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The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-Ups

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THE UNCERTAIN CASE FOR TAKEOVER REFORM: AN ESSAY ON STOCKHOLDERS, STAKEHOLDERS AND BUST-UPS

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In this Article, Professor John Coffee considers under what circumstances there could be a legitimate role for state regulation of tender offers. Professor Coffee suggests that state anti-takeover laws could (but do not) function to protect other stakeholders, including corporate management, in the target corporation where the implicit contract between the corporation and these stakeholders has broken down. He advances a model of corporate directors as mediators between shareholders and stakeholders in order to protect the expectations embodied in a web of implicit and explicit contracts.

Professor Coffee suggests that takeovers would be more palatable if the interests of stakeholders were taken into account. Compensation formulas could be designed that would give managers a share in takeover gains. State takeover control legislation could have a legitimate role if it encouraged a more equitable sharing of takeover gains with stakeholders, such as employees and contractors, who are unable to contract with shareholders. Although Professor Coffee does not believe that takeovers should be prohibited or chilled, he believes that it is a valid legislative goal to seek to protect the expectations of these other stakeholders through a policy of sharing the control premium.

Finally, Professor Coffee concludes that judicial scrutiny of corporate governance laws will ultimately continue to incorporate a balancing test, even if courts do not explicitly acknowledge the use of such criteria. Courts will continue to weigh the intrastate justifications and the results of the legislation against any resulting restraints on interstate commerce in deciding whether the laws pass constitutional muster.

This is an argumentative essay, longer on speculation than substantiation. It considers under what circumstances and premises there could be a legitimate role for state regulation of tender offers. In so doing, it assumes that existing justifications for such legislation are largely meritless or disingenuous, and often both. Nonetheless, the phenomenon of state takeover regulation is becoming a pervasive fact, which is likely to alter significantly the balance of advantage between bidder and target. Between late April 1987 and February 1988—roughly the time period between the United States Supreme Court's decision in *CTS Corp. v. Dynamics Corp. of America*[1] and the date of

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1. 107 S. Ct. 1637 (1987) (upholding Indiana Control Share Acquisitions Chapter, IND. CODE §§ 23-1-42-1 to -11 (Supp. 1987), against claims that it impermissibly burdened interstate commerce and was preempted by the federal securities laws).

this paper—at least fourteen states have amended or enacted anti-takeover legislation[2] —a trend recently culminated by Delaware's passage of a weak, but broadly applicable statute, which will apply to the roughly half of the New York Stock Exchange-listed firms that are incorporated in that state.[3] Put simply, there has been an epidemic-like character to the spread of state anti-takeover legislation; a majority of the states have now enacted a "second generation" statute in the wake of *Edgar v. MITE Corp.*[4] and, although the constitutional dust has not yet settled on the *CTS* decision, many of these states (or others) may soon move to a "third generation" statute after *CTS*, exploiting the considerable latitude that case may permit.

This activism at the state level contrasts sharply with the relative caution being shown by the Congress. Even Senator William Proxmire, the Senate's most zealous critic of takeovers, has only been able to secure approval within the Senate Banking Committee for a modest statute that attempts no more than minor reforms of current practices.[5] In short, the states—particularly those in the "Rustbelt" extending through New York, Pennsylvania, Ohio, Indiana, Wisconsin and Minnesota—have become protective havens for target corporations, while the Congress has tended more towards neutrality.

For many—including most academics—the prospect of state regulation of tender offers threatens a Balkanized world in which a national securities market is gradually fragmented, special interest legislation is adopted under the transparent guise of "protecting" shareholders and the disciplinary capacity of the hostile takeover is gradually dulled. Such fears are far from groundless. State takeover reform could easily impose externalities on the American economy, as individual states

2. Thirteen state statutes were passed between late April and December, 1987, according to the Investor Responsibility Research Council [hereinafter IRRC], a non-profit organization which monitors legislative developments at the state and federal level. *See* IRRC, *Delaware Bar Considering Takeover Law with Three-Year Delay*, 4 CORP. GOVERNANCE BULL. 186 (Nov./Dec. 1987); IRRC, *States' Rush to Adopt Protective Anti-Takeover Laws Continues*, CORP. GOVERNANCE BULL. 152 (Sept./Oct. 1987) (surveying post-April 1987 statutes enacted by Arizona, Florida, Louisiana, Massachusetts, Minnesota, Missouri, Nevada, North Carolina, Oregon, Utah, Washington and Wisconsin). Thereafter, Delaware enacted its new law. *See infra* note 3.

3. For an interesting debate over the likely impact of Delaware's new statute, compare Bandow, *Curbing Raiders is Bad for Business*, N.Y. Times, Feb. 7, 1988, at F-2, with Veasey, *A Statute Was Needed to Stop Abuses*, N.Y. Times, Feb. 7, 1988, § 3, at 2; *see also* Franklin, *Drafting in Delaware: Bar Group Floats Controversial New Anti-Takeover Bill*, N.Y.L.J., Dec. 3, 1987, at 5, col. 2; IRRC, *Delaware Bar Considering Takeover Law with Three-Year Delay*, *supra* note 2.

4. 457 U.S. 624 (1982). At least twenty-eight states now have a "second generation" anti-takeover statute. *See* IRRC, *Delaware Bar Considering Takeover Law with Three-Year Delay*, *supra* note 2 (surveying twenty-seven states prior to Delaware's passage of its new law).

5. For a summary of pending legislative proposals, all of which appear to be stalled in the wake of the recent market crash, see IRRC, *Action on Tender Offer Legislation Delayed Until 1988*, 4 CORP. GOVERNANCE BULL. 196 (Nov./Dec. 1987). For a critique of the Senate bill (now S. 1323), see Grundfest, *Proxmire's Doubletalk on Takeovers*, Wall St. J., Sept. 16, 1987, at 30.

seek to protect local interests at the nation's expense. These arguments have been well developed by others and need not be repeated here.[6] Put simply, few commentators believe that such legislation benefits shareholders,[7] and most suspect that its intended purpose is either to entrench target management or to prevent plant closing and job loss.[8] If so, state legislation regulating corporate governance in order to prevent corporate flight arguably achieves what might otherwise be invalidated on either preemption or interstate commerce grounds if the same goals were pursued explicitly through plant closing legislation (or by any other means that sought to embargo the transfer of jobs or assets out of

6. *See, e.g.*, Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987); Baysinger & Butler, *Anti-Takeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563 (1983).

7. Although there are difficult methodological problems surrounding any attempt to measure the effect of the passage of legislation on shareholder welfare (*see* Binder, *Measuring the Effects of Regulation with Stock Price Data*, 16 RAND J. ECON. 167 (1985)), some studies have found that the passage of anti-takeover statutes was associated with a decline in stock prices for at least some corporations incorporated in the jurisdiction. *See* Schumann, *State Regulation of Takeovers and Shareholder Wealth: The Effects of New York's 1985 Takeover Statutes*, Bureau of Economics Staff Report to the Federal Trade Commission (Mar. 1987) (finding negative but statistically insignificant effect on New York corporations); Office of the Chief Economist, Securities and Exchange Commission, *Shareholder Wealth Effects of Ohio Legislation Affecting Takeovers* (May 1987) (finding negative and statistically significant effect on share price of the Ohio firm that lobbied for the statute and smaller but still statistically significant effect on other Ohio corporations). The New Jersey Office of Economic Policy has also found that the New Jersey statute had a statistically significant negative effect on the share prices of affected New Jersey corporations. IRRC, *N.J. Takeover Law a Bad Idea, Says State Economic Adviser*, 4 CORP. GOVERNANCE BULL. 188 (Nov./Dec. 1987). In contrast, a study by Professor Romano has found no discernible impact on share prices following the passage of the Connecticut, Missouri and Pennsylvania statutes. Romano, *supra* note 6, at 180-87.

8. There is a debate over the nature of the political coalition supporting anti-takeover legislation. Professor Romano argues that such legislation is simply the result of concentrated lobbying by the target firm, which usually has greater local clout than the distant bidder. In her study of the Connecticut statute, she found that other potentially affected groups—labor unions, shareholders, communities—did not participate in the lobbying effort. Romano, *supra* note 6, at 131-45. I find this explanation incomplete. In politics, silence may imply consent. Groups that are seemingly passive (such as labor) may remain on the sidelines because they sense an identity of interests with the target firm which is lobbying for the legislation. Labor clearly fears takeovers and, correctly or incorrectly, associates them with plant closings and job loss. Moreover, the alacrity with which state legislatures have responded to tender offers by passing legislation overnight is virtually unprecedented. Corporations have not been so fortunate with respect to most other items on their lobbying agenda, even when they also are unopposed. To illustrate, take the example of the recent Wisconsin statute, signed into law on September 17, 1987. The Wisconsin statute was passed after the legislature met in special session for two days to consider legislation drafted by a local brewer (G. Heileman) which was the object of a takeover bid by a foreign bidder (Bond Corp. Holdings Ltd. of Australia). Special sessions and a legislative pace of this character occur only in a perceived crisis, and for a crisis to be perceived, there must be a diversity of local interests that are threatened. *See* IRRC, *States' Rush to Adopt Protective Anti-Takeover Laws Continues*, *supra* note 2, at 152-53.

state).[9] As a result, many have either sought to construe *CTS* narrowly or have advocated federal preemption of state takeover legislation.[10]

The most vulnerable aspect of state takeover legislation is the claim that these statutes are designed to benefit target shareholders. This claim approaches the ludicrous because the available evidence seems to show that target shareholders reap extraordinary gains in takeovers,[11] and this finding is further confirmed by the behavior of institutional investors who have recently organized to resist both takeover defensive tactics and state legislation. Indeed, stock price studies suggest that the group most exposed to risk in takeovers is the shareholders of the bidder firm, who have consistently lost money throughout the 1980s from takeovers.[12] But if takeovers thus result in wealth transfers from bidder shareholders to target shareholders, the logical response should seemingly be to enact legislation to protect sharehold-

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9. To date, plant closing legislation has been chiefly challenged on preemption grounds. *See* Note, *NLRA Preemption of State and Local Plant Relocation Laws*, 86 COLUM. L. REV. 407 (1986). In Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 264 (7th Cir. 1986), *rev'd on other grounds*, 107 S.Ct. 1637 (1987), Judge Posner wrote: "The commerce clause does not allow states to prevent corporations from moving assets and employees to other states." Whether this statement would apply also to state plant closing laws remains to be seen. *See infra* notes 75-86 and accompanying text.

10. Congress appears at present to be intent on ducking the preemption issue in its consideration of takeover reform. *See* IRRC, *Preemption Issue is Thorny One for Congress on Takeover Bill*, 4 CORP. GOVERNANCE BULL. 146 (Sept./Oct. 1987) (noting that Senator Proxmire agreed to drop his proposal to affirm the right of states to adopt anti-takeover statutes in order to win support on the Senate Banking Committee). On the House side, H.R. 2668, proposed by Representatives Lent and Rinaldo, would give the SEC authority to preempt state laws if they impede the exercise of voting rights. *See* IRRC, *supra* note 5, at 197. The House Subcommittee on Telecommunications and Finance has not yet reported out any bill on takeover reform, and its chairman, John Dingell, is the co-author of a bill, H.R. 2172 (the "Dingell-Markey bill"), which does not address the preemption issue. As a generalization, Republicans seem more prepared to preempt state takeover legislation, but Democrats seem either protective or neutral toward such state legislation.

11. The latest and most methodologically sophisticated stock price study finds that for a sample of 236 successful tender offers between 1962 and 1984, target shareholders received a mean percentage gain of 31.77% (which percentage is the cumulative abnormal return from five days before the first tender offer to five days after the last offer made by the bidding firm) and dollar gains of $107.08 million. During both the 1970s and 1980s, this percentage was even higher, averaging slightly over 35%. *See* Bradley, DeSai & Kim, *Synergistic Gains From Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, J. FIN. ECON. 12 (Aug. 1987).

12. While target shareholders gain, bidder shareholders lose, according to the Bradley, DeSai and Kim study, *supra* note 11. Over the entire period of 1962-1984, bidder shareholders experienced small but statistically significant stock price gains of 0.97% (in terms of the cumulative abnormal return from five days before the first offer to five days after the last offer) and dollar gains of $17.30 million. However, over the most recent period studied, January 1981 to December 1984, bidders experienced mean percentage losses of 2.93% and dollar losses of $27.28 million. *Id.* at 12. It should be emphasized, however, that this study finds that the gains to target shareholders to dwarf the losses to bidder shareholders; in 75% of the cases studied, the combined revaluations of the two firms were greater than before the tender offer.

ers of the bidder firm,[13] not paternalism aimed at those who clearly benefit.

Despite this empirical evidence, an enormous body of academic writing has focused on the problem of coercion in takeovers, particularly in partial bids, where in theory bidders can pressure target shareholders to tender because of a fear of being "worse off" after the tender offer shifts control of the target to the bidder.[14] This literature has an undeniable theoretical elegance and is no doubt correct within its four corners, but the problem of coercion in takeovers nonetheless represents the hobgoblin of the law professors. In the real world, demonstrated examples of coercion remain as rare as confirmed sightings of the Loch Ness monster. Why? The answer is twofold: First, shareholders are more than able to protect themselves against bidder coercion through self-help remedies, such as "fair price" charter amendments or the more controversial "poison pill" shareholder rights plans.[15] Market solutions have probably been even more effective, as competitive auction markets have largely solved or mitigated the problem of two-tier or low premium bids. In short, the simplest remedy for an inadequate bid is for the target to seek a higher one within the active and liquid market for corporate control; as a last resort, management, itself, can always create an auction by making a self-tender.[16] Given these alternatives, the view that shareholders are exposed to a high potential for coercion is probably the first and greatest myth in this field. The reality is that, if anything, shareholders tend to be overprotected by managements who have excessive incentives to fortify the battlements and deepen the moats around their corporate castles.

If shareholders do not need or want statutory protections when they can tailor their own protections, does it necessarily follow that there is no case for statutory intervention? This is a non-sequitur. There

13. For example, if reforms were thought necessary to protect bidder shareholders from acquisition overpayments by their managers, one could legislate a rule requiring shareholder ratification of tender offers. I have explored the problems of such a rule elsewhere. *See* Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1269-72 (1984). *But see* OHIO REV. CODE ANN. § 1701.83 (Baldwin 1979) (requiring two-thirds vote by bidder shareholders if bidder will be issued shares equal to or in excess of one-sixth of those outstanding).

14. *See, e.g.*, Bebchuck, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983); Bradley and Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1377 (1986). Many of these articles also address other points, and all represent valuable contributions to the literature. Nonetheless, I think they focus on a phantom issue.

15. For discussions of the available defenses against coercive pressure by bidders, see Carney, *Shareholder Coordination Costs, Shark Repellents and Takeout Mergers: The Case Against Fiduciary Duties*, 1983 AM. B. FOUND. RES. J. 341; Hochman and Folger, *Deflecting Takeovers: Charter and By-law Techniques*, 34 BUS. LAW. 537 (1979).

16. *See* Bradley and Rosenzweig, *supra* note 14 (arguing for some restraints on management's ability to purchase its own shares once a hostile tender offer has been commenced).

exist other "stakeholders" in the corporation—for example, creditors, employees, local communities—some of whom are in a poor position to bargain. Having sunk substantial investments in the firm, they are exposed, it will be argued, to shareholder opportunism. Still, any claim that these stakeholders therefore deserve statutory protection may prove too much, as it could justify an absolute veto power for those who have only a marginal interest in the processes of corporate governance. Nor is it clear that the extent of their exposure is that great; all that can honestly be claimed is that plausible scenarios—more plausible, at least, than the coercion scenario—can be described under which they face unanticipated losses that, under some circumstances, could exceed the gains to shareholders as a class. The political conflict over takeovers is, then, not between classes of shareholders, but rather divides shareholders and stakeholders, and thus transcends the usually narrow concerns of corporate law.

This is a controversial theory to describe even in the abstract, and the other commentators to this symposium will likely recoil from it with horror. They will, I anticipate, reject any such justification for state legislation on the broad ground that it would interfere with the market discipline that the takeover generates, or would preclude other synergistic gains. Yet, the source, extent, and even the observability of these gains remain open to serious dispute.

Indeed, myths often travel in matched pairs, and the counter-myth to the claim that the potential for coercion of shareholders justifies state regulation is this disciplinary thesis that the impact of takeovers is simply to replace bad managers with good ones. Once, this simple model of the takeover process, which views takeovers as a competition among managerial teams for control of the target corporation's assets, seemed persuasive. However, Part I of this Article will examine a new learning that finds this model over-simple and misleading. Part II will then turn to the alternative interpretations of the source of takeover gains, and Part III will focus on the doctrinal and normative consequences of these alternative interpretations. Finally, Part IV will search for a role for state legislation that seeks not to prevent changes in corporate control, but to restrict opportunism—here, by shareholders against stakeholders. In so doing, Part IV will also consider how such statutes should fare under the *CTS* decision. Notwithstanding the Court's clear preference in *CTS* to avoid a balancing analysis, Part IV predicts that, in some form, balancing, like death and taxes, will always be with us.

I. FISSURES IN THE FOUNDATION

In overview, there are at least five categories of reasons why the simple disciplinary model of the hostile takeover today seems inadequate:

First, takeovers and mergers appear to occur in waves. These waves are not cyclical and have little obvious relationship to the business cycle, interest rates or the economy as a whole.[17] If managerial incompetence at target firms were really the driving force behind takeovers, one would expect a less volatile pattern, because managerial incompetence is hardly cyclical. Moreover, acquirers constantly report that they are seeking strong target managements (by which they appear to mean strong operating managements at the middle management levels).[18]

Second, takeovers tend to be industry specific. Over the last decade, they have swept in succession through diverse industries: natural resources, broadcasting, airlines, financial services, food products.[19] Conversely, no one has sought to tender for International Harvester, Continental Illinois, Chrysler (under earlier management), Bethlehem Steel, or any of a host of other obviously sick and troubled companies. Perhaps bidders are risk averse, or perhaps they simply doubt that the problems of most distressed companies can be solved by a quick transition in management.

Third, takeover premiums are roughly comparable with the premiums paid in leveraged buyouts.[20] If target managements can raise money in the capital markets at equivalent (or cheaper) rates to those paid by the bidder and can even raise more funds to outbid the hostile bidder, this process hardly seems to reflect the market's judgment that the target was poorly managed. Some other motor force must, then, be driving takeovers if the supposedly inept target management can obtain more and better financing than the supposedly more efficient bidder.

Fourth, recent empirical work on the financial characteristics of target firms has consistently found target firms not to be statistically distinguishable from other firms—either other acquisition targets in

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17. I have analyzed the point elsewhere. *See* Coffee, *supra* note 13, at 1210-11. *See also* R. NELSON, MERGER MOVEMENTS IN AMERICAN INDUSTRY 1895-1956 (1959).

18. *See* Coffee, *supra* note 13, 1211-12.

19. The Council of Economic Advisers found that between 1981 and 1983, over 50% of the transaction value of mergers and acquisitions was accounted for by five industries (petroleum, banking and finance, insurance, mining and minerals, and food processing). *See* ECON. REP. PRESIDENT, *The Annual Report of the Council of Economic Advisors* 192-95 (1985). More recently, airline and broadcasting acquisitions have predominated.

20. *See, e.g.*, DeAngelo, DeAngelo & Rice, *Going Private: Minority Freezeouts and Stockholder Wealth*, 27 J.L. & ECON. 367 (1984); Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730 (1985).

"friendly" mergers or other firms within the same industry. A 1987 study by Lynn Browne and Eric Rosengren for the Federal Reserve Bank of Boston concluded that target firms could only be characterized "as rather ordinary firms, at worst mediocre firms," but rarely the laggards within their industry.[21] This view has been corroborated by earlier research as well. John Pound's work for the Investor Responsibility Research Center, Inc.,[22] a recent paper by Morck, Shleifer and Vishny for the National Bureau of Economic Research,[23] and earlier work by other scholars—such as Langetieg[24] and Harris, Stewart and Carleton[25] —concur that the targets of takeovers seem to cluster around the means in their industry. Although the stock price of target firms may have been depressed before the takeover, some research suggests that this is an industry-specific factor, rather than a firm-specific one[26] —a finding which corroborates the industry wave pattern noted above.

Fifth, follow-up studies by industrial organization economists have found little evidence of increased efficiency after the acquisition: some indeed find evidence of a loss.[27] This is the most perplexing finding: stock price studies by financial economists find immediate substantial gains to the target shareholders, and smaller gains or insignificant losses to the bidder shareholders;[28] but longer-term, follow-up studies, using a variety of methods, have not found significant gains in revenues, profits, market share, or cost efficiency criteria after the acquisition. Indeed, a recent survey by Richard Caves of Harvard finds some evidence

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21. L. BROWNE & E. ROSENGREN, SHOULD TAKEOVERS BE RESTRICTED?: A FINANCIAL PERSPECTIVE 27 (Working Paper 1987).

22. Pound, *Are Takeover Targets Undervalued? An Empirical Examination of the Financial Characteristics of Target Companies* (Investor Responsibility Research Center, Washington, D.C., 1985).

23. MORCK, SHLEIFER & VISHNY, CHARACTERISTICS OF HOSTILE AND FRIENDLY TAKEOVER TARGETS (National Bureau of Economic Research Working Paper, June 1987).

24. Langetieg, *An Application of a Three-Factor Performance Index to Measure Stockholder Gains From Merger*, 6 J. FIN. ECON. 365 (1978).

25. Harris, Stewart & Carleton, *Financial Characteristics of Acquired Firms*, in MERGERS AND ACQUISITIONS: CURRENT PROBLEMS IN PERSPECTIVE (M. Kennan & L. White eds. 1982).

26. *See* Langetieg, *supra* note 24, at 379. Acquirers also show negative returns in some studies. *See* Malastesta, *The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms*, 11 J. FIN. ECON. 155, 180 (1983).

27. For a survey of these findings, see R. CAVES, EFFECTS OF MERGERS AND ACQUISITIONS ON THE ECONOMY: AN INDUSTRIAL ORGANIZATION PERSPECTIVE (Working Paper, Oct. 1987). Professor Caves finds that ex post studies of acquisitions show little evidence of increased productivity, either in terms of market share, business-unit profitability, or technical efficiency. *See also* D. Mueller, *Mergers and Market Share*, 67 REV. ECON. & STATISTICS 259 (1985); D. RAVENSCRAFT & F.M. SCHERER, MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY (Brookings Inst. 1987).

28. *See* Jensen and Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5 (1983) (finding slight gains to bidder and large gains to target). *But see* Bradley, DeSai & Kim, *supra* note 11 (finding significant, but not offsetting, losses to bidder shareholders in recent takeovers).

of a net loss.[29] In short, the ex ante perspective of the financial economist and the ex post viewpoint of industrial organization specialists appear to conflict, and thereby pose a substantial mystery. Of course, the methodology of both sides may be flawed. Industrial organization specialists tend to rely on accounting data, which may be biased by its use of historical cost figures, while financial economists are heavily dependent on short-term stock price studies, which measure the market's immediate reaction to an event, and the market's prediction may not accurately gauge the event's ultimate economic significance.

Still, if much is uncertain, one fact is clear: target shareholders gain from takeovers by much more than bidder shareholders lose; these aggregate gains may be as high as $167 billion, according to a recent SEC report.[30] What, then, can explain wealth creation on this scale if there appear to be no villains that deserve the tender offer's guillotine? Several competing hypotheses are next analyzed in Part II.

II. THE ALTERNATIVE HYPOTHESES: EMPIRE BUILDING VERSUS IMPLICIT CONTRACTING

Even the strongest proponents of the market for corporate control have long conceded that the source of takeover gains remains a mystery.[31] Recently, the debate over the source of these gains has become more focused, as increasing evidence suggests that target firms sell in the market at significant discounts off their asset liquidation or breakup values. A National Bureau of Economic Research working paper finds that the one financial characteristic that distinguishes hostile takeovers from friendly transactions (at least among Fortune 500 companies) is the ratio of market value to replacement value of tangible assets, which ratio was lower for the hostile targets.[32] In short, targets sell in the stock market at a discount off their seeming asset value. Does this discount off liquidation (or "bust-up") value reflect managerial incompetence? Not necessarily. It could reflect the market's preference for "negative synergy"—that is, for a general downsizing and streamlining of the conglomerate firm in the belief that diversification makes more

29. Harvard Economics Professor Richard Caves concludes "ex post evidence on the efficiency of mergers . . . amounts to a convincing rejection of the presumed efficiency of mergers." *See* Caves, *supra* note 27, at 2.

30. According to a study prepared for SEC Commissioner Joseph Grundfest, takeover activity generated increases in shareholder wealth of at least $167 billion from 1981 through 1986. Professor Michael Jensen has estimated $244 billion in gains in shareholder wealth over the same period. Neither believes, however, that bidder shareholders lose wealth and thus they make no subtraction for such losses. *See* IRRC, *Shareholder Gain From Takeovers Cited in Grundfest Study*, 4 CORP. GOVERNANCE BULL., 194 (Nov./Dec. 1987).

31. *See* Jensen and Ruback, *supra* note 28, at 23-27 (acknowledging that source of takeover gains remains a mystery).

32. *See* Morck, Schleifer & Vishny, *supra* note 23.

sense at the shareholder level than at the firm level. If this is a general market preference, most large industrial firms will trade at such a discount, and the bidder's choice among targets may be more influenced by the speed with which the bidder can liquidate assets or divisions to realize this discount. In short, if discounts are in fact pervasive, they cannot be meaningfully equated with managerial inferiority.

I have examined this trend at length elsewhere and argued that the characteristic pattern of takeovers began to shift in the early 1980s from "synergistic" acquisitions to "bust-up" takeovers.[33] The key difference here is between aggregative and disaggregative transactions. Although synergistic acquisitions had been the dominant pattern throughout the earlier history of the takeover (and indeed all earlier merger and acquisition peak periods), the "bust-up" takeover is in contrast fundamentally disaggregative. It is motivated not by the assumption that the union of bidder and target has a value greater than the sum of its parts, but by the reverse assumption that economic value can be liberated by breaking up the target into its constituent parts. Essentially, "bust-ups" involve a bidder who is seeking to arbitrage the disparity between the stock value of the target and its higher asset liquidation value. Historically, the appearance of the junk bond market in the early 1980s made such arbitrage transactions possible, but the deeper question involves how to explain this "reverse synergy" that makes many firms more valuable broken up than intact.

Of course, takeovers have many causes and not all can be characterized as "bust-ups." But the prevalence of "bust-ups" requires explanation for many reasons, not the least of which is the legislative concern that there is something suspect about this type of transaction. "Bust-up" is a pejorative word, the use of which implicitly conveys a sense that there is something wrong (and even vaguely immoral) with breaking up companies.[34] Yet it is equally arguable that there is something wrong with allowing firms whose asset value substantially exceeds their stock value to remain intact, because such assets would not appear to have been put to their highest and best use. Still, the real question is what factors explain this "negative synergy" that appears to motivate "bust-ups." As is usually the case when important social phenomena require explanation, very different answers are possible, which range along a continuum from efficiency-enhancing explanations at one pole to pure wealth transfers at the other. At the efficiency-enhancing end of

33. Coffee, *Shareholders Versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 2-7 (1986).

34. Symptomatic of the public's attitude is the plot of the recently popular movie, *Wall Street*, in which the arch-villain, Gordon Gekko, attempts a "bust-up" takeover and liquidation of Blue Star Airlines, but is foiled by the hero, Bud Fox, who redeems himself by siding with the unions.

the spectrum, Professor Michael Jensen has offered his well-known "Free Cash Flow" hypothesis.[35] Essentially this theory postulates a managerial bias in favor of earnings retention; managers invest cash flow in projects that have a negative present value when discounted at the firm's cost of capital, because they have little incentive to pay dividends. In truth, this theory seems largely a re-interpretation—with original elements, to be sure—of the long tradition of "managerialist" theories, which has featured notable efforts by such writers as Baumol, Marris, Williamson and more recently Gordon Donaldson.[36] All these writers agree that there is an inherent tendency for excessive growth, because managers' preferences deviate from those of the shareholders. If so, logically the market should discount the firm's stock value below its "break-up" asset value, because the market would anticipate that inefficient investment, i.e., diversion of the free cash flow, would continue. Obviously, the recent finding that target firms have a low market value to replacement cost ratio seems to corroborate this theory.

At the middle of the spectrum, one can explain the discount between a firm's liquidation value and its considerably lower stock value as similar to the standard phenomenon under which closed-end mutual funds trade at a discount off the aggregate value of the securities they hold.[37] The reason for this discount in the case of mutual funds is difficult to explain, but may reflect an agency cost problem: namely, that investors cannot be certain that the fund's managers will ever liquidate or even revise the fund's portfolio at the same times that they would. Even though the fund holds cash equivalent securities, shareholders seem to demand some premium in exchange for surrendering the effective right to dictate the contents of the fund's portfolio or to liquidate it. In this respect, a conglomerate vaguely resembles such a mutual fund because it also holds a portfolio of investments whose liquidation the shareholders cannot dictate.

Alternatively, the "negative synergy" that a "bust-up" liberates may stem from the possibility that there are persons who place a more optimistic valuation on each of the firm's operating divisions. Suppose, for example, that a firm has fifteen distinct and free-standing divisions,

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35. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323 (1986).

36. *See, e.g.*, W. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH (1959); R. MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM (1964); Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032 (1963); G. DONALDSON, MANAGING CORPORATE WEALTH: THE OPERATION OF A COMPREHENSIVE FINANCIAL GOALS SYSTEM (1984). For an overview of these critiques, see Coffee, *supra* note 33, at 20-24, 28-31.

37. Professor Reinier Kraakman examines this phenomenon of share discounts in closed-end investment funds and applies it as an explanation for acquisitions in a forthcoming article. *See* Kraakman, *Taking Discounts Seriously: The Implications of "Discounted" Share Prices As an Acquisition Motive* (forthcoming in COLUM. L. REV. in 1988).

which it has never sought to sell. In an active market for corporate control with many participants, the probability seems high that there is some unique purchaser for each of these divisions who places a more optimistic valuation on a particular division's future earnings than does any bidder for the firm as a whole. Thus, the aggregate price obtainable in a "bust-up" should exceed the aggregate stock price of the firm as a whole, because the bidder intends a piecemeal liquidation under which each division will be sold to the unique eventual purchaser who places the highest value on it. Of course, it is uncertain whether these purchasers are simply overly optimistic—and hence are paying too much—or are more efficient users, with the result that assets are then moving to their highest and best use.[38] In the former case, where the purchaser is overly optimistic, the result is simply a wealth transfer from bidder shareholder to target shareholders, while in the latter case, there is a true social gain from enhanced efficiency. The efficiency implications of this optimism thesis are thus uncertain.

At the other end of the spectrum is the view, which this author has elsewhere articulated,[39] that "bust-ups" may in substantial part be explained as wealth transfers. Modern institutional economics views the corporation as a "nexus of contracts"—a complex institutional mechanism, which is designed, at least in part, to uphold (and thus permit reliance upon) "implicit contracts" reached between the shareholders and other "stakeholders" in the corporation (e.g., managers, creditors, employees and possibly certain suppliers).[40] The nature of these implicit contracts—that is, what is exchanged—can be variously defined. Some emphasize that the motivating force is risk aversion, that is, because shareholders own many stocks, while managers have but one job, they strike an arrangement under which shareholders keep the residual returns, while managers receive the assurance of continuing employment and stable income.[41] Thus, managers trade off higher return for lower risk, but are, as a result, unwilling to commit the firm to risky financial or investment decisions that shareholders would favor because they do not benefit from accepting higher risk.

While the foregoing explanation postulates a risk differential between shareholders and managers to explain the disparity between asset and stock values, other theorists have reached similar conclusions without placing any emphasis on risk aversion as the driving force. Instead,

38. *See* Coffee, *supra* note 33, at 8-9, 73-81; *see also* Knoeber, *Golden Parachutes, Shark Repellents, Hostile Tender Offers*, 76 AM. ECON. REV. 155 (1986).

39. Coffee, *supra* note 33, at 13-14, 16-24.

40. For the standard overview, see Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (1983).

41. Coffee, *supra* note 33, at 16-24.

they view the shareholder/manager "implicit contract" as an attempt to foster investment by managers in "firm-specific" human capital.[42] To encourage such investment, managers must be promised a form of quasi-tenure, because their "firm-specific" capital will have limited value to the market.

Finally, a third view begins with the recognition that it is difficult to evaluate the senior manager's value to the firm contemporaneously. Thus, optimal compensation requires an "ex post" settling up process.[43] That is, because one cannot know until years later whether a specific investment decision or marketing strategy will pay off, it is necessary to rely upon a system of deferred compensation, awarded on an ex post basis, in order to reward managers on a basis commensurate with their contribution to the firm's earnings.

For present purposes, the differences among these "implicit contract" theories are of secondary importance, because in common all recognize the possibility that shareholders could opportunistically breach the implicit contract. In so doing, shareholder wealth is increased, but social wealth is not. On a more abstract level, the implicit contracting perspective produces an important paradigm shift, because it moves the focus of the debate away from the law's usual concern with reducing "agency costs" to protecting the interests of stakeholders who are arguably exposed to opportunistic behavior by shareholders. In effect, the participants in the corporate web of contracts who are mere "agents" from the perspective of a traditional "principal/agent" analysis become independent actors who are vulnerable to exploitation from an "implicit contracting" perspective.

III. IMPLICATIONS

The implicit contract perspective leads directly to a recognition that shareholder wealth and social wealth do not necessarily coincide. This may seem an unexciting conclusion, except for the fact that it has not been seriously considered by financial economists. Yet, in theory, the gains accruing to shareholders in takeovers could simply be wealth transfers from other stakeholders in the corporation (for example, creditors, managers, etc.). Indeed, the social loss could easily exceed the private gain. Such an example has been forcefully posed by Professors Summers and Shleifer, who focus on the ripple effect when plants are closed in a small, one-company town (e.g., Bartlesville, Oklahoma, or Findley, Ohio—the home bases of Phillips Petroleum and Marathon

42. *See, e.g.*, Williamson, *Corporate Governance*, 93 YALE L.J. 1197, 1207-09 (1984). *See also* M. AOKI, THE CO-OPERATIVE GAME THEORY OF THE FIRM 25-26 (1984). For a review of these arguments, see Coffee, *supra* note 33, at 73-76.

43. *See* Knoeber, *supra* note 38, at 157-59, 162.

Oil, respectively).[44] Not only do employees lose salary, but the fixed investments of local suppliers and indeed the local infrastructure are jeopardized. Moreover, other firms are also affected because they may thereafter find it more difficult to induce other suppliers to make fixed investments or to encourage their employees to invest in "firm-specific" human capital. Finally, even if there is no net social loss, any wealth transfer here is probably in an anti-egalitarian direction, because employees are losing as shareholders gain. If we assume that money has a decreasing marginal utility—that the poor value one additional dollar more than the rich—then such transfers have negative social utility, even if there is no net financial loss.

To be sure, any argument that stakeholder losses exceed shareholder gains encounters difficulties, in part because the opportunity cost to an employee from being terminated is seldom, if ever, equal to the employee's full wage. Indeterminacy rears its ugly head at this point, however, because there may be third parties with fixed investments that cannot be redeployed (such as the small community) who are adversely affected by any decline in local employment. This ripple effect might be trivial, of course, if takeovers did enhance allocative efficiency and move assets to their highest and best use, but it is exactly this conclusion that is problematic in light of recent research of industrial organization economists.[45]

Another significant aspect of the implicit contracting perspective is that it forces us to see the board of directors in a very different light. Although the law has traditionally viewed the board of directors as the agent of the shareholders, an alternative perspective sees the board's role not as that of an agent, but as that of a mediator.[46] Put simply, because long-term contracting among shareholders and the other constituencies is costly, and numerous contingencies can arise that cannot be covered even in a very detailed contract, the parties to the implicit contract need an independent body to serve as, in effect, an arbitration panel to preserve the fair expectations of each side. Thus, on an ex ante basis, the parties designate the board to perform this role through ex post adjustments. In this light, implicit contracts are enforced through governance mechanisms that essentially use the board to protect each party's legitimate expectations.

44. *See* A. SHLEIFER & C. SUMMERS, HOSTILE TAKEOVERS AS BREACHES OF TRUST 4-7, 17-20 (National Bureau of Economic Research Working Paper on The Economic Effects of Mergers and Acquisitions, Feb. 1987).

45. *See* sources cited *supra* note 28.

46. *See* Coffee, *supra* note 33, at 81-86. This is not an argument that the board is simply entitled to balance the interests of different constituencies or to protect the public interest, but rather that its assigned role is to prevent the disruption of implicit contracts by protecting the fair expectations of those contracting within the corporation.

This view sounds heretical because, as we all know, only shareholders elect the board of directors, but in practice senior management nominates the candidates for election to the board, with shareholders only ratifying their selection. By most accounts, the CEO still dominates the process.[47] Thus, in reality, the balance of power over the selection of directors tilts in favor of management, and managers could view the board as a guardian of their "legitimate" expectations.

Viewing the board as a mediating body brings us back to the distinctive character of the hostile takeover. Uniquely, it permits the bidder to outflank the board. In contrast, a merger or sale of assets generally requires board approval before it is submitted to shareholders. Preempting the board's role arguably has special significance if we view this role as that of a mediator entrusted by the various stakeholders with the task of protecting the expectations of all the contracting parties. This view does not mean that defensive tactics are therefore justifiable, but it does suggest a role for the board beyond that of a bargaining agent for the shareholders; in particular, it invites criticism of those Delaware decisions, most notably *Revlon,* which see the board's role (at least once a takeover is inevitable) as only that of a "fair auctioneer."[48]

Predictably, some will respond that this view is overly idealized, because there is little evidence to believe that the board has behaved in the past as the wise, paternal, benign mediator that such a theory seems to contemplate. Still, there is a major difference between this mediation model of the board's role and any claim that the board will show a benevolent paternalism to all, because not all participants in the enterprise are necessarily entitled to have their interests protected by the board. Lower echelon employees contract through other means and institutions (i.e., collective bargaining) and are not as exposed to opportunism because they do not invest in much "firm-specific" capital or expect an ex post "settling up."[49] The real contracting parties are chiefly managers and shareholders.

The relevance of this implicit contracting perspective to the subject of state takeover statutes turns in large measure on this last assertion that takeovers preempt the board's role. Hence, if the implicit contract has been breached, a contractual failure has arguably occurred, and

47. For the view that the board typically only rubber stamps the CEO's selection, see H. GENEEN, MANAGING 255-74 (1984). Mr. Geneen was for many years the CEO of IT&T. *See also* E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 30-48 (1981). For earlier but similar critiques, see M. MACE, DIRECTORS: MYTH AND REALITY (1971) and J. BACON & J. BROWN, CORPORATE DIRECTORSHIP PRACTICES: ROLE, SELECTION AND LEGAL STATUS OF THE BOARD (1975).

48. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986). *See also* Edelman v. Fruehauf Corp., 798 F.2d 882, 886-87 (6th Cir. 1986).

49. In theory, the "settling up" process is intended to compensate those employees whose contribution to the firm's productivity cannot be currently estimated. *See* Knoeber, *supra* note 38, 157-59, 162. This category will rarely include lower-echelon employees.

legal regulation becomes justifiable. In this perspective, state takeover statutes have little to do with shareholder protection, but are instead aimed—albeit covertly—at stakeholder protection, because the old system of implicit contracting has failed. Some state statutes—most clearly, New York's anti-bust-up statute that permits a change in control, but forbids any sale or liquidation of the firm for a five-year period after a hostile takeover[50] —seem self-evidently designed to function in a manner similar to statutes that restrict plant closings. Presumably, the legislature believes that if the acquirer must continue to own the same assets, it will continue to operate them and thus will maintain employment at near pre-existing levels.

IV. AN EVALUATION: DO THE GAINS EXCEED THE LOSSES?

To state the foregoing paternalistic arguments for state regulation is not necessarily to accept them. The claim that takeover gains are accounted for by the losses of other stakeholders remains unproven. No clear pattern is evident with respect to creditors,[51] and managerial losses are difficult to estimate. Conversely, the first hypothesis—the Free Cash Flow Theory—probably has greater explanatory power, because the scale of recent takeover gains (roughly $167 billion according to one recent study)[52] cannot be plausibly explained simply on the basis of cost savings to shareholders from opportunistic breaches of implicit contracts. This becomes clearer if we consider takeovers on the micro level. Today, the average takeover premium is around 40 to 50 percent. One cannot generally explain a rational bidder paying $1.5 billion for a target whose prior aggregate stock market value was $1 billion, simply in terms of the cost savings that managerial layoffs are likely to effect. Indeed, for such a takeover to be rational on this basis, given both the risks and the notoriously high transaction costs, the bidder would have to expect to realize cost savings considerably greater than this $500 million premium in order for it to earn a reasonable profit. Although the total losses to third parties, such as local communities and suppliers, may conceivably approach this level, these losses do not necessarily make the bidder better off; the bidder is not one dollar richer because local store owners will sell less when the local plant closes. Moreover, there will be social gains elsewhere where new plants are opened and

50. *See* N.Y. BUS. CORP. LAW § 912 (McKinney 1986).

51. One recent survey estimates that bondholders have lost as much as $530 million in 1986 as the result of mergers, acquisitions and recapitalizations. *See* IRRC, *Bondholders Fight Back Against Takeover Losses*, 4 CORP. GOVERNANCE BULL. 156 (Sept./Oct. 1987). Financial economists have, however, generally found no net losses. *Id.* at 157. *See also* Coffee, *supra* note 33, at 68-70.

52. *See supra* note 30.

new suppliers hired, although this may occur abroad and thus not offset national social wealth loss. Given this asymmetry between private gains and social losses, social losses cannot by themselves explain the bidder's motivation.

For the sake of argument, let us assume (as seems more likely) that the disparity between stock and asset values of the typical target firm is probably more attributable to inefficient empire building and a bias for earnings retention than to shareholder opportunism or inefficient markets. Still, this view that the Free Cash Flow Theory explains more (or even most) of the discount does not refute the possibility that stakeholders are exposed to significant losses as a result of takeovers. Thus, it leads us to the critical issue: If shareholders have more to gain from takeovers than managers have to lose, why haven't shareholders found ways to "bribe" managers into acquiescence? This is, of course, what a keystone of modern economic theory—namely, the Coase Theorem—would predict.[53] The most obvious means by which to align managerial incentives with those of the shareholders is through management compensation formulas. Why, then, has private ordering not devised new compensation formulas designed to secure managerial acquiescence in takeovers? At this point, it is useful to step back and connect two seemingly unconnected issues: managerial compensation and state takeover statutes.

Although the scope of the *CTS* decision is debatable, because the Indiana statute there at issue required substantially more contact with the jurisdiction than simply the fact of incorporation,[54] the lower federal courts may read (or mis-read) *CTS* as establishing the validity of "Control Share Acquisition" statutes and New York-style anti-bust-up statutes. Assuming statutes of these varieties are widely adopted (as appears to be happening) and are upheld, what happens to the market for corporate control? The short answer would seem to be that acquisitions will again become consensual transactions as to which senior management will have a de facto veto.

This answer only frames, however, the next question: what can shareholders who desire that takeover and acquisitions proposals be made to them do to secure managerial acquiescence? Even if we assume that the Free Cash Flow Theory is substantially accurate and management thus has a bias in favor of earnings retention, one must next ask

53. *See* Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). For a discussion of a Coasean perspective on takeovers, see Coffee, *supra* note 33, at 104-06.

54. The Indiana Control Share Acquisition Act upheld in *CTS* applied only to Indiana corporations having either (a) more than 10% of their shareholders resident in Indiana; (b) more than 10% of their shares owned by Indiana residents; or (c) 10,000 shareholders resident in Indiana. *See* IND. CODE § 23-1-42-4(a) (Supp. 1987).

whether internal contracting within the firm could curb this bias and, if so, why hasn't such contracting been visible?

To begin, let us focus on the manager's position, assuming the validity of the Free Cash Flow Theory. Because inefficient retention of earnings does not directly enrich management personally, it can have only a marginal utility for them. As a result, it follows that, whatever the psychic or other utility from re-investing "free cash flow" inefficiently, there should be some cash payment to managers that would induce them to pay out free cash flow as dividends. Seemingly, a compensation formula could be devised that effectively leads managers to overcome their bias in favor of earnings retention. Yet, even to state the Free Cash Flow hypothesis is, in effect, to concede that optimal managerial compensation formulas have not yet been worked out. By the same token, managerial resistance to takeovers can also be seen as a problem in managerial compensation. In principle, under some set of rules that shared the takeover gains between target shareholders and target management, managers should not oppose tender offers, but instead would seek them out and would conduct a vigorous but fair auction. This view of managerial resistance to takeovers as evidence of a failure in compensation arrangements becomes relevant precisely to the degree that state takeover statutes make managerial consent a de facto prerequisite to a change in corporate control.

What, then, are the barriers to more efficient systems of managerial compensation that better align managerial and shareholder interests? Several answers are possible: One answer may be that the failure to pay out free cash flow to shareholders has more to do with implicit contracting within the firm than has hitherto been recognized. For example, risk-averse managers might prefer the lower, but less risky, positive utility associated with empire building to the highly risky cash substitute that a compensation formula offers. This answer may also explain why target firms do not have more distinctive financial characteristics (because risk aversion may be widely prevalent). Still, some risk premium should be able to compensate management in both cases.

Another answer may be that there are legal barriers that preclude the adoption of more optimal management compensation formulas. This answer has been tentatively put forward by Professors Jensen and Murphy in a recent working paper,[55] but it ultimately needs refinement. Jensen and Murphy begin with a striking fact: as they compute it, executive compensation is extremely insensitive to the stock market performance of the firm employing the manager. In fact, "CEOs receive average raises of less than a penny . . . for each $1,000 of increased

55. M. JENSEN & K. MURPHY, ARE EXECUTIVE COMPENSATION CONTRACTS STRUCTURED PROPERLY? 41-45 (MERC Working Paper No. 86-14, 1987).

shareholder wealth and get pay cuts of less than a penny when shareholders lose $1,000."[56] If this is the case, it is little wonder that managers have let stock market values sink below asset liquidation values. In such a world, managers are essentially in the position of fixed interest creditors; they anticipate receiving a relatively fixed, if increasing, stream of payments and, thus, should behave in a highly risk-averse fashion. This conclusion leads, in turn, to the next question: why are management compensation practices so indifferent to the firm's stock value? Here, Jensen and Murphy suggest that fears of legal liability may lead directors to undercompensate managers. This seems overstated, because cases imposing such liability are notoriously lacking. Only in the case of twelfth-hour "golden parachutes" or gratuitous pensions to the chairman's widow have courts intervened to enjoin the transaction.[57] In general, the business judgment rule reigns more supremely in this area than in most others.

Part of the problem may instead lie with the inherent difficulty of designing a management compensation formula that aligns shareholder and managerial interests with respect to takeovers. To this claim, some may respond that stock options have long been used to produce precisely such an alignment. This answer is too simple. Simply keying managers' salaries to the firm's stock price is too crude a technique, because it does not distinguish the "firm-specific" component from the "systematic risk" component of the stock price. Admittedly, formulas have been suggested that would focus on the "firm-specific" component by compensating the manager to the extent that his or her firm's stock outperforms its rivals in the same field.[58] Yet, such formulas may be overly complicated and are not easily implemented, particularly if managers are poor risk bearers and need a stable income stream. Alternatively, if most managers are risk neutral, then a heavily stock-based compensation formula could at some point give rise to a moral hazard problem, as these managers would have an incentive to accept highly risky investments and policies. The result would begin to resemble a world in which the managers were selected exclusively by the firm's warrant holders. Finally, a "firm-specific" stock option, which compen-

56. *Id.* at 12.

57. *See, e.g.*, Adams v. Smith, 275 Ala. 142, 153 So. 2d 221 (1963). Courts have been considerably more tolerant of change-in-control related compensation (or "golden parachutes"). *See* Koenings v. Joseph Schlitz Brewing Co., 126 Wis. 2d 349, 377 N.W.2d 593 (1985). For a review of the case law, see Vagts, *Challenges to Executive Compensation: For the Market or the Courts?* 8 J. CORP. L. 231 (1983); Note, *Golden Parachutes and the Business Judgment Rule: Toward a Proper Standard of Review*, 94 YALE L.J. 909 (1985).

58. *See* Note, *The Executive Compensation Contract: Creating Incentives to Reduce Agency Costs*, 37 STAN. L. REV. 1147 (1985) (proposing a stock option based on only the "firm-specific" component of the firm's stock price, which would be measured by subtracting out general market movements, or the "systematic" component).

sates the executive to the extent the firm's stock outperforms the stocks of a selected group of rival firms, will work poorly in the takeover context, because of the earlier-noted industry-specific wave pattern. That is, if the stock prices of all firms within a specific industry tend to rise in unison as the industry becomes the focus of takeovers, then a formula that looks chiefly to how much the specific firm's stock has outperformed its rivals will tend to undercompensate managers (because stock prices in the industry will move in unison), and thus this approach will not overcome takeover resistance.

What approaches, then, appear promising? As a starting point, it needs to be recognized that considerably more compensation must be offered to convince a utility-maximizing manager to acquiesce in a takeover than is necessary to convince the same person to work diligently or otherwise to manage the firm in the shareholders' interests. Obviously, this is because such a manager is likely sacrificing "firm-specific" capital, or at least an expected future income stream, when the firm consents to the acquisition. Given this need for a higher level of promised compensation to secure managerial acquiescence to takeovers that present or future state laws may effectively enable management to block, an optimal compensation formula may need to contain contingent provisions specially focused on takeovers and acquisitions. In this light, it is useful to consider a provocative proposal that will offend some: imagine a very different compensation formula, one patterned after the manner in which the law has historically rewarded the successful plaintiff's attorney in class or derivative actions. Typically such a successful plaintiff's attorney is paid a contingent fee out of the recovery, measured by a percentage of the recovery (generally ranging between twenty percent to thirty percent in securities class actions).[59] This may sound like a strange precedent to adopt, but uniquely it gives the firm's managers an incentive both to accept, and to maximize, the takeover gains. Hypothetically, such a formula could be implemented by a provision in the corporate charter authorizing or instructing the board to pay to the firm's senior managers a specific percentage (for example, ten percent) of the premium paid to shareholders in a merger, acquisition or tender offer. Such payment would be made by the target corporation, not the bidder; a by-law could commit the board to make such a payment, subject perhaps to some limited exceptions. This compensation would be in addition to the salary and stock option compensation the managers were paid to manage the firm from day to day. (Admittedly, a tendency to reduce regular compensation in light of this contingent bonus might arise.)

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59. *See* Coffee, *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877, 889 n.31 (1987).

What would be the incentive effects of such a system? In a more focused manner than existing stock options, such a form of compensation should encourage target managers not only to acquiesce in a takeover, but to seek out bidders and conduct legitimate value-maximizing auctions. To be sure, some managers might still resist, but particularly for the CEO nearing retirement age, the lure of such a bonus should be considerable. Nor is this compensation system as costly to shareholders of firms for which no offer is made (as stock options and bonuses are). The manager would be paid only to the extent that his or her firm successfully secures a takeover premium.

Would there be any perverse incentives? Here, any answer must be qualified. Because such a compensation system gives the manager an interest in maximizing the margin between the firm's stock value and its higher break-up value, there could conceivably be an incentive to mismanage the firm in order to maximize this spread. This possibility seems small for at least four reasons. First, there are the normal mechanisms of corporate accountability, of which the board of directors here seems the most important. A decline in corporate earnings would likely affect the manager's ordinary compensation by reducing bonus income or the value of stock options, and it would also expose him to the threat of ouster by the board. Second, relatively few firms (on a percentage basis) have been acquired in either hostile or friendly deals over any relevant recent period. Thus, a deliberate strategy of mismanagement seems unwise and even counterproductive. Third, the damage might be irreversible, particularly because the truly inefficient, mismanaged firm seems to escape the hostile takeover (witness the success of International Harvester, Chrysler, Continental Illinois and others in this regard). Bidders instead tend to focus on the better-managed firms within an industry, probably because they fear acquiring a "turkey" with more intractable problems than they can cure.[60] Finally, corporate culture is another factor that makes deliberate mismanagement an unlikely scenario. Because senior corporate managers probably feel a greater loyalty to the persons with whom they have worked for years than to remote and invisible shareholders, it seems scarcely credible to believe they would deliberately risk corporate insolvency to profit themselves by imposing high costs and risks on their former colleagues.

60. *See* Coffee, *supra* note 13, at 1210-12 (citing survey evidence that acquiring firms focus on quality of target firm's management); Browne & Rosengren, *supra* note 21, at 24-27. Also, to the extent acquiring firms are dependent on the high risk (or "junk bond") debt market for financing, this market may be reluctant to finance a highly leveraged acquisition of a troubled firm. Finally, bidders in takeovers face considerable uncertainty and generally have less information about the target than does the acquiring firm in a merger, thus making it more wary of "problem" targets.

A more realistic danger is that such a compensation formula would give management an incentive to withhold favorable information from the stock market in order to privately reveal it to selected bidders. Again, this conduct would maximize the spread between the stock market and break-up value—here, by seeking to retard positive stock market revaluations—but it would not lead to any penalty in terms of reduced current earnings, because salary tends to be based on historical reported earnings, not future discounted cash flows. This problem resembles the standard insider trading scenario under which managers withhold positive information until they first trade, but the period of delay would likely be longer. Of course, to the extent one believes in the efficiency of the stock market, the ability of management to conceal material information from the market while revealing it selectively to potential bidders may be limited. Bidders who learn such information will logically buy the stock in the open market, and insider trading and normal information leakage should tend to close the gap between the two values. Thus, although there is the possibility of allocative inefficiency caused by managerial concealment of material information, the magnitude of this problem seems small.[61] In any event, a ceiling can be placed on the formula (that is, "but in no event shall any person be entitled hereunder to receive more than [ten] million dollars").

The more serious problems with this proposal are threefold. First, its political acceptability seems questionable because it may appear to legitimize extortion. Managers may seem in effect to be exacting extortion for not exercising their de facto power under these new takeover statutes. Second, this proposal is undesirably open-ended. In truth, the percentage of the recovery fee award, as used in class actions, was always subject to judicial scrutiny for reasonableness, and fee awards exceeding thirty percent of the recovery in class actions have been extremely rare. Thus, although it may be in the shareholders' interest to allocate on an ex ante basis ten or even twenty percent of the takeover premium to managers who are otherwise in a position to block a takeover, a fifty-percent allocation seems unreasonable. But how likely is such a charter provision? Much depends on how much confidence we place in the charter amendment process, where collective action problems and high information costs may make shareholders rationally apathetic. The more we doubt this process, the more we may be legitimizing an extortionate diversion by managers of the takeover premium.

61. After all, if management can, and is willing to, conceal material information from the market, it need not rely on a takeover to profit; rather it can engage in insider trading. For example, in the case of positive developments, it can first buy stock and then publicly release the positive information. Thus, the likely marginal impact of the compensation formula here suggested on the market's allocative efficiency seems small.

Third, charter provisions and compensation formulas are unlikely to benefit middle managers and other stakeholders with less leverage over the shareholders. Thus, if we believe that takeovers invite shareholder opportunism and reneging on implicit contracts, this proposal represents only a partial answer, because it does not necessarily benefit lower echelons. The tension here is obvious: the more senior management shares the portion of the takeover premium allocated to management with middle levels, the less will be senior management's expected return and the more management will still be likely to oppose a takeover. The difficulty of this trade-off and the arguable need for a ceiling on the maximum amount allocatable to management suggest a need for legislative limits, possibly including nondiscrimination rules paralleling the statutory provisions regulating pension plans.[62] Here, we come at last full circle back to our original focus: what should be the role of state statutes? My answer is that they should seek a more equitable sharing of takeover gains, thereby reducing the level of managerial resistance.

The sharing of takeover gains here envisioned goes well beyond any use that has yet been made of golden parachutes. Even in the more "liberal" cases upholding such compensation, courts have focused narrowly on the predictable loss in compensation over, typically, a three-year period and have adopted a "reasonableness" test.[63] Uncertain as such a standard is, a decision by the board alone to allocate ten to twenty percent of the takeover gains to management seems unlikely to pass muster under such a test, absent special factors.

If, however, such a provision were inserted in the corporate charter by a shareholder vote, well in advance of any takeover, its prospect for judicial approval seems materially enhanced—although still not certain. Now, the case for it becomes not that it is "reasonable" in judicial eyes, but that it was approved by a disinterested majority of shareholders (and possibly ratified within some reasonable "sunset" period). Only if the plaintiffs could demonstrate "waste" (a legally vague term

62. I have discussed the desirability of such constraints elsewhere. *See* Coffee, *supra* note 33, at 75-81.

63. *See* Koenings v. Joseph Schlitz Brewing Co., 126 Wis. 2d 349, 377 N.W.2d 593 (1985) (upholding "change in control" compensation formula as a reasonable stipulated damages clause). This focus on the manager's losses (until he finds equivalent employment elsewhere) seems overly limited and does not consider his "firm-specific" capital or earlier opportunities that were forgone. More importantly, the employee's loss is by no means the most logical benchmark for measuring the permissibility of such compensation. The logical focus should be on what payments rational shareholders would be willing to make on an ex ante basis to secure managerial acceptance of the role of a "fair auctioneer."

approaching sheer irrationality) would such a provision be invalid under the Delaware case law.[64]

To implement such a provision, some changes in the federal tax laws will probably be necessary, because "change of control" executive compensation is today subject to special and punitive taxation.[65] Absent such change in the federal tax laws, some second-best substitutes are, however, still possible.[66]

V. CONCLUSION: THE FUTURE AFTER *CTS*?

With the passage of the new Delaware takeover statute, it has been estimated that eighty percent of American business capital is now "protected" by a state statute that seeks to chill takeovers.[67] The irony in this movement is that the group so protected—target shareholders—is both the only group that clearly benefits from the activity being regulated and probably the only group capable of protecting itself through self-help measures. The other affected constituencies—bidder shareholders, target managements, local communities, existing bondholders—are at least exposed by the takeover to the possibility of a sudden loss. Despite the incongruity involved in legislating "protections" for the "winners" at the behest of the "losers," state takeover regulation has to date largely amounted to a classic exercise in rent-seeking by these losers. They have been highly effective because they are a politically cohesive and visible local force, while target shareholders are dispersed nationally. Only in Delaware are there both a politically important interest group—the disproportionately large local bar—whose future earnings would be adversely affected by a decline in the level of takeovers and relatively weak anti-takeover constituencies, because few Delaware-chartered corporations have local plants or assets that could migrate elsewhere. Not surprisingly, Delaware has enacted one of the weakest statutes of the second generation of state takeover statutes.[68]

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64. *See* Lieberman v. Becker, 38 Del. Ch. 540, 155 A.2d 596 (1959); *see also* Saxe v. Brady, 40 Del. Ch. 474, 184 A.2d 602 (1962) (disinterested shareholder ratification shifts burden to plaintiff to prove waste).

65. Under current law, "excess parachute payments" may not be deducted by the corporation and the recipient is subject to a 20% excise tax. 26 U.S.C. §§ 280G, 4999 (Supp. III 1985). Change of control compensation that exceeds three times the executive's average annual compensation over the preceding five years is defined to be an "excess parachute payment," thus capping most golden parachutes at three times annual salary. Such a level seems unlikely to secure executive acquiescence, and indeed has not.

66. Alternatively, stock options may be used to award similar amounts, but the drafting of such an optimal option contract would have to subtract out general market movements (for which the manager should not be rewarded, at least not on the basis here proposed).

67. *See* Bandow, *supra* note 3.

68. Unlike N.Y. BUS. CORP. LAW § 912 (McKinney 1986), which served as its model, new § 203 of the Delaware Corporation law does not apply if the bidder acquires 85% or more of

My assertion that stakeholders are net losers in takeovers, while shareholders are net winners, raises two obvious questions. First, if stakeholders are vulnerable to exploitation today, why can they not protect themselves, as shareholders clearly have, through private ordering? Why is legislative or judicial activism necessary? Second, can existing takeover statutes be justified on stakeholder protection grounds? Several answers to the first question help explain why private ordering works better for shareholders than stakeholders. First, stakeholders must generally depend upon their contract rights—explicit or implicit—and do not have access to a governance mechanism, such as the board of directors, designed to protect their fair expectations. Put simply, these contracts never contemplated the risks to which stakeholders now have been exposed. Second, there is a potential conflict between the interests of senior management and other stakeholders. Senior management has no long-term identity of interests with creditors (as the *Revlon* case revealed, when bondholders were effectively sold down the river[69]); and middle management has often been axed in the wake of recent leveraged buyouts. Third, managers generally have a strong interest in preserving their reputational capital, which may be diminished if, for example, they propose a novel and unprecedented takeover compensation formula explicitly aimed at their own protection. Thus, given the still low base expectancy rate on takeovers, senior management may prefer to take its chances than to seek new charter provisions that could elicit adverse publicity or signal vulnerability. Finally, the current tax laws make any such proposal academic because of their punitive treatment of "change of control" compensation.

Against a backdrop of contending forces engaged in a rent-seeking competition—investment bankers on one side and the corporate business community largely on the other—only an incurable optimist would predict a satisfactory legislative solution. Stalemate and piecemeal compromise seem more likely. From an economic perspective, however, we can witness a familiar story being played out in a new context: instead of railroads and cornfields, we here see shareholders and managers locked in the standard Coasean attempt to negotiate an efficient outcome. The gains to the former seem to outweigh the losses to the latter, and thus the possibility of an efficient outcome is discernible if legal barriers can be relaxed that might prevent a mutually beneficial transaction from being invalidated. Yet, the transaction costs are high,

the target's stock in one step or if there is a subsequent two-thirds vote in favor of a merger by the other shareholders. Also, it does not preclude "bust-up" sales or liquidations generally, but only such sales to the bidder for a review. *See* Veasey, *supra* note 3.

69. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). In *Revlon*, management waived loan covenants that protected its note holders in order to facilitate first a competing bid and then a leveraged buyout.

both because there are serious collective action problems and because serious conflicts of interest exist within each of the constituent groups that must negotiate.

In this light, a legitimate role for state legislation is not to prevent takeovers but to encourage a more equitable sharing of takeover gains—in short, to compensate stakeholders. Private ordering will not accomplish equitable proration because senior and middle management have very different interests. Only legislation can impose non-discrimination rules or other sensible side constraints. To be sure, such legislation could go too far and chill takeovers, but it would not be in the self-interests of managers to seek such prohibitive legislation if the legislation held out the prospect that they could receive a substantial share of the takeover gains through charter provisions.

Once we penetrate the transparent myth that state takeover statutes are intended to protect shareholders and recognize that their real aim is to alter the balance of power between shareholders and other stakeholders in the corporation, the next question becomes whether these "second generation" statutes can be defended as sensibly related to the protection of stakeholder interests. A few of these statutes clearly reveal an intent to subordinate stockholder interests to those of stakeholders,[70] and others such, as the New York form of anti-bust-up statute, also seem aimed at preventing job flight and plant closings on the intuitive premise that managements will continue to operate assets they cannot sell.[71] Still, the problem with statutes such as New York's is that they confer a de facto veto power. Real and exposed as the interests of stakeholders are, they do not merit relief this drastic when less restrictive alternatives will suffice. This premise frames the last questions this Article will address: assuming that these statutes do affect the interstate migration of jobs and corporate assets, should they therefore be seen as offending the dormant commerce clause? Put differently, are there any limits left after *CTS* if a state of incorporation seeks to preclude takeovers in order to protect employees and other stakeholders?

Although the *CTS* decision understandably did not address statutes beyond the one before it, competing views about the scope of corporate governance regulation clearly struggle for supremacy within the

70. *See, e.g.*, 15 PA. CONST. STAT. ANN. § 1408.B3 (Purdon Supp. 1986); ILL. ANN. STAT. Ch. 32 § 8.85 (Smith-Hurd Supp. 1986); OHIO REV. CODE ANN. § 1701.59 (Anderson 1985) (all authorizing or instructing directors to consider interests of groups other than shareholders).

71. *See* N.Y. BUS. CORP. LAW § 912 (McKinney 1986) (restricting mergers, certain asset sales or liquidations for five years after a hostile takeover). Of course, as a matter of simple microeconomics, a management will cease to operate a plant when it cannot recover average variable costs, but it will seek to relocate when the discounted future cash flows at some other location exceed those at existing sites. I also recognize that when divisions or plants are sold they do not disappear into a black hole, but are usually operated by the new owners (although not always if the plant has a higher real estate liquidation value).

decision. At one point, the decision endorses the view that "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law."[72] If so, state law could create a very different corporate form, for example by recognizing that employees are stakeholders and even assigning them voting rights. Such legislation might indeed amount to creeping socialism (and at some point might encounter an outer limit in the Takings Clause of the fifth amendment), but it would seemingly be within the state's authority to decide who are participants in the corporate governance game. Nonetheless, taken as a whole, the *CTS* decision repeatedly emphasizes that the Indiana statute "only provides regulatory procedures designed for the better protection of the corporation's shareholders."[73] In this view, the Indiana statute fostered shareholder sovereignty, rather than chilled it. Implicit here is the view that corporate governance is a game limited to shareholders. Yet, this is a view that the Court cannot mandate as a constitutional rule, because it has repeatedly emphasized that the states themselves have the authority to define their own rules for corporate governance.[74] Nor would it be illogical for the states to recognize the interests of nonshareholder constituencies, because economic theory views the corporation as a relational contract among multiple constituencies, including other stakeholders.[75]

To illustrate this tension, suppose a state corporation statute went well beyond the current New York anti-bust-up statute and required a very high shareholder super-majority vote before a New York corporation could close or relocate plants or dispose of significant assets. Alternatively, such a statute might even require employee approval of the takeover by assigning employees share voting rights under certain contingencies. The impact of such a statute is obviously to restrict the interstate movement of assets (and thus might seem suspect under the traditional "movement-of-goods" Commerce Clause cases). But, because it uses the protective mantle of corporate governance regulation, such a statute may fare much better.

Professor Regan has sought to view *CTS* as based on an implicit, or at least underdeveloped, constitutional principle, one forbidding extraterritorial state regulation.[76] As he analyzes the cases, those rulings that have struck down state legislation based on the Commerce Clause have found such legislation either to be discriminatory against inter-

72. CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1637, 1649 (1987).

73. *Id.* at 1652.

74. For the standard statement of this theme, see, e.g., Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977).

75. *See* sources cited *supra* note 40.

76. Regan, *Siamese Essays: (I)* CTS Corp. v. Dynamics Corp. of America *and Dormant Commerce Clause Doctrine; (II) Extraterritorial State Legislation*, 85 MICH. L. REV. 1865 (1987).

state commerce or to have an impermissible extraterritorial reach. Under this latter extraterritorial test, the focus is on whether the regulated behavior occurs inside or outside the state. Thus, a state may not forbid a physical transfer of shares in another state (as was attempted in *Edgar v. MITE Corp.*[77]), but a state of incorporation may forbid the exercise of voting rights (as in *CTS*) on the debatable premise that the situs of voting rights is within the state.[78] This territoriality test has the virtues and vices of simplicity. Its charm is that it seems to spare courts the burden of balancing in an often standardless world by instead using a categorical approach. The deficiency of this mechanical approach is its formalism; its bright line rules are achieved only by treating as self-evident some highly debatable assumptions about where the regulated behavior occurs. Angels seem to be dancing on the heads of pins when a line is drawn under which shareholders not residing in the jurisdiction of incorporation have the right to sell their shares (no matter what the jurisdiction of incorporation says) but no right to vote them (if the jurisdiction of incorporation wishes to forbid such voting). Although such a rule is comprehensible as a conflicts rule, the problem with constitutionalizing it becomes clear when we examine its flip side. If the situs for voting is the jurisdiction of incorporation and if situs controls, then a state in which all the shareholders reside and in which all the corporation's assets and operations are conducted would be constitutionally devoid of jurisdiction if the corporation happened to be incorporated in another jurisdiction.[79] This immunity for "pseudo-foreign" corporations is a high price to pay only to avoid the danger of inconsistent regulation.

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77. 457 U.S. 624 (1982).

78. Regan, *supra* note 76, at 1884-1913. This test at times leads Professor Regan to make what I consider to be metaphysical distinctions. He argues that the situs of control transfers should naturally be seen as occurring in the jurisdiction of incorporation. *Id.* at 1876. This may well be the traditional conflicts rule, but it is a formalistic response that ducks the question of whether the traditional conflicts rule burdens interstate commerce.

79. Although in the foregoing example the internal affairs rule would make the law of the jurisdiction controlling, several states have legislated to subject "pseudo-foreign" corporations (that is, corporations having substantial contacts with the forum state) to some elements of that state's corporate law, at least where the corporation has sought to do business in the jurisdiction. There is a substantial literature on the power of a state to subject a foreign corporation to its corporate law. *See, e.g.*, Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137 (1955); Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433 (1968); Note, *Pseudo-Foreign Corporations and the 'Internal Affairs' Rule*, 1960 DUKE L.J. 477. Some decisions have also deviated from the "internal affairs" rule when the only contact with the jurisdiction of incorporation is the "naked fact" of incorporation there. *See, e.g.*, Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317, 321 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959). My point is not that the "internal affairs" rule is wrong or unjustified (it obviously reduces the risk of inconsistent regulation) but that it would be a mistake to constitutionalize it by the back door as Professor Regan's extraterritoriality analysis does implicitly when it postulates that the situs of voting and other corporate governance activities is necessarily the jurisdiction of incorporation.

Under a territoriality mode of analysis, the answer to the foregoing hypothetical of a de facto plant closing statute adopted as a corporate governance regulation seems clear: to the extent the regulated behavior (plant closings) occurs within the state, it survives under such a test; to the extent that plants are located out of state, the statute is impermissibly extraterritorial. But where is the situs of plant closings? If Professor Regan can argue that the situs of corporate voting is within the state of incorporation, it can also be argued that other important corporate decisions similarly have a situs within the state of incorporation. At the least, this claim seems plausible if the corporate headquarters are located within the state of incorporation, because this would be the situs where the board and senior management make all important strategic decisions. Certainly, traditional conflicts law permits a jurisdiction to preclude the formation of schemes and plans within its boundaries.[80]

To be sure, such a statute might still fail under Professor Regan's alternative standard of discrimination if the court finds that the statute has a discriminatory purpose.[81] Yet, it is far from clear that such a statute, if artfully drawn, will be found to discriminate against interstate commerce, as it is arguably justified by legitimate local interests. In fact, the Supreme Court has been singularly unclear about the whole conception of discrimination in Commerce Clause analysis: should the test look to result or intention?[82] Here, then, lies the real rub: by whatever name we call it, balancing survives. Both discrimination and extraterritoriality analysis inherently involve some judicial consideration of the justifications for the legislation. This leads quickly to a weighing of the local benefits versus the interstate burden—in short, balancing. One recent Supreme Court decision even upholds an overtly discriminatory statute because of the "legitimacy" of its purpose.[83]

80. *Cf.* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 (2d Cir. 1972) (U.S. law applicable where scheme planned in United States but executed abroad).

81. In his dissent in *CTS*, Justice White raised this theme of discriminatory purpose but did not persuade the majority. CTS Corp. v. Dynamics Corp. of America, 107 S. Ct. 1649, 1655-56 (1987) (noting that the statute may have been motivated by a desire to protect jobs and local corporate operations). This suggests that discriminatory intent will not be easily inferred by the majority. Moreover, the hypothetical statute does not distinguish between intrastate and interstate relocations; in reality, it protects the status quo. Subtler variations which downplay the visibility of a discriminatory purpose are also possible: voting stock that carried no equity interest could be given to employees; mandatory ESOPs could be required, etc. Ultimately, some protectionist impact is present in many permissible forms of welfare legislation (such as a very modest thirty-day notice requirement on plant closings). Inevitably, courts covertly or unconsciously balance the burden and the benefit when they decide if a statute is discriminatory.

82. For a good analysis of the Court's shifting approaches, see Smith, *State Discriminations Against Interstate Commerce*, 74 CAL. L. REV. 1203 (1986).

83. The Supreme Court has recently upheld a statute that was overtly discriminatory against interstate commerce on the explicit ground that this impact was justified by local benefits. *See* Maine v. Taylor, 106 S. Ct. 2440 (1986) (Maine statute that prohibited importation of baitfish into state upheld because ban served a legitimate local purpose). I recognize that Justice Scalia has

Similarly, every state regulates employee rights in some way that in principle burdens commerce; these statutes have equally "legitimate" purposes. Few would assert, for example, that a statute requiring some notice of plant closings and some compensation is unconstitutional, but clearly it does burden commerce by restricting employers from folding their tents in the night and stealing away.[84]

Therefore, what I find most lacking in the analysis of those who oppose a balancing approach is their failure to recognize that the concept of "discrimination" in Commerce Clause analysis is not clear-cut, but rather involves some inquiry into the legitimacy of the regulation. Inevitably, any such inquiry involves a kind of balancing—a consideration of less restrictive alternatives, the need for the regulation, etc. Even if unconsciously or covertly, courts "balance" when they apply the concept of discriminatory purpose because an overbreadth analysis is functionally very similar to standard balancing methodology.[85] Discrimination and extraterritoriality are, then, not the exclusive categories of Commerce Clause analysis, but rather are illustrations of the more general rule that the Commerce Clause forbids unjustifiable burdens on interstate commerce.

Thus, although the Court may have thought it was escaping the balancing test of *Pike v. Bruce Church, Inc.*[86] in *CTS* (and Professor Regan clearly wants it to do so), I suspect *CTS* will, in the end, achieve only a temporary moratorium on balancing. Eventually, as powerful interest groups find ways to exploit *CTS*, I predict the Court will be forced back to a tacit rediscovery of some version of the *Pike v. Bruce Church* formula that balances the local benefit against the interstate burden. To be sure, the Court need not acknowledge that it has backtracked, because balancing can be engaged in under the guise of searching for a discriminatory purpose. Concededly, balancing is muddy, and the standard can no doubt be improved, but both the concepts of extraterritoriality and discrimination are open-ended and give courts ample

objected to this whole tradition of balancing, but in his strongest challenge to it he obtained only the concurring vote of Chief Justice Rehnquist. *See* Tyler Pipe Indus. v. Washington Dep't of Revenue, 106 S. Ct. 2810 (1987).

84. For a statute, recently upheld by the Court against a preemption attack, that also has the effect of reducing the mobility of corporate assets and restricting relocations, see Fort Halifax Packing Co. v. Coyne, 107 S. Ct. 2211 (1987). There, a Maine statute required that special severance payments be made to employees not covered by a pension plan when the corporate employer closed a plant. Although the Court did not consider the possible Commerce Clause issue latent in such a statute, I believe courts would uphold it by essentially balancing its local benefits against the interstate burden and finding any discriminatory impact to be justified as in *Maine v. Taylor, supra* note 83.

85. *See* G. GUNTHER, CONSTITUTIONAL LAW 1156 (11th ed. 1985); *see also* Monaghan, *Overbreadth*, 1981 SUP. CT. REV. 1.

86. 397 U.S. 137 (1970).

discretion to consider policy considerations and thus to balance. If I am wrong, so were a generation of Legal Realists.

This Article has not claimed that stakeholder protection presents a national crisis, but only that it offers a perspective on takeovers from which not every chilling effect is per se undesirable. Although considerable evidence supports the view that takeovers can prune inefficient corporate empires, the new characteristic pattern of bidder losses also suggests that wealth transfers are endemic and interfere with the simple story of assets moving to their highest and best use. Still, the appropriate response should be not to bar takeovers, but to spread the premium so as to compensate the "losers." To so argue is not to justify extreme or discriminatory state statutes, and thus this Article has asserted both that judicial oversight under the Commerce Clause is necessary, and that some element of balancing must survive. To be sure, such state statutes will raise the cost of acquiring control. Yet, at the margin, this could arguably be more a virtue than a vice, given the highly uncertain state of our current knowledge about the efficiency impacts of takeovers.