such as a management buyout in which incumbent management will emerge as the dominant party, and the planned sale appears to favor incumbents over outside rival bidders.

Lock-up options issued by management in the midst of battles for corporate control also have been looked down upon by courts. Lock-ups give the firm to which they are issued rights to purchase specified assets of the target firm at a particular price when triggered by a particular

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133. *Id.* at 1344.

134. *City Capital Assocs. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988).

135. *CRTF Corp. v. Federated Dep't Stores*, 683 F. Supp. 422, 411-42 (S.D.N.Y. 1988).

136. *Black & Decker Corp. v. American Standard, Inc.*, 682 F. Supp. 772 (D. Del. 1988).

137. *See id.*

138. *Herzel and Shepro*, *supra* note 127, at 317.

139. *Id.*

140. *Black & Decker Corp.*, 682 F. Supp. at 786.

event. In *Hanson Trust PLC v. ML SCM Acquisitions, Inc.*,<sup>141</sup> SCM, the target firm, granted Merrill Lynch the right to buy two businesses, which accounted for more than half of its income, for \$430 million if anyone other than Merrill Lynch acquired more than one-third of SCM's common stock.<sup>142</sup> This lock-up option was approved by the SCM board of directors. The Second Circuit Court of Appeals, however, invalidated the agreement as a breach of management's fiduciary duties to shareholders on the grounds that the SCM was unable to prove that the option's strike price was within the range of fair value.<sup>143</sup>

But the granting of lock-up options appears to be perfectly consistent with the auction literature. By raising a bidder's probability of success, a target firm can also raise the amount it is willing to invest in search concerning the target, and hence the amount a bidder is willing to pay. Similarly, by granting a lock-up option, a target firm can induce a previously unwilling bidder to consider making a bid for a firm. This is a particularly important consideration in a takeover situation where the costs of entry into a bidding contest are quite high due to the estimation costs and bid preparation costs necessary to formulate an intelligent, legally acceptable bid.

Thus, the dominant state law on corporate takeovers holds that an open-ended auction must be conducted once it is determined that a firm is to be sold. While this strategy might be optimal for some firms, for others it will discourage bidding, thus reducing shareholder wealth. In particular, Delaware's law reduces shareholder wealth by making it difficult for directors of target firms to control the rules governing the conduct of public corporation sales. First, directors who do not think that conducting an auction will maximize firm value will be reluctant to announce that their firm is for sale, since such an announcement will trigger the Delaware duty to auction. Second, the law makes it difficult for auctioneers to end auctions. This makes it difficult for bidders to calculate their bid costs, and thereby lowers the amount they are willing to bid. It also makes it difficult for bidders to recover their sunk prebid costs. Finally, the law forbids sellers from preferring certain buyers over others. In a world in which some buyers are more credible, this rule harms shareholders by forcing firms to expend resources dealing with potential buyers they do not believe are serious. Similarly, by forcing sellers to deal with all buyers, sellers are prevented from acting to reduce buyers' search costs by identifying specific purchasers whom the sellers believe to be particularly appropriate.

#### IV. THE JUSTIFICATION FOR REQUIRING THE BOARD TO HOLD AN AUCTION

As noted above, a common feature of the academic and judicial commentary on takeovers is its rigidity. Both camps favor a single rule to

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141. 781 F.2d 264 (2d Cir. 1986).

142. *Id.* at 267.

143. *Id.* at 273.

govern the conduct of all sales of control of publicly held corporations. While important differences exist about the particular rules favored by the various camps, all seem to agree that one rule will benefit all shareholders of all firms, despite the important differences in bidding situations that exist in the real world.

#### A. Agency Costs

There is another important common feature among the judicial and academic commentary. Both camps are overwhelmingly concerned with the problem of agency costs within the public corporation, and this significantly influences their views on the proper method for transferring control. For example, Judge Easterbrook and Professor Fischel argue that target firms' managers "have a substantial interest in . . . preserving their salaries and status."<sup>144</sup> They even claim that "the less effective they have been as managers, the greater their interest in preventing a takeover."<sup>145</sup> Because there is no way to differentiate between honest efforts to conduct an auction and resistance that simply entrenches incumbent management (and because resistance consumes real resources), all resistance should be prohibited, according to Easterbrook and Fischel.<sup>146</sup>

Where Easterbrook and Fischel argue that passivity is the best means for insuring that management does not resist takeovers for the wrong reason, Bebchuk argues that his auction rule works best. Bebchuk asserts that:

[m]anagement cannot be trusted to use these [defensive] tactics primarily to gain a limited delay that will facilitate a bidding contest . . . . [I]t may employ these tactics to avoid a takeover altogether and perpetuate its control . . . . Alternatively, it may use them to distort an existing contest among prospective acquirers . . . in order to favor one that offers a better deal for management . . . . Therefore, time for making competing bids should be provided solely by regulatory mandate, and incumbent management should be barred from actions that obstruct any tender offer.<sup>147</sup>

Professor Gilson begins his article on defensive tactics by explaining that:

[t]ender offers present an obvious and inherent conflict of interest between management and shareholders. On the one hand, an offer provides shareholders with the opportunity to sell their shares for a substantial premium over market price. On the other hand, the tender offer is the principal mechanism by which management can be forcibly unseated from control.<sup>148</sup>

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144. Easterbrook and Fischel, *supra* note 47, at 1175.

145. *Id.*

146. *Id.*

147. Bebchuk, *supra* note 59, at 1054.

148. Gilson, *supra* note 87, at 819.

These claims, while plausible, are unconvincing as a complete explanation of managerial behavior. Agency costs of major dimensions exist within the large publicly held firm. But it is not clear why these agency costs inevitably will manifest themselves in the form of tactics that *obstruct* takeovers. For two reasons, it seems equally plausible that the opposite agency problem will exist, and that managers will *encourage* changes in control, regardless of whether such changes are in the shareholders' interest.

### 1. *Side payments*

First, while resistance allows incumbent management to retain their positions of power and authority, refusing to resist is a method by which incumbent managers can extract sizeable side payments from bidders. These side payments can come in the form of severance packages such as golden parachute arrangements, or in the form of "consulting fees" for agreeing to provide management services to the firm's new officers and directors.

From the perspective of bidding firms, it often will be far less costly to "buy off" incumbent management by providing them with side payments than it will be to face staunch resistance from incumbent management. It is not unheard of for resistance to consume tens of millions of dollars in bidding firm resources.<sup>149</sup> A bidding firm, of course, will prefer to reduce its takeover costs by avoiding these payments. Splitting the savings with incumbent management is one means to accomplish this. Similarly, it is likely that at least some incumbent managers will prefer to obtain side payments to resisting and keeping their jobs.

### 2. *Risk aversion*

The second reason incumbent management may choose not to resist is related to the first. Aside from the non-pecuniary benefits associated with managers' retaining their jobs, incumbent management is basically choosing between two income streams when deciding whether or not to offer resistance. Managers will value their current positions at the present value of their future earnings, discounted by the extremely high probability that they will be unsuccessful in remaining independent. These streams are unstable for two reasons. First, they depend on the fate of the firm. If the firm goes bankrupt, discharges its top management, or simply suffers low earnings, the income of the firm's top managers will decline or disappear. Second, as noted above, putting up resistance does not guarantee that managers will keep their jobs. Indeed, under current law which mandates auctions of firms that are for sale, the odds of remaining truly independent in the face of a takeover battle are exceedingly low.

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149. See Easterbrook and Fischel, *supra* note 47, at 1176 n.39 (describing two contests for control, one in which the fees paid to lawyers, investment bankers and other participants amounted to \$17 million, and one in which such fees amounted to \$15 million).

Thus, the payoffs to management from successful resistance are exceedingly uncertain. By contrast, the benefits of a side payment from a bidder in exchange for an implicit promise not to resist, which often will come in a lump sum severance payment, are extremely certain. Thus, side payments will be especially preferred by risk averse managers because they reduce the uncertainty associated with expected future earnings.

### B. MBOs: A Useful Illustration

The above discussion suggests that the existence of agency costs does not provide a justification either for requiring or prohibiting open-ended auctions for target firms. Obviously, if a court concludes that a particular defensive strategy has been adopted or rejected solely because it furthers managers' interests at the expense of shareholder welfare, then the strategy should be abrogated. But as indicated above, there is no *a priori* reason to conclude that managers will always respond to takeovers with too much resistance: They may respond with too much passivity.

Thus, takeover policy should not be based on the assumption that agency costs only manifest themselves in the form of too much resistance. The policy implications of this point can be illustrated with reference to the legal treatment of management buyouts,<sup>150</sup> because these transactions appear to represent an obvious situation in which the sales techniques selected by incumbent management should be heavily regulated. After all, in these transactions, management clearly has a strong incentive to select the sales strategy that maximizes its own chances of winning. These transactions represent a clear conflict of interest because management is simultaneously acting on behalf of the shareholders to determine whether a sale is in their interest, and on their own behalf as prospective purchasers.<sup>151</sup>

In response to this perceived conflict of interest, courts have invalidated a variety of techniques used by target management to give themselves a heavy advantage in bidding. Lock-up options,<sup>152</sup> no-shop clauses<sup>153</sup> and break-up fees,<sup>154</sup> all have been invalidated on the grounds that corporate boards should not be allowed to favor the management group over outside bidders.

It is significant that the judicial antagonism towards preferential treatment for incumbent management in management buyouts (MBOs) is not mitigated even where management's proposals are approved by an

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150. A management buyout involves the purchase of the assets of a public corporation pursuant to a statutory merger or other transaction in which members of former management acquire a significant equity interest in the successor corporation.

151. Lowenstein, *Management Buyouts*, 85 COLUM. L. REV., 730, 732 (1985).

152. *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 271 (2d Cir. 1986).

153. Bryer & Vlatakis, *Enforcement of No-Shop Clauses*, N.Y.L.J., December 10, 1984, at 33, col. 6.

154. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 178 (Del. 1986).

independent committee of the firm's board of directors. In *Edelman v. Fruehauf*<sup>155</sup> for example, the Sixth Circuit affirmed the trial court's injunction prohibiting a management buyout of Fruehauf. Management had obtained a break-up fee and a no-shop clause, which gave management an advantage in an auction over outside bidders. Management's bid was approved by a committee of independent directors, but the court struck it down, nevertheless, on the grounds that the board's goals were "not to create a fair bidding process but to make sure that the managers . . . bought the company and that other bidders would be turned away."<sup>156</sup>

This sort of result is not consistent with the analysis presented in this article. For a variety of reasons, it may be efficient for a firm that wishes to transfer control of itself to stifle an auction and favor incumbent management. The existence of a conflict of interest between management and shareholders in a management buyout does not detract from this conclusion. To mitigate this conflict of interest, the right to determine the appropriate sales technique should be delegated to an impartial group of directors. But this disinterested group of board members should be able to select the most efficient sales technique and should be able to negotiate exclusively with the firm's incumbent management if, in their business judgment, they determine that that is the best way to sell the company.

Managers may clearly value control of their company more highly than any other group. Where this is the case, shareholders will benefit most by selling their firm to a management buyout group in a direct sale rather than in an auction. The direct sale often will be superior to the auction where the highest valuing purchaser is known, because the costs of holding the auction can be avoided.

An examination of some of the likely sources of gain from management buyouts indicates that negotiation with management, rather than open auction, may be the best way to sell a company in certain situations. In particular, managers are likely to value their firm more highly than others where managers have made firm-specific, human capital investments in information about the company for which they work, and can best exploit that investment by buying the firm for which they work.

A firm-specific, human capital investment is one in which a manager has developed a skill that is particular to a specific employer.<sup>157</sup> Professor Coffee has observed that there are unique patterns of communication within a large corporate structure that "necessitate that special interpersonal skills be acquired to function in individual corporate environments."<sup>158</sup> In a situation such as this, incumbent management will be willing to pay more than other bidders for the firm in order to protect the

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155. 798 F.2d 882 (6th Cir. 1986).

156. *Id.* at 887.

157. G. BECKER, HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION 26-28 (2d ed. 1975).

158. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 17 n.42 (1986) (citations omitted).

value of these investments. Similarly, where management has not made firm-specific, human capital investments, but where the value of the firm would be enhanced if such investments were made, management might value the firm more highly than other bidders because ownership by management would prevent these investments from being exploited by shareholders.<sup>159</sup>

In these cases, managers will value the firm more highly than outsiders, and hence will be willing to pay more. The negotiating team of independent directors can benefit shareholders by charging the management group the highest price that an outside bidder would be willing to pay *plus* a share of the costs saved by not holding a costly auction. The gains will be shared by the shareholders and the managers.

Another situation in which management negotiation will be better than holding an auction is where managers have information that suggests that the firm's shares are undervalued in the marketplace, even though information is not fully reflected in the firm's share price because it is costly to verify. In this situation, the firm's share price could be adjusted to its correct level by holding an auction. The auction participants would be more willing than general market participants to spend the resources necessary to verify the information known to management, because the winner of the auction would be able to capture the full difference between the market's value of the firm's shares and their true value. But money spent verifying information already known to management would be a waste of real resources. The price that purchasers would be willing to pay would be reduced by the amounts they expended to verify management's information.<sup>160</sup>

Obviously, incumbent management should be required to disclose the information in question to the independent directors engaged in negotiations to sell the firm. But these directors should be able to decide for themselves whether an auction or a negotiated sale to incumbent management would be the optimal means for disposing of the assets of the target firm.

A closely related argument applies in a situation where a firm's shares are "undervalued" simply because of the very existence of agency costs within the corporation. Rational shareholders will reduce the price they are willing to pay for stock by an amount equal to any expected divergence from a policy of strict profit maximization by a firm's officers

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159. *Id.* at 24 (arguing that shareholders can exploit managers' firm-specific, human capital investments by selling firm to hostile acquirer after such investments have been made).

160. It might be argued that the expenditure of real resources by other bidders is irrelevant because incumbent management, which does not have to make these expenditures, inevitably will win any auction that is held. This is erroneous for two reasons. First, the costs incurred by the other bidders remain a waste of real resources, and hence socially undesirable. Second, the incumbent management team doing the management buyout will spend more on legal fees, investment banking fees and related costs in an auction than they will in a negotiated sale, and the cost of these expenditures will be borne by the target firm's public shareholders.

and directors. Where a firm undergoes a management buyout, agency costs are reduced dramatically, and the gulf between ownership and control is essentially eliminated. A management buyout allows shareholders to obtain some of the gains associated with this radical diminution in agency costs.

In all probability, incumbent management is the group that will have the best estimate of the possible savings by eliminating agency costs. Consequently, this group is the likely candidate to purchase the firm in a leveraged acquisition. After the appropriate disclosures are made to the bargaining team of independent directors, it does not appear that there are any gains to shareholders available from holding an auction. Rather, the costs of the auction would simply diminish the size of the gains available to shareholders.

A final situation in which a negotiated sale to incumbent management would be preferable to an auction occurs when the buyout is being undertaken simply to avoid the regulatory burdens of the securities laws, or where the target firm is being acquired for certain tax credits that the target was previously unable to exploit, or for the substantial interest deductions available on debt financing.<sup>161</sup> In these situations, there are no gains for bidders to invest resources in obtaining information about the target, because all of the value enhancement associated with the takeover is endogenous to the target. Adding additional bidders to an auction is not going to produce a higher price, because all bidders will value the savings equally. Consequently, holding an auction increases the cost of a transfer of control without resulting in a concomitant increase in bid price. Under these circumstances, if management is willing to purchase the firm, there is no reason to prevent managers from negotiating an appropriate price with independent directors.

### CONCLUSION

Lucian Bebchuk has described his regulatory regime for transferring control of public corporations as the sole owner standard because, in his view, it is the regulatory system that treats shares of stock in a publicly held corporation as though they were held by a single owner.<sup>162</sup> As Bebchuk notes, these sole owners are most likely to select the sales strategy that maximizes the value of the assets being sold. Professor Bebchuk is clearly correct that the sole owner standard is the appropriate reference point. Indeed, the point is so obvious as to be trivial. The difficult question is determining which, among the virtually infinite array of available sales strategies, would be the one that a sole owner would select.

The point of this article is that, contrary to the views of the existing

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161. Until the Tax Reform Act of 1986, management buyouts generated substantial tax advantages because the transactions permitted a stepped-up basis in target firm assets which enabled firms to obtain additional depreciation deductions for depleted assets and to decrease recognized gains on the eventual sale of assets.

162. Bebchuk, *supra* note 85, at 216.

dominant critics, there is no single answer to this question. Indeed, it seems clear that open auctions will greatly benefit some firms. Similarly, selling a firm in a negotiated transaction with a single buyer will maximize firm value (and thereby conform to the sole owner standard) for other firms. In particular, auction literature shows that sometimes additional bidders can create value in the assets for which they are bidding by making important discoveries about them. In these cases, adding additional bidders to an auction will enhance the price shareholders will be able to obtain in a transfer of control. On the other hand, sometimes bidders will not be able to add very much, and any investments in information by bidding firms will be wasted. In these cases, auctions simply are likely to reduce the price for which a target firm can be sold. This article has provided numerous other examples of situations in which either auctions, or negotiated sales, or some hybrid sales mechanism might be preferred by target shareholders.

Finally, this article has shown that the undeniable presence of agency costs within a corporation should not cause us to favor auctions over negotiated sales. The existence of a wide divergence of interest between managers and shareholders should mandate that a board of directors appoint a group of independent directors to serve as negotiating agents. But if the optimal means of disposing of a firm's assets is to sell those assets in a negotiated sale to incumbent management, then clearly that is how the firm should be sold.

