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The Case for an Unbiased Takeover Law (with an Application to the European Union)

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ABSTRACT

Takeover regulation should neither hamper nor promote takeovers, but instead allow individual companies to decide the contestability of their control. Based on this premise, we advocate a takeover law exclusively made of default and menu rules supporting an effective choice of the takeover regime at the company level. For political economy reasons, we argue that different default rules should apply to newly public companies and companies that are already public when the new regime is introduced. Newly public companies should be governed by default rules that favor the interests of (minority) shareholders over those of management and controlling shareholders, because these are more efficient on average and easier to opt out of when they are or become inefficient for the particular company. Companies that are already public when the new regime is introduced should instead be governed by default rules matching the status quo, even if this favors the incumbents. This regulatory dualism strategy is intended to overcome the resistance of vested interests towards efficient regulatory change. Appropriate menu rules should be available to both groups of companies in order to ease opt-out of unfit defaults. Finally, we argue that European takeover law should be reshaped along these lines. Particularly, the board neutrality rule and the mandatory bid rule should become defaults that only individual companies, rather than member states, can opt out of. The overhauled Takeover Directive should also include menu rules, for instance a poison pill defense and a time-based breakthrough rule. Existing companies would continue to be governed by the status quo until incumbents decide to opt into the new regime.

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I. INTRODUCTION

Takeovers remain the most controversial corporate governance mechanism. Since the early 1960s, the debate has been over whether regulation should promote or impede attempts to acquire control of a corporation by making an unsolicited offer directly to shareholders.

The dogged persistence of the debate reflects the internal logic of two conflicting positions.[1] According to pro-takeover commentators, takeovers are generally beneficial for corporate governance. Takeovers can displace poorly performing managers.[2] Ex ante, the threat of displacement encourages better performance. When management is unable to see past existing industry patterns and recognize the opportunity for strategic change, hostile takeovers, possibly initiated by bidders from outside the industry, can facilitate corporate restructuring.[3] From this perspective, regulation should encourage takeovers by restricting the ability of managers to block a takeover bid, leaving to shareholders, comprised increasingly of sophisticated institutional investors,[4] the decision whether the bid will succeed.[5]

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[1] The stylized presentation that follows of the two standard conflicting views cannot reflect the richness of the debate and the variety of nuanced positions scholars have taken therein. *See, e.g.*, Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions As Precommitment*, 152 U. PA. L. REV. 473, 480–89 (2003). For a survey of the economic literature on takeovers, see, e.g., Marco Becht, Patrick Bolton & Ailsa Röell, *Corporate Law and Governance*, *in* 2 HANDBOOK OF LAW AND ECONOMICS 833, 848–53, 877–86 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

[2] *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 162–74 (1991).

[3] *See, e.g.*, Ronald J. Gilson, *The Political Ecology of Takeovers: Thoughts on Harmonizing the European Corporate Governance Environment*, 61 FORDHAM L. REV. 161, 163–64 (1992); Klaus J. Hopt, *Obstacles to Corporate Restructuring: Observations from a European and a German Perspective*, *in* PERSPECTIVES IN COMPANY LAW AND FINANCIAL REGULATION 373, 373–78 (Michel Tison et al. eds., 2009).

[4] By the late 2000s, for example, institutional investors held over seventy percent of the outstanding shares of the one thousand largest U.S. public corporations and the ten largest institutions owned more than twenty-five percent of the outstanding shares in many large public corporations. *See* Ronald J. Gilson & Jeffrey Gordon, *The Agency Costs of Agency Capital-*

Other observers have a darker view. Those who oppose hostile takeovers argue that they can disrupt well-functioning companies[6] and encourage short-termism, as opposed to long-term commitments to shareholder value. From this perspective, managers have better information than shareholders, who will apply a myopically high discount rate to managers' long-term plans.[7]

In this article, we reject a categorical pro- or anti-takeover position, instead taking what we will call an "unbiased" stance on the desirability of takeovers. While takeovers may be efficient in the aggregate,[8] the efficiency of individual takeovers and individual companies' exposure thereto depends on a variety of factors. These factors include the production functions of companies, conditions in the relevant industry, the problems confronting the corporation, and the best response to those problems. Because all of these factors may differ from company to company and over time, the appropriate stance to takeovers in each case may also differ. Consequently, we posit that takeover regulation should sanction individual company efforts to devise a takeover regime appropriate to their own, mutable circumstances.

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ism: Activist Investors and the Revaluation of Governance Rights, 113 COLUM. L. REV. 863, 863–65 (2013).

[5] Some commentators, including one of us, have taken a more moderate position, arguing in favor of allowing directors to expend corporate resources, either to persuade shareholders that rejecting a hostile bid would create more value than offered by the bidder, or to provide shareholders a more valuable alternative. *See, e.g.*, Ronald J. Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982); Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982); Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985).

[6] *See, e.g.*, Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 18–20 (1987). Still others share the negative view of hostile takeovers, but without the pro-management underpinning. They see managers as disloyal agents who will protect their positions one way or another. If they cannot block a hostile takeover directly, they will block it indirectly by taking substantive actions that will make the corporation less attractive to hostile bidders at a cost to shareholders that exceeds that of blocking a hostile offer. *See* Jennifer Arlen & Eric Talley, *Unregulatable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577 (2003). Because regulation cannot effectively constrain self-interested managers, the second best solution is to reduce their incentive to do their worst. *Id.* These commentators thus favor restricting hostile takeovers, whether by allowing the target board of directors to prevent shareholders from accepting them or by making bids costlier via regulation.

[7] For discussions of the argument that public company management overly discounts the future, see, e.g., Michael L. Wachter, *Takeover Defense When Financial Markets Are (Only) Relatively Efficient*, 151 U. PA. L. REV. 787 (2003). On the claim that stock markets are short-termist, see John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, DEPARTMENT FOR BUSINESS, INNOVATION & SKILLS 14–22 (July 23, 2012), https://www.gov.uk/government/consultations/the-kay-review-of-uk-equity-markets-and-long-term-decision-making.

[8] *See* Sandra Betton et al., *Corporate Takeovers*, *in* 2 HANDBOOK OF CORPORATE FINANCE 291, 358–74 (B. Espen Eckbo ed., 1st ed. 2008) (arguing, on the basis of event studies, that the combined returns of target and acquiring companies are positive on average). *But see* Klaus Gugler et al., *Market Optimism and Merger Waves*, 33 MGMT. DECISION ECON. 159, 170–72 (2012) (showing that, in as much as overvaluation of the acquirers' stock is a determinant of takeovers, the long-term wealth effects of takeovers are negative on average).

Put differently, we propose a kind of horizontal subsidiarity approach.[9] Regulation of takeovers should defer to choices made at the level best suited to a nuanced assessment of particular circumstances and industries: that of the individual target company. From this perspective, takeover regulation's central role is to set the default rules governing the available responses to a takeover. These rules will be subject to opt-out by individual companies. The likelihood of opt-out will depend on the rules governing the corporation, and on whether the constituency that such rules empower—whether it is management, controlling or minority shareholders—welcomes the change. Accordingly, our policy goal here is to determine both the default rules and the means of altering those rules so that choice or inertia at the individual company level is not biased for or against takeovers.

Our unbiased approach reflects an effort to move the debate beyond categorical positions in which mandatory rules are insensitive to context. Takeovers are one of a range of governance mechanisms, the optimal mix of which, for a particular company, should be endogenous to a significant extent. The conditions a corporation confronts can be expected to change over time, thus reinforcing the endogeneity of the "right" mix of governance techniques rather than a mandatory set specified at any one point in time. And while we make recommendations about the correct default rules, these are made with careful attention to their structure, the method by which they can be changed, and the realities of political economy surrounding takeover regulation.

In the debate over takeovers, the pro- and anti-takeover positions are typically framed as addressing a simple question: who should decide whether a hostile takeover goes forward? There are three obvious candidates. First, the board may be given the power to block an offer. Second, the board may be restricted from acting to hinder a takeover, thereby allocating the decision to shareholders. In this vein, the U.K. City Code on Takeovers and Mergers and English company law more broadly disarm the board by prohibiting actions that prevent shareholders from deciding on a bid.[10] Third,

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[9] In the European Union jargon, horizontal subsidiarity refers to the preference for self-regulation by private actors over (European or national) regulation from public bodies, as expressed in the Conclusions of the Presidency, Edinburgh European Council (Dec. 12, 1992). *See, e.g.*, Edward Best, *Alternative Methods and EU Policy-Making: What Does "Co-Regulation" Really Mean?*, EIPASCOPE, no. 2, 2008, at 11. To be sure, no one has so far used the term to refer to the relationship between private ordering and mandatory provisions in the context of company law. Vertical subsidiarity (or subsidiarity tout court), as enshrined in Article 5(3) of the Treaty on European Union, refers instead to a preference for national or local legislation in matters in which the European Union has no exclusive competence. *See, e.g.*, Kees Van Kesbergen & Bertjan Verbeek, *The Politics of Subsidiarity in the European Union*, 32 J. COMMON MKT. STUD. 215 (1994).

[10] The City Code restricts the board's ability to adopt defensive tactics that would frustrate an unwelcome bid, unless shareholders authorize it. *The City Code on Takeovers and Mergers*, Rule 21 (The Panel on Takeovers and Mergers, 11 ed. 2013) (U.K.). On board neutrality as a more general feature of English company law see David Kershaw, *The Illusion of Importance: Reconsidering the UK's Takeover Defence Prohibition*, 56 INT'L & COMP. L.Q. 267 (2007).

the final decision could be left to the courts. That would imply the application of a standard and hence the possibility of taking context into account when determining whether the board or the shareholders should decide. Over most of the last 25 years, this has been the Delaware approach.[11]

We argue that individual companies should be able to decide who decides. Deferring to the choices of individual companies, however, implies more than mere advocacy of freedom of contract in takeover law. In a world of positive transaction costs, the selection of the default rules matters greatly, as do the procedures by which they can be changed.[12] The crucial question for an unbiased takeover law thus becomes the choice of the default rules: the rules that apply unless companies provide otherwise in their governing documents, whether initially or as later amended. Selecting the right default rules based on the conditions for opting out at different points in time facilitates efficient, as opposed to inertial or opportunistic, choices at the company level.

Default rules matter both for newly public companies (IPO companies) and for those companies already public when a new default regime is introduced (installed-base companies). In the former, setting the default rules that suit the majority of IPO companies saves transaction costs. As we argue below, this generally speaks in favor of defaults that do not restrict takeovers. More importantly, while a company's efficient exposure to takeovers may vary across time, defaults tend to be sticky.[13] Takeover-unrestrictive defaults are easier to change if they turn out to be inefficient down the road.

From an economic perspective, takeover-unrestrictive defaults would also be generally preferable for installed-base companies. However, the matter stands differently from a political economy perspective. In fact, the introduction of takeover-unrestrictive default rules is bound to be opposed by those having an interest in existing takeover-restrictive default rules; similarly, those having an interest in existing mandatory rules will likely resist their becoming defaults. These vested interests may successfully oppose regulatory change, thereby depriving IPO companies of the opportunity to benefit from the establishment of an unbiased takeover law. To address this problem, we propose to reform takeover law based on a model of regulatory dualism.[14] Regulatory dualism implies that reform makes two regimes available. The new, unbiased defaults will apply to IPO companies. Installed-base companies will instead remain subject to the existing regime, *unless those having endowments therein agree to opt out of it*. This solution seeks to mute

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[11] *See* Ronald J. Gilson, *Unocal Fifteen Years Later (and What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001).

[12] *See generally* Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032 (2012).

[13] Default rules are sticky, particularly in corporate law. *See* Henry Hansmann, *Corporation and Contract*, 8 AM. LAW ECON. REV. 1, 4–5 (2006).

[14] *See generally* Ronald J. Gilson, Henry Hansmann & Mariana Pargendler, *Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the United States, and the European Union*, 63 STAN. L. REV. 475 (2011).

incumbent opposition to regulatory change by granting them the right to veto a move away from the status quo at the company level. However, such a move is still possible to the extent that parties are willing to contract upon their endowments.[15]

To illustrate how an unbiased regime would work, we contrast our approach with the current European Union (EU) takeover regime, whose main rules are included in the Takeover Bid Directive (the Directive).[16] We start with the core policy choice on whether the board or the shareholders should make the final decision on a hostile bid. We argue that, in contrast with the current regime in all EU member states aside from Italy, the rule should be that shareholders decide unless IPO companies choose otherwise. We then extend the unbiased approach to the provisions that are more important in the presence of a controlling shareholder, where takeovers are typically friendly. In this context, we argue that the rules mainly affecting the takeover decision should be pro-minority shareholders by default, not because we believe that minority shareholders will more often be in need of protection, but because at the IPO stage they can be persuaded to give up protection only if this is efficient. Two prominent applications of this reasoning are a one-share-one-vote default (1S1V) and a rule conferring upon minority shareholders the right to sell their shares at the same price as the outgoing controller. The latter provision, which is takeover-restrictive, is reminiscent of the mandatory bid rule under Article 5 of the Directive. In the unbiased regime we advocate, the mandatory bid rule should become a default rule.

Finally, we contend that menu rules, which do not apply by default but can be adopted by a company, are an important complement to default rules in an unbiased takeover regime for two reasons. First, the existence of menu rules facilitates opt-out by those companies for which the default regime is inefficient.[17] Second, menu rules established at the EU level would displace, if chosen, incompatible mandatory rules set at the member state level, thereby countering the residual opposition to the unbiased regime that can be expected from the vested interests despite regulatory dualism.[18]

The remainder of this article is structured as follows. Section II presents the economic case for an unbiased takeover law. Section III discusses the different criteria for choosing default rules for IPO companies and for installed-base companies. Section IV applies this framework to the EU, illus-

[15] Current examples of such contracting include the holders of a class of common stock with enhanced voting rights agreeing to give up their extra voting rights. For a description of a current effort by a Canadian public company to eliminate the heightened voting rights of one class of shares in a public company, see generally Bernard S. Black, *Equity Decoupling and Empty Voting: The Telus Zero-Premium Share Swap*, 16 M&A LAW. 1 (Oct. 2012).

[16] Directive 2004/25/EC, of the European Parliament and of the Council of 21 Apr. 2004 on Takeover Bids, 2004 O.J. (L 142) 12 [hereinafter the Directive].

[17] *See infra* text accompanying notes 71–74.

[18] *See infra* text accompanying notes 149–50.

trating how a review of the Directive could result in the introduction of an unbiased takeover regime. Section V concludes.

II. Economics of Takeovers: The Case for Unbiased Takeover Regulation

Takeover law should allow individual companies to decide their degree of takeover exposure. No single rule insensitive to context and strategy will perfectly distinguish between value-increasing and value-reducing takeovers. However, economic analysis counsels in favor of a default rule that assigns decision rights to shareholders. In this section, we take up the basis for this default rule.

At the outset, a qualification is in order concerning how we differentiate value-creating from value-reducing takeovers. Whether a particular takeover is efficient depends on whether the winners' gains exceed the losers' losses net of transaction costs.[19] Importantly, we ignore here the wealth effects of takeovers on non-shareholder constituencies (employees, customers, local communities, the national economy, and the like—typically referred to unhelpfully in the aggregate as "stakeholders") and focus only on the joint gain of the acquiring and the target company measured in terms of shareholder value.

Our point is not that non-shareholder gains or losses are either irrelevant or necessarily of limited magnitude. Rather, the point is that takeovers are merely one way in which corporations respond to changes in economic conditions. Competition can force corporations to fire workers, lower wages, or close plants that are important to a community. Takeovers are, in this respect, just one mechanism through which competition operates and equilibration occurs. Serious issues of political economy frame how a particular country addresses competition's effect on non-shareholders, including those resulting from (hostile) takeovers.[20] For our purposes, the scope and the features of the safety net protecting individuals and communities against the effects of economic and regulatory change are only relevant to the takeover debate if takeover regulation is the best (or the only) protection tool available. Because we have not seen that position carefully presented in the takeover debate, our discussion of takeover regulation in the following does not further consider it.

The central problem in crafting takeover rules is that decisions about whether a takeover goes forward are made ex ante based on probabilistic information, while the ultimate efficiency of the takeover is revealed only ex

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[19] This is a Kaldor-Hicks measure of welfare: a move is efficient if those who benefit from it can compensate the losers and still be better off. *See generally* John R. Hicks, *The Foundations of Welfare Economics*, 49 Econ. J. 696 (1939); Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 Econ. J. 549 (1939).

[20] *See generally* Varieties of Capitalism: The Institutional Foundations of Comparative Advantage (Peter Hall & David Soskice eds., 2001).

post. A decision-maker can *approve* a takeover that existing information suggests will be value-reducing because: (1) she is mistaken: she misinterprets the existing facts and so overestimates the transaction's ex post value; (2) she pursues personal benefits (such as empire building or the potential to loot); or (3) she believes that the market will mistakenly overvalue the transaction ex post, whether due to poor information or myopia.

In turn, the decision-maker can make ex ante mistakes in rejecting a value-increasing takeover for reasons that parallel those associated with mistaken acceptance. The decision-maker may *reject* a takeover because: (1) she is mistaken: she misinterprets the existing facts and so underestimates the takeover's ex post joint value; (2) she pursues personal benefits (such as entrenching herself or sustaining a bad strategy that increases the value of the management's real option on control);[21] (3) she is hyperopic, i.e., she mistakenly applies too low a discount rate to future revenues.

Traditionally, takeover law has attempted to answer the "who decides" question on an aggregate basis. The idea is that if the law allocates the decision regarding whether to proceed with a certain takeover to the right decision maker, good transactions will go through and bad ones will be stopped more often than under alternative regimes (including the option of having no mandatory rule in place at all). With respect to takeovers of public companies with dispersed ownership, the fundamental policy choice then becomes whether the ultimate decision to let a takeover bid go forward is allocated to the board or to the shareholders. The board may be subject to constraints, including pressure from incumbent management to resist the takeover. On the other hand, the shareholders would normally be limited to public information in assessing the merits of a proposed transaction.[22]

Similarly, with respect to blockholder-controlled companies, the question is whether controlling shareholders should be limited in their ability to enter into, or to block, a control transaction. These limits mainly include two sets of rules. On the one hand, there are rules intended to protect minority shareholders from transactions that favor the dominant shareholder, e.g., the mandatory bid rule or the requirement that certain transactions be authorized by a majority of the minority shareholders. On the other hand, there are rules aimed at facilitating takeovers by constraining controlling shareholders' abil-

[21] In this formulation, management holds a call option on the benefits of control. The value of this option can be increased by extending the period over which the option can be exercised, even if the current strategy has a negative net present value.

[22] Delaware's intermediate standard, announced in *Unocal*, held out the possibility of a third decision-maker: the courts. Under the initial framing of this intermediate standard, the court independently would review any defensive action based on the presence of a threat and the proportionality of the response. *See, e.g.*, Ronald J. Gilson & Rainier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247 (1989). Over time, the intermediate standard has largely collapsed into an allocation of decision making to the target board, so long as the hostile bidder's chance of success in a proxy fight to replace the board with members who will redeem the pill is not mathematically or practically impossible. *See* Ronald J. Gilson, *Unocal Fifteen Years Later*, *supra* note 11, at 500–01.

ity to entrench themselves (e.g., a 1S1V mandate) or to block an offer (e.g., via the so-called breakthrough rule devised in the Directive).[23]

The problem with this one-size-fits-all approach is that no single rule allows only value-increasing transactions to go through in either setting. Regardless of which party is accorded discretion with respect to a takeover—management, shareholders, a controlling shareholder, or a court—the risk of error remains, whether because of mistake or of self-interest. From this perspective, the most that takeover law can accomplish is to set general screens that minimize the *average* impact of biases across the population of companies. However, there is an alternative to general screens that apply the same rules to all companies and all transactions under all circumstances. Takeover regulation could allow an individual company to select the screen that will minimize the impact of *its own decision-maker's* biases. As we argue below, under certain conditions this approach may fare better than a general, one-size-fits-all screen mandated by regulation.

A. *Companies With Dispersed Ownership*

In companies without a controlling shareholder, the crucial point is whether allocating power to the board to block a takeover better differentiates between value-increasing and value-decreasing than allocating the decision to the shareholders.[24] Let us first consider the advantages and disadvantages of allowing the board to block hostile takeovers, for example by adopting a poison pill, to prevent shareholders from tendering enough shares to approve a takeover the board does not favor.[25] Managers may have

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[23] *See infra* text accompanying notes 126–28.

[24] This part builds upon Ronald J. Gilson, *Lipton and Rowe's Apologia for Delaware: A Short Reply,* 27 Del. J. Corp. L. 37, 40–46 (2002). The United States' experience illustrates that the poison pill concept requires more detail to be useful. The text assumes that a poison pill actually allows the board to block a hostile bid. For some period of time, the Delaware Chancery Court allowed the adoption of a pill and its use to secure the board time to present shareholders with information or an alternative, but still required that, in the end, shareholders have the right to decide whether to accept the offer. Thereafter, the Delaware Supreme Court allowed a company to use the pill to force resolution of a bid to take place through a proxy contest to replace board members with the bidder's nominees who presumably would redeem the pill and let the bid go to the shareholders. *See* Gilson, Unocal *Fifteen Years Later, supra* note 11, at 500–01. This tension between the rule the Chancery Court believes correct and that imposed by the Supreme Court remains. *See* Air Products and Chemicals, Inc. v. Airgas, Inc., 16 A.3d 48 (Del. Ch. 2011). This, in turn, caused the pill's effectiveness to depend on whether a particular company had a staggered board, which would force a bidder to win two proxy contests in order to replace a majority of the board. *See, e.g.*, Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan. L. Rev. 887, 919–24 (2002) (explaining how prohibitively costly a hostile takeover attempt is if winning two board elections is needed to succeed). Finally, target companies remained subject to capital market pressures regardless of structural defences. *See* Marcel Kahan & Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U. Chi. L. Rev. 871, 893–99 (2002) (showing how market forces have shaped adaptive responses to developments in Delaware case law on takeovers).

[25] When we refer to a "shareholders decide" default rule, we consciously assume away the problem of shareholder coercion in tender offers for two reasons. First, in most developed

better information than shareholders about a particular takeover; resistance, then, could be motivated on this ground. However, managers may have conflicted motives and also may be cognitively biased. Underperforming managers can be reluctant to acknowledge mistakes, explaining bad strategy as market misvaluation.[26] The combination of self-interest and cognitive bias can lead to managerial hyperopia. Managers may honestly (in the sense that cognitive biases are not intentional), but incorrectly, believe that their view of the company value will eventually be proven right despite temporary underperformance. And, consciously or not, they may also push this view opportunistically in order to protect their positions.[27]

The flip side of the coin is that management may in fact know something that the market does not know. This potential information asymmetry is the primary reason why shareholder assessment of a takeover bid also may be biased. From this perspective, the shareholders' information costs of evaluating a takeover bid are higher when company value depends on future growth options, which in turn depend importantly on management decisions that remain to be made. This is precisely the kind of circumstance when the claim that managers have an information advantage is most plausible.[28] In these circumstances, shareholders may be myopic compared to management.

Other factors may also contribute to shareholders' acting myopically compared to managers. Some institutional investors may be rationally oriented to the short-term, either because their positions are levered (and thus they can bear losses only for a limited amount of time), or because they are subject to rational herding, both as entities and internally as a result of agency costs within their organizations.[29] Finally, shareholders may be sub-

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jurisdictions, the presence of a set of "traffic" rules, like minimum offer length, proration, disclosure requirements, and so on, significantly attenuates the problem. *See, e.g.*, Paul Davies & Klaus Hopt, *Control Transactions*, *in* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 225, 248–56 (2d ed. 2009). Second, reconcentration of share ownership in the hands of institutional shareholders (*see supra* note 4) further reduces coordination problems among target shareholders. On pressure to tender, see generally Lucian A. Bebchuk, *The Pressure to Tender: An Analysis and a Proposed Remedy*, 12 DEL. J. CORP. L. 911 (1987).

[26] This bias involves finding more psychologically supportive explanations for personal failures. *See generally* LEON FESTINGER, A THEORY OF COGNITIVE DISSONANCE (1957). Festinger's development of a cognitive path dependence bias in decisions over whether to continue an existing strategy is an obvious precursor to the influential work of Daniel Kahneman and Amos Tversky concerning biases in decision making that has served as the foundation for behavioral finance and economics. *See generally* DANIEL KAHNEMAN, THINKING FAST AND SLOW (2011).

[27] In this regard, note that the incumbency of managers whose strategies are performing poorly functions as a real option whose value is increased by extending the duration of the option by delaying or blocking a takeover. A similar analysis has been applied with respect to management incumbency in the context of bankruptcy: managerial power to retain control in bankruptcy is priced as an option in measuring deviation from absolute priority. Julian Franks, *Empirical Investigation of US Firms in Reorganizations*, 44 J. FIN. 747, 768 (1989).

[28] In a sense, this explanation parallels the pecking order theory of capital structure. *See* Stewart Myers & Nicholas S. Majluf, *Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have*, 13 J. FIN. ECON. 187, 195–96 (1984).

[29] Andrea Devenow & Ivo Welch, *Rational Herding in Financial Economics*, 40 EUR. ECON. REV. 603, 607–09 (1996).

ject to cognitive biases and be irrationally short-termist. This argument, however, is deployed far more frequently than it is supported given the concentration of shareholdings in institutions rather than individuals and the fact—which we discuss below—that institutional investors are not all alike.[30]

The bottom line is that choosing either screen will lead to some inefficiency. If board veto is chosen, value-decreasing takeovers are more likely to be stopped. However, value-increasing takeovers may be foregone as well because of managerial opportunism and mistake. Conversely, under shareholder choice, value-increasing takeovers are more likely to go through, but some value-decreasing takeovers also may occur because of shareholders' comparatively higher information costs and other possible sources of short-termism.

Yet, shareholder choice has some general advantages over board veto that in our view make it a better screen on average.[31] First, managers' information advantage can be reduced by disclosure, although this can work only to the extent that disclosure does not undermine the value of proprietary information (disclosing managers' ideas could benefit competitors), and only if managers can make their disclosure credible in light of the managers' incentive to overstate the value of long-term projects.[32]

Second and more important, the impact of managerial self-interest and cognitive bias is likely more significant than that of shareholder ignorance and irrationality. To the extent that shareholders are not alike and their biases are not correlated across types, some of their biases are likely to regress out in the market, whereas we are unaware of any regression mechanism that reduces the impact of managerial biases, which are likely to be correlated. To be sure, institutional investors may have correlated biases too, for example because of leverage (particularly if it is widespread across institutions)[33] or rational herding on the length of investment horizons. However, the crucial point is that while at least some, if not many, of the errors based on shareholder biases are likely to be corrected by the heterogeneity of shareholders, the same result cannot be expected for management biases.

Therefore, were one required to choose a single screen among a set of imperfect options, on average, shareholder choice would get the call. But that still leaves another question, typically neglected in the policy debate on takeover law: can an on-average, second-best, solution be improved by allowing individual companies to choose their own takeover regime? If the

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[30] To be sure, individuals within organizations may be systematically irrational, or the organization may be ineffective at constraining irrational behavior by its agents, but this is a more complicated argument, which must be made rather than assumed.

[31] *See* Gilson, *supra* note 11, at 502.

[32] *See* Myers & Majluf, *supra* note 28.

[33] The leverage concern may be overstated because many institutions, which collectively hold more equity than hedge funds, are limited in their ability to leverage their holdings. Mutual funds, which hold approximately 25% of equities in the U.S., are an important example. *See* Gilson & Gordon, *supra* note 4, at 886.

most effective takeover screen depends on the circumstances affecting individual companies, presuming appropriate mechanisms of choice, an even better screen is simply to let companies choose their own takeover regime. Indeed, we believe that under certain circumstances departing from a shareholder choice regime can be efficient for some companies, although arguably not for the majority of them.

First, the information asymmetry argument that provides the principal support for allocating decision authority over takeovers to the board will be stronger in certain industries and at certain points of a firm's lifecycle. In general, the information gap is more likely to be limited, and less costly to reduce through disclosure, in those industries and companies where management performance is measured, relatively speaking, by the effective discharge of the tasks the market anticipates.[34] This will particularly be the case where innovation is linear: good managers will anticipate customer needs and deliver on production and distribution. But one can expect quite the opposite in industries characterized by non-linear innovation, particularly if a company has only recently gone public or experienced significant restructuring. When company value depends heavily on future growth options, then stock price depends heavily on characteristics that are difficult to observe. Current performance may then be a noisy indicator of skill and effort, carrying a more significant risk that value-decreasing takeovers occur because of shareholder misinformation.[35]

Second, the impact of shareholder short-termism based on information asymmetry depends not only on the company's characteristics, but also on the type and concentration of institutional ownership. These factors affect the likelihood that the market regresses out shareholder mistakes. For instance, absent sizeable ownership by long-term investors, it may be efficient for companies with high earnings volatility (a likely pattern for companies in markets where non-linear innovation makes the future more difficult to predict) to temper the shareholder choice regime in order to reduce the risk that value-decreasing takeovers are triggered by what turns out to be temporary underperformance.[36]

Finally, full exposure to takeovers is not always good. In certain companies—especially those companies suffering from information asymmetries

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[34] *See* Oliver D. Hart, Firm, Contracts, and Financial Structure 126 (1995).

[35] *See* Jean-Jacques Laffont & Jean Tirole, *Repeated Auctions of Incentive Contracts, Investment, and Bidding Parity with an Application to Takeovers,* 19 Rand J. Econ. 516, 529–31 (1988).

[36] When institutional ownership is characterized by transient investors, short-termism may ensue. Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings Over Long-Run Value?,* 18 Cont. Acct. Res. 207 (2001). *But see* A. Edmans, *Blockholder Trading, Market Efficiency, and Managerial Myopia,* 64 J. Fin. 2481, 2504 (2009) ("[S]hort-term trading may in fact support long-term investment"). Activist investors, whose goal is explicitly to influence corporate policy, may have a short-term bias; however, it is usually the case that they can influence corporate policy only if they can persuade institutional investors that their position is correct. *See* Gilson & Gordon, *supra* note 4, at 899.

in favor of management, resulting in shareholders' short-termism—insulating management from hostile takeovers can be a strategy to promote innovation while saving on overall managerial compensation.[37] This argument parallels the long-standing debate over whether management's investments in firm-specific human capital might be lost by shareholders accepting a hostile bid.[38] Seemingly, one way to cope with this problem is to award golden parachutes to managers who lose their jobs in the event of a successful hostile takeover.

The difficulty with this approach, however, is that increased compensation in return for a commitment by management to make the "right" level of firm-specific human capital investment, and not to undertake business strategies that indirectly discourage takeover bids is not a workable contract. Neither the "correct" level of managerial investment nor the motive for management-determined strategy is readily observable and verifiable. The compensation contract thus reduces to a commitment to pay managers in the event of a takeover, but without an enforceable reciprocal commitment from management. Recent research shows that only particular combinations of managerial entrenchment with a pay structure rewarding late success may make sense, particularly with an eye towards innovation.[39] Whether and under what circumstances this kind of trade-off can increase firm value is an empirical question that has yet to be resolved.[40]

B. Companies With a Controlling Shareholder

For companies with controlling shareholders, the question for takeover law remains structurally the same as for widely-held companies: is there a single allocation of decision-making authority that effectively screens good

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[37] *Cf.* Andres Almazan & Javier Suarez, *Entrenchment and Severance Pay in Optimal Governance Structures*, 58 J. FIN. 519, 519–20, 538–39 (2003) (stating that shareholders may reduce compensation costs by giving more power to the CEO); Gustavo Manso, *Motivating Innovation*, 66 J. FIN. 1823, 1846–47 (2011) (stating that shareholders may promote innovation by committing not to fire a manager).

[38] For a discussion of the latter debate, see Oliver E. Williamson, *Comment* on Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 33, 65 (Alan J. Auerbach ed., 1988), and Monika Schnitzer, *"Breach of Trust" in Takeovers and the Optimal Corporate Charter*, 43 J. INDUS. ECON. 229, 230 (1995). Masahiko Aoki stresses the interdependency between employees' incentive to invest in firm-specific human capital and protection of management from control challenges in Japanese firms where innovation is linear and decision-making is horizontal. Masahiko Aoki, *Toward an Economic Model of the Japanese Firm*, 28 J. ECON. LITERATURE, 1 (1990).

[39] *See* Manso, *supra* note 37, at 1839–44.

[40] *But see* Thomas J. Chemmanur & Xuan Tian, *Do Anti-Takeover Provisions Spur Corporate Innovation?*, 29 (AFA 2012 Chi. Meetings Paper, Mar. 27, 2013), *available at* http://ssrn.com/abstract=1572219 (stating that antitakeover provisions tend to increase value for firms engaged in "intensive innovation" and tend to decrease value otherwise); and Mark Humphery-Jenner, *Takeover Defenses, Innovation and Value Creation: Evidence from the Acquisition Decisions*, STRATEGIC MGMT. J. 668 (2014) (showing that, in "hard-to-value" companies, antitakeover provisions support innovation-driven acquisitions instead of encouraging empire building).

transactions—ones that make controlling and minority shareholders net better off—from bad ones? We similarly argue that there is no optimal one-size-fits-all solution to this problem because no single screen will separate value-enhancing from value-reducing control transactions.

The choice in this setting is between a legal framework that lets controlling shareholders decide whether and under what circumstances to part with control and one that imposes mandatory restrictions on such a choice. The two main restrictions on controlling shareholders' discretion over control transactions are a pro-takeover, mandatory 1S1V provision and the takeover-restrictive mandatory bid rule (or other equivalent restrictions such as a majority of the minority approval of control transactions). To understand why neither pro-takeover nor anti-takeover rules would univocally lead to a superior setting for control transactions, we have to focus on how private benefits of control affect controlling shareholders' decisions.

Private benefits of control come in at least two kinds: *pecuniary* and *non-pecuniary*.[41] Pecuniary private benefits are extracted at the expense of minority shareholders.[42] Non-pecuniary private benefits of control differ from the pecuniary kind in that they do not directly transfer resources from minority to controlling shareholders, but only reward the latter with utilities unattainable by the former.[43] A common example is the ownership of a major newspaper or media company, which can provide the controlling shareholder social status and political influence.[44] Controlling shareholders may appropriate private benefits of control through the ordinary operation of the business or they may take the capitalized value of operational private benefits through a control transaction.

Private benefits are not a problem per se. They compensate controlling shareholders for the costs of monitoring management (or directly managing the business) and for the foregone diversification of a significant financial investment.[45] From the perspective of minority shareholders, the level of pri-

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[41] Ronald J. Gilson, *Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy*, 199 HARV. L. REV. 1641, 1663–64 (2006). For two alternate taxonomies of private benefits of control, see ALESSIO M. PACCES, RETHINKING CORPORATE GOVERNANCE: THE LAW AND ECONOMICS OF CONTROL POWERS 84–87 (2012), and John C. Coates IV, *Ownership, Takeovers and EU Law: How Contestable Should EU Corporations Be?*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE 677, 690–94 (Guido Ferrarini et al. eds., 2004).

[42] *See generally* Vladimir Atanasov, Bernard Black, & Conrad S. Ciccotello, *Law and Tunneling*, 37 J. CORP. L. 1 (2011) (discussing the effectiveness of U.S. rules limiting tunneling by managers and controlling shareholders of public companies).

[43] Gilson, *supra* note 41, at 1663–64.

[44] Consider, for example, the Murdoch family with respect to News Corp. and the Berlusconi family with respect to Mediaset, a broadcasting company based in Italy. Hollinger Inc. v. Hollinger Int'l Inc., 858 A.2d 342 (Del. Ch. 2004) illustrates by reference to Conrad Black's newspaper empire that pecuniary and non-pecuniary private benefits of control are not mutually exclusive. *See id.* at 355–56 (Black both profited from significant ownership shares in equity and was able to name political allies to key management positions.).

[45] Patrick Bolton & Ernst-Ludwig von Thadden, *Blocks, Liquidity, and Corporate Control*, 53 J. FINANCE 1, 2–3 (1998). *See also* William B. Bratton & Joseph A. McCahery, *Incom-*

vate benefits is analogous to the costs of overcoming agency problems in widely held companies. The key, whether through regulation or contract, is to allow controlling shareholders to credibly commit to levels of private benefits that leave the minority shareholders net better off, and thus are *efficient*.[46] When this commitment is credible, there is a strong case for letting controlling shareholders decide about changes in control. When the commitment to extract private benefits of control efficiently is lacking or is not credible, the controlling shareholder's decision will likely be biased. The problem is that the expected direction of the bias is not the same for every company.

A controlling shareholder may block a *value-increasing* takeover when she extracts pecuniary private benefits of control through the company's ongoing operations, but the present value of these benefits exceeds the premium the controller would receive from the takeover. This may be because the underlying legal or contractual rules do not allow the controlling shareholder to credibly commit to an efficient level of private benefits or because private benefits are extracted to an efficient level and the transaction undercompensates them.[47] In the latter case, it is actually efficient that the transaction fails to go through.[48] In the former case, inefficiently high levels of private benefits of control prevent transactions that would benefit minority shareholders more than controllers stand to lose. A 1S1V mandate could temper this effect inasmuch as it makes the inefficient extraction of private benefits of control less profitable for a controlling shareholder.[49] From this perspective, mandatory 1S1V rules can be understood as an ex ante, second-best substitute for ex post judicial enforcement of an efficient level of private benefits of control, especially in jurisdictions without an effective court system. However, because 1S1V mandates cannot displace the incentive to extract inefficient levels of private benefits of control when the legal system

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plete Contracts Theories of the Firm and Comparative Corporate Governance, 2 THEORETICAL INQUIRIES IN LAW 745 (2001).

[46] *See* Ronald J. Gilson & Alan Schwartz, *Constraints on Private Benefits of Control: Ex Ante Control Mechanisms Versus Ex Post Transaction Review*, 169 J. INST. & THEORETICAL ECON. 160, 171 (2013); Ronald J. Gilson & Alan Schwartz, *Contracting About Private Benefits of Control*, *available at* http://ssrn.com/abstract=2182781; PACCES, *supra* note 41, at 133–45.

[47] One example in which pecuniary private benefits may be extracted efficiently is the presence of larger synergy gains from participation in a corporate group. *See, e.g.*, Luigi Zingales, *Insider Ownership and the Decision to Go Public*, 62 REV. ECON. STUD. 425, 428 (1995).

[48] The transaction that fails to go through would only apparently be value-increasing: once the efficient extraction of private benefits by the incumbent is accounted for, the net gains disappear.

[49] *See* Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Cost of Separating Control from Cash-Flow Rights*, *in* CONCENTRATED CORPORATE OWNERSHIP 295, 313–14 (Randall K. Morck ed., 2000).

allows it, rules of this kind are not very effective in promoting value-increasing takeovers;[50] and, as we explain below, they may have other drawbacks.[51]

The presence of pecuniary private benefits of control can also make a particular type of *value-decreasing* takeovers more likely. Controlling shareholders could agree to sell their blocks to someone who is able to extract higher private benefits from minority shareholders, for instance, because the acquirer is able to divert resources or opportunities to other companies of the group she controls, while the existing controlling shareholders had committed to capping ongoing extraction of private benefits by restricting related party transactions.[52] Takeover-restrictive rules, like the mandatory bid rule, can prevent such value-decreasing transactions from going through, but they come at a cost: the mandatory bid also operates as an additional curb to value-increasing takeovers. By ruling out the payment of a control premium to the seller alone, the mandatory bid rule makes it even more difficult for prospective acquirers to compensate the incumbent controller's private benefits in order to effect a value-increasing transaction.

In countries with high-quality corporate law and effective courts, or in companies where controllers can credibly commit to dealing fairly with minority shareholders, pecuniary private benefits are usually not substantial.[53] However, controlling shareholders may still receive non-pecuniary private benefits of control. These benefits can also be a source of bias when it comes to screening out takeovers, but even more than in the case of pecuniary private benefits of control, the bias does not unambiguously lead to an inefficient outcome.[54]

Controlling shareholders will refuse to part with control so long as they believe that the control premium that prospective acquirers offer them under-compensates their private benefits. As in the case of management of widely held public companies, they also may oppose the takeover for unselfish reasons, about which they may or may not be right; for instance, they may believe that the offer underestimates the company's intrinsic value. In the absence of expropriation, the controlling shareholder's decision to resist a takeover may depend on stubbornness (i.e., failure to acknowledge underperformance), better information (i.e., knowing something that the market either does not know or misunderstands), or non-pecuniary private benefits of control not valued by the bidder. However, in these circumstances there is an important reason to consider the controlling shareholder's

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[50] Legal rules promoting takeovers cannot impose contestability. This is at best a partial, indirect approach to limiting private benefits of control to efficient levels. *See, e.g.*, Luca Enriques, *Corporate Governance Reforms in Italy: What Has Been Done and What is Left to Do*, 10 Eur. Bus. Org. L. Rev. 477, 492 (2009); Pacces, *supra* note 41, at 157.

[51] *See infra* text preceding note 55.

[52] *See* Gilson & Schwartz, *Constraints on Private Benefits*, *supra* note 46.

[53] Alexander Dyck & Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J. Fin. 537, 575–89 (2004)

[54] *See* Pacces, *supra* note 41, at 103–08.

assessment a valid screen of takeovers: because controlling shareholders have a very substantial investment in the company, they stand to lose the most from their mistakes and to gain the most from their superior knowledge. In sum, because they bet their own money, they serve as a useful screen for value-increasing takeovers.

The fact that a controlling shareholder may have levered control, for example, through dual-class stock, changes the analysis slightly, but not the result. Consider a founder choosing to go public with a dual-class shares voting structure, for example, Mark Zuckerberg of Facebook. At the IPO stage, Zuckerberg bears part of the cost of using a dual-class structure to protect his control: the price Zuckerberg receives for the shares he sells in the IPO is reduced, as is his proportionate interest in the proceeds that the company receives for the stock it sells. No additional cost arises unless either Zuckerberg or the company chooses to sell more stock, in which event Zuckerberg can choose to give up levered control if the discount is too high. Minority shareholders suffer no future cost because they paid the control-discounted price.

The crucial point is that the controlling shareholder both pays a price for the restriction on future takeovers and retains an option to remove the overhang of the restriction on the value of his retained stock and on the price of future company stock sales. If the market underestimates the level of private benefits that the controlling shareholder takes, then the structure will have worked to the disadvantage of minority shareholders. However, this trade-off can also work to the advantage of minority shareholders. This would occur when at some point the price of the restriction (the market discount on non-controlling stock) becomes higher than the subjective value of non-pecuniary private benefits (the demanded premium on the controlling stock), so that removing the restrictions generates net gains.[55] Finally, leveraged control structures may allow a talented entrepreneur to secure scale and scope economies associated with her talent.[56] The result may be that the optimal controlling ownership departs from fifty percent of the shares. While

[55] *See generally* Alessio M. Pacces, *Control Matters: Law and Economics of Private Benefits of Control* (Eur. Corporate Governance Inst., Law Working Paper 131/2009, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1448164 (explaining why dual class shares may be established at the IPO stage).

[56] A response to this point is that it flies in the face of Miller-Modigliani capital structure irrelevancy: it claims a benefit for a particular kind of equity financing. While it is beyond the scope of our effort here to fully address the issue, we note that these capital structures emerge primarily in circumstances characterized by entrepreneurial effort and high uncertainty resulting from the importance of future growth options to the value of the company. Information costs can be expected to be high in these circumstances, one setting in which the irrelevancy proposition fails. *See* Zohar Goshen & Assaf Hamdani, *Concentrated Ownership Revisited: Idiosyncratic Value and Agency Costs* (Columbia Law and Econ., Working Paper No. 444, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2228194 (developing the theme that some controlling owners seek control to protect their special capacity to create value in the context of the corporation's business, which accrue to all shareholders, rather than private benefits of control, which accrue only to the controller if they exceed the value that is shared with the minority. Since those circumstances will occur most commonly when future

1S1V is only moderately helpful when pecuniary private benefits of control are inefficiently extracted, in all of the other situations—particularly in the presence of non-pecuniary private benefits—a 1S1V mandate may prevent the efficient ownership structure from being chosen.

In short, for controlled companies, the most effective structure of takeover regulation is the same as for widely distributed companies: a default rule that can be altered by individual companies. The efficient screen is chosen at the company level, not the legislative level. For controlled companies, the efficiency of both pro-takeover and anti-takeover rules depends on the nature and size of the private benefits of control involved, which in turn vary with individual companies and their stages of development, relevant industry conditions, and the jurisdiction where they are established. Importantly, determining the efficient screen is a dynamic process: all of these individual circumstances may change over time.

III. Designing an Unbiased Takeover Law

A. *Default and Menu Rules Matter*

We have argued in the previous section that where no single screen distinguishes between efficient and inefficient takeovers in the aggregate, the most efficient takeover rules are those set at the individual company level. That leaves what we have characterized as the central question in the design of an unbiased takeover law: what rules should govern takeovers if a company does not specify particularized takeover rules? In other words, what should the default takeover regime be?

This question is important for two reasons. First, companies may prefer to retain the statutory defaults. Studies of jurisdictions featuring significant freedom of contract in corporate law show that companies tend to underuse this freedom, although the explanations for this are unclear.[57] Moreover, companies even at the IPO stage appear more inclined to opt in to takeover-restrictive rules than to opt out of them when they are default.[58] In this situation, the default takeover regime should be unrestrictive.[59] If shareholder

growth options are important, the information problem arises importantly in these circumstances.).

[57] Hansmann, *supra* note 13 (surveying the explanations in the literature and why they are not satisfactory).

[58] Yair Listokin, *What do Corporate Default Rules and Menus Do? An Empirical Examination*, 6 J. Empirical Legal Stud. 279, 295 (2009) (showing that 57 percent of IPO companies incorporated in Georgia opted in to a fair price statute when it was passed, whereas 97 percent of IPO companies incorporated in states passing opt-out fair price statutes stuck with the antitakeover default); *see also* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J. L. Econ. & Org. 83, 95 (2001) (stating that where there is a controlling shareholder, the bias in favor of antitakeover provisions at the IPO stage may reflect their option-like character in that setting).

[59] Our proposal for a default mandatory bid rule would be the exception. The reasons for such an exception are outlined in section III.B.

choice is more efficient in the aggregate, as we argued in section II.A, this default would fit the majority of companies, subject to founders or existing management choosing to retain (and pay for) an option on control.[60] Perhaps more importantly, such a default would also be easier to opt out of for those companies that it does not fit.

Recent theory stresses that a key consideration in the design of default arrangements should be the ease with which the default arrangements can be altered by contract.[61] In the presence of different types of companies for whom differing exposure to takeovers may be efficient at different points in their development and in different business conditions, altering the default arrangement should be easier to accomplish for those companies for which the default is inefficient than for those for which it is efficient. In both kinds of companies the management or the controlling shareholder can be expected to have easier access to the mechanisms by which the default rule can be altered than non-controlling shareholders.[62] Rules that favor the latter are thus comparatively cheaper to opt out of, but importantly the cost of doing so is not zero. Default rules set against the interest of management or controlling shareholders are still sticky if non-controlling shareholders can penalize an inefficient choice by reducing the price they are willing to pay in an IPO or by voting against a proposal to move to an inefficient rule later on. Arguably, the balance of costs and benefits from altering the default varies with the type of company and the concentration of minority shareholders.[63] Because the costs of opting out of a pro-takeover default would only be borne in the presence of offsetting benefits, such a sticky default effectively screens for the companies for which the takeover restriction is efficient.[64]

This choice of default rules would not undermine the unbiased character of the regime as we have defined it; shareholders of an individual company could choose to empower management with takeover-restrictive rules, like board veto or variations thereof, or in the case of a company with a controlling shareholder, vest continued control in that shareholder through a leveraged control structure. However, that should be reflected explicitly in

[60] *See supra* text accompanying note 56.

[61] *See* Ian Ayres, *supra* note 12 at 2043–46.

[62] In the setting of widely held companies, *see generally* Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

[63] The relative difference in the cost of altering the default rules may be ameliorated by the reconcentration of equity ownership, as has taken place in the U.S. *See supra* note 4. Paralleling the reconcentration, for example, an increasing number of companies have redeemed poison pills by board action and eliminated staggered boards by charter amendment. *See, e.g.*, Randall J. Thomas & James F. Cotter, *Shareholder Proposals in the New Millennium: Shareholder Support, Board Response, and Market Reaction*, 13 J. CORP. FIN. 368 (2007); Re-Jin Guo, Timothy A. Kruse, & Tom Nohel, *Activism and the Shift to Annual Elections* (July 6, 2012), http://tigger.uic.edu/~rguo/WP_dboard_2012.pdf.

[64] *See* Ayres, *supra* note 12, at 2086–92 (stating that sticky defaults help screen for efficient opt-out in contract law).

the company's charter. The founders can be expected to choose takeover-restrictive screens efficiently because they are betting their own money and, in the case of the use of a leveraged control structure, retain the largely unilateral option of giving it up should circumstances change.[65] In all events, the inefficiency can be expected to be reflected in the price paid by the minority.[66]

There is a second reason why defaults matter. Changes in the default rule in connection with takeover regime reform can dramatically affect installed-base companies when the previous default allowed the board to restrict takeovers. In these circumstances, the articles of incorporation of these companies normally would be silent on the issues covered by the new takeover defaults; and new default rules may prove *de facto* mandatory, especially where opting out requires consent from both the board and the shareholders.[67]

Applying the new regime to installed-base companies thus creates a two-sided opportunism problem. One side reflects the potential for opportunism by those in control of these companies. Managers and controlling shareholders could seek to retain, or campaign for opting into, incumbent-friendly rules for reasons of self-interest, despite their inefficiency for the individual company. The other side reflects the potential opportunism of dispersed or minority shareholders in changing a previously accepted rule by, for example, purchasing shares of a company with a pro-management takeover regime and then seeking to change it. The appropriate choice of default rules (including procedural rules for opting out of defaults) could counter

[65] *See, e.g.*, Anete Pajuste, *Determinants and Consequences of the Unification of Dual-Class Shares* (Eur. Cent. Bank Working Paper No. 465, Mar. 2005) (analyzing determinants and consequences of dual-class shares unifications using a database comprising 108 European firms which unified dual-class shares between 1996 and 2002).

[66] In their influential article, Daines and Klausner (Daines & Klausner, *supra* note 58, at 113) speculate that their findings may be evidence that antitakeover provisions are not priced in the IPO market. What they find is that none of the efficiency explanations they consider (namely bargaining power, myopia, and private benefits) explain antitakeover provisions. The authors themselves concede that they cannot rule out the efficiency of antitakeover provisions, particularly when idiosyncratic private benefits are not measurable and may be matching a low cost of antitakeover provisions. The authors also offer the plausible interpretation that the structure of venture capital arrangements contemplate that the founders retain an option to retake control from investors if the company is successful—that is, if the company achieves an IPO. *See generally* Ronald J. Gilson & Bernard Black, *Venture Capital and the Structure of Capital Markets: Banks Versus Stock Markets*, 47 J. Fin. Econ. 243 (1998) (stating that the structure of venture capital financing incentivizes management by providing an option on control exercisable on the occurrence of an IPO).

[67] The problem here is not that the existing companies would be caught by surprise: obviously, the transition to the new regime will give existing companies the time and the opportunity to amend their articles of association. The crucial issues, which we discuss below, are the rules governing the amendment; some new default rules may be effectively mandatory because non-controlling shareholders will not agree to opt out of them, whereas some other rules may become easier to amend compared to a previously mandatory regime.

both forms of opportunism.[68] But here we face an even more compelling political economy problem.

Any proposal for reform that contemplates an adverse change of the status quo for managers, controlling shareholders, or concentrated institutional investors, if only by way of a new default rule, would predictably trigger organized resistance. Because these interest groups are homogeneous and sufficiently small, they can be expected to effectively oppose or at least dilute regulatory reform.[69] The long gestation of the Directive, as well as its outcome, is illustrative of this dynamic.[70] To prevent installed-base companies, which at any single point in time represent the greatest part of a country's economy, from blocking a desirable change for IPO companies, we must take into account the constituencies having interests in maintaining the status quo when designing an unbiased regime for takeovers. Reform does not occur in a political vacuum.

An important complement to default rules in an unbiased takeover regime is a set of menu rules available for companies that wish to opt out of one or more items of the default regime. As the experience in the U.S. shows, articles of incorporation do not reflect an enabling statute's invitation to customization.[71] In the few circumstances in which these articles depart from the statutory defaults, menu provisions are often chosen.[72] According to one interpretation, there are significant network effects involved in providing off-the-rack legal arrangements.[73] To be sure, also private menus could perform this and other functions of statutory menus.[74] But statutory menus have two advantages over private ones.

For one, statutory menus are more effective at removing uncertainty as to whether a certain opt-in provision (e.g., a poison pill) is legal. This is a crucial aspect in the context of takeovers, where the time necessary to establish private menus through case law may be too long for them to be helpful. Put differently, statutory menus are meant to reduce the cost of altering a sticky default, facilitating opt-out by companies that benefit from it. From this perspective, menu rules support effective choices at the individual company level, which is in turn an essential element of an unbiased regime.

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[68] *See* Lucian A. Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 Nw. U. L. Rev. 489, 500–06 (2002).

[69] *See, e.g.*, Johan Den Hertog, *Economic Theories of Regulation*, *in* 9 Regulation and Economics 25, 52–53 (Alessio M. Pacces & Roger J. Van den Bergh eds., 2012).

[70] *See, e.g.*, Ben Clift, *The Second Time as Farce? The EU Takeover Directive, the Clash of Capitalisms and the Hamstrung Harmonization of European (and French) Corporate Governance*, 47 J. Common Mkt Stud. 55, 62–66 (2009) (describing the process that led to the adoption of a much less pro-takeover directive than the Commission had envisaged).

[71] Daines & Klausner, *supra* note 58.

[72] Listokin, *supra* note 58, at 304-5.

[73] Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. Corp. L. 779, 793 (2005).

[74] Daniel M. Häuserman, *The Case Against Statutory Menus in Corporate Law*, 9 Hastings Bus. L.J. 45, 55–75 (2012) (arguing that all the function of statutory menus, including network effects, could be more efficiently replicated by private menus).

The effect of statutory menus on the legal certainty of opt-in provisions could be theoretically replicated by other solutions.[75] For example, safe harbors could enable a broad range of private menus by stating that takeover-restrictive charter clauses would not be considered invalid just because they restrict takeovers; or judicial opinions could specify under what circumstances particular opt-in arrangements would be respected.[76] These solutions, however, are not often observed, suggesting that statutory menus have another advantage compared to private menus: they may commit a legislature to the validity of given opt-in arrangements. This turns out to be especially useful when another legislative body—in a federal system, for instance, the state (in the U.S.) or the member state (in the EU) as opposed to the U.S. or EU level legislative body—or the judiciary may be unwilling to make such a commitment. Most importantly, their reticence may be due to the influence of the interest groups concerned with preserving the status quo in the face of the introduction of a new unbiased regime. Setting menu rules at the legislative level that is less likely to succumb to that kind of influence is therefore an important step towards establishing an unbiased takeover regime.

B. IPO Companies

We start with the criteria that should guide the selection of default rules for IPO companies. One would select the takeover regime that works best on average while leaving it to individual companies to opt out of the default provisions that are inefficient under their particular circumstances. This approach would minimize the transaction costs of contracting around statutory defaults since efficient opt-out would be relatively infrequent. Furthermore, the ability to contract around these defaults at minimal cost would allow individual companies to craft the takeover screens most suitable to their business, lifecycle, and ownership structure. The increased use of dual-class voting structures in U.S. technology companies going public is consistent with this approach. From the beginning of 2010 through the end of March, 2012, twenty companies out of the 170 companies that made initial public offerings in the U.S. went to the market with dual-class common stock and other structural features that allow the controlling shareholders to retain control with a less than proportional equity investment.[77] Facebook is the most visible current example, but those with only a slightly longer memory will recall Zynga, Groupon, and Google. This argument leads to a simple criterion for the default allocation of decision-making powers between managers and shareholders in takeover bids: allocate decision authority over takeovers to shareholders.

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[75] *Id.* at 74–75.

[76] *See* Ian Ayres, *Menus Matter*, 73 U. Chi. L. Rev. 3, 9 (2006).

[77] *See Controlled Companies in The Standard & Poor's 1500: A Ten Year Performance and Risk Review*, IRRC Institute 15 (Oct. 2012), http://irrcinstitute.org/pdf/FINAL-Controlled-Company-ISS-Report.pdf.

The U.S. experience provides a second and equally important reason for this default choice. The problem with all the options that our takeover-unbiased regime would, in principle, provide is that companies may fail to choose any of them and simply stick to the default rules. This concern is supported by the observation that very few public companies contract around statutory defaults.[78] However, one important difference between the regime that we are advocating and U.S. takeover law is that, in the latter, the default rules are not consistently pro-takeover. To the contrary, in Delaware perhaps the most important decision-making rules, the ones governing adoption and redemption of the poison pill, have evolved into an anti-takeover regime: boards need not redeem a poison pill so long as a proxy fight remains realistically possible (although management may stack the deck against the bidder conducting a proxy contest), even if it would take a bidder two years to replace a majority of the board because of a staggered board.[79] Recent empirical studies of U.S. statutory defaults show that companies are unlikely to opt out of takeover-restrictive defaults in their charter documents.[80] But the opposite is true for pro-takeover rules, which companies do opt out of, especially in the presence of statutory menus that feature takeover restrictions.[81]

This evidence suggests that an appropriate choice of default and menu rules can effectively enable the selection of the most efficient regime at the company level. This is exactly what we expect from an unbiased takeover

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[78] *See, e.g.*, Hansmann, *supra* note 13.

[79] *See Airgas*, *supra* note 24; Gilson, *Unocal Fifteen Years Later*, *supra* note 11. Individual companies could elect to redeem their poison pill either by amending governance documents or redeeming an already outstanding pill. Individual companies could also opt out of the poison pill at the IPO stage, but apparently this does not happen. *See* Daines & Klausner, *supra* note 58, at 95 ("no firm adopted a [. . .] term limiting the authority of the management to adopt a [. . .] poison pill in the future"). This analysis is complicated in two respects. First, the text describes the end point of a judicial process. At various points along the way, the default takeover rule was much closer to shareholder choice. Even then, there was diversity among IPOs—a large number of companies simply took the default, whatever it might evolve into. Hansmann, *supra* note 13, and Klausner, *supra* note 73, offer a plausible explanation. Uncertainty makes the writing of state-contingent articles costly, due to the chance that the failure to address an unanticipated event (e.g., a bidder tactic) in bespoke articles will be read as rejecting any constraints on that event. From this perspective, choosing the default rule amounts to allocating to the (Delaware) courts the role of updating the articles through the evolution of its application of fiduciary principles. More recently, however, U.S. companies have been redeeming or not renewing their poison pills in response to shareholder activism, likely as a consequence of the reconcentration of shareholdings. *See supra* note 63.

[80] Listokin, *supra* note 58, at 292–95.

[81] *Id. See also* Daines & Klausner, *supra* note 58. This pattern has begun to change in the U.S. with respect to later changes in company specific takeover rules. As a result of reconcentration of equity ownership (*see supra* note 4), institutional investors have been able to persuade an increasing number of public corporations with staggered boards to move to annual elections. *See Harvard Shareholder Rights Project 2012 Report*, Shareholder Rights Project (2012), http://srp.law.harvard.edu/releases/SRP-2012-Annual-Report.pdf (last visited May 22, 2014). On the reasons why it may still be rational for the same investors to accept takeover restrictions at the IPO stage, see Lucian A. Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 730–4 (2003).

law. In this perspective, a shareholder choice default is to be preferred because it is easier for individual companies to select a more managerialist takeover structure with such a default than for them to choose a pro-shareholder one under the opposite default. Incumbent management has either full control (up until the IPO) or proposal rights (for charter amendments after the IPO). In either case, shareholders would have the right to reject the more restrictive rule, either by not buying in the IPO or by voting against a charter amendment later on.[82] The opposite would be harder to obtain, both because of collective action problems and, at least in the U.S., because of the requirement that a charter amendment first be approved by the board of directors. Should the board resist efforts to amend the charter, a proxy fight would be necessary to replace the board. While these barriers are far from insurmountable and depend in no small measure on the concentration of public shareholders, they impose a cost to overcome.

In circumstances without a controlling shareholder, post-IPO changes are worrisome as they may be motivated by managerial opportunism. Because of this concern, the procedural rules for charter amendments implementing midstream changes also should presumptively protect shareholder choice. In other words, any change from pro- to anti-takeover should require shareholder approval. The founder could contract around this procedural default and make it easier or more difficult to opt out, for instance by setting special quorums and/or majorities. However, the parties adopting the restriction bear its cost through the pricing of the IPO, and unless there is a post-IPO controlling shareholder, the restriction loses its optional character.[83] It may be future generations of management who act to constrain takeovers.

While an unbiased takeover regime could operate with only the default rules, the additional provision of statutory menus will facilitate a company's opting out of the default shareholder choice rule. Providing a non-exclusive menu of options could benefit companies not just by saving the (likely negligible) costs of negotiating and drafting the restrictive takeover-clauses, but also by encouraging investors to overcome their reluctance to consider and price non-standard restrictions when courts and practitioners have not yet cleared the uncertainties surrounding their enforcement.[84]

Selecting the most efficient default rules with respect to sales of control by controlling shareholders is less straightforward. As developed in the previous section, the case for controlling shareholders having unfettered discretion over whether or not to part with control is strong only under circumstances when they can credibly set limits on the level of private benefits of control. Such circumstances occur when the legal system will effec-

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[82] *See supra* text accompanying notes 59–64.

[83] *See supra* text accompanying notes 55–56.

[84] Klausner, *supra* note 73, 796–97; Ronald J. Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613–21 (1984) (information costs of understanding new securities terms constrain innovation). On the advantages of statutory menus over private menus, see *supra* text accompanying notes 75–76.

tively enforce statutory, judicial, or contractual limits or when there are industrial organization or reputation-based constraints.[85] As the capacity to credibly commit to levels of private benefits varies considerably among jurisdictions,[86] which takeover screen would fit the majority of controlled companies is hard to tell.[87] But another criterion for choosing defaults is of help here: the one justifying what Professors Ayres and Gertner called penalty default rules (i.e., non-majoritarian defaults that prompt a party to disclose information useful to the other party in the process of bargaining for an opt-out).[88] Professor Ayres has recently suggested that the notion of such information-forcing defaults could be extended to an "intermediate" sort of penalty default rule that seeks to induce only some, and not necessarily the majority, of contractors to opt out.[89] As in the case of widely held companies, then, default rules should be based on whether they are easier (i.e. cheaper) to alter by the companies for which opt-out is efficient.

When pecuniary private benefits of control are involved, opportunistic controlling shareholders are even more worrisome than self-interested management: controlling shareholders' self-dealing may go largely unchecked so long as they control the majority of the votes cast at the general meeting. This is a good reason to bias the choice of the default rules against controlling shareholders. Such a strategy would force founders who want to eliminate barriers to selling control premiums not shared with the minority to do two things. First, the founder will need to disclose reasons—other than expropriation of minority shareholders—why a deviation from equal sharing of a control premium is valuable for the company. Second, the founder will need to allow the market to price the deviation. It also would encourage innovation in devising strategies to credibly limit the levels of private benefit extraction. Therefore, a rule restricting controlling shareholders' freedom to sell control should be the default.

Now consider a controlling shareholder who wants to enjoy non-pecuniary private benefits rather than expropriating minority shareholders. For her, a restriction on control sales is unfortunate because it prevents her from having the value of (non-pecuniary) private benefits compensated via a con-

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[85] Absent such observable limits, the puzzle is deeper than what is the appropriate default rule. Rather, the task is to explain why we observe any minority shareholders at all. *See* Ronald J. Gilson, *Controlling Family Shareholders in Developing Countries: Anchoring Relational Exchange*, 60 STAN. L. REV. 633 (2007); Gilson & Schwartz, *Contracting Over Private Benefits*, *supra* note 46.

[86] *See, e.g.*, Dyck and Zingales, *supra* note 53.

[87] Because markets price private benefits differently across jurisdictions, *see id.*, the default rule problem may be less serious than the text suggests. In this circumstance, the challenge is how to allow controlling shareholders who wish to commit to lower levels of private benefit extraction to do so credibly in jurisdictions with less effective judicial systems. *See* Gilson & Schwartz, *Constraints on Private Benefits of Control*, *supra* note 46.

[88] *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 93 (1989).

[89] Ayres, *supra* note 12, at 2116.

trol premium.[90] Yet a founder who wants to opt out of the restriction has an incentive to signal her type credibly in order to avoid an excessive discount on the stock price. That is, she will have to credibly commit to irrevocably extracting only non-pecuniary private benefits as opposed to pecuniary private benefits. This may be an easy exercise in jurisdictions that either impose effective legal limits on private benefits or effectively enforce contractual limitations, but it may be quite difficult in a number of other jurisdictions. The crucial point is that a default restriction facilitates the pricing of private benefit extraction by encouraging both disclosure and innovation in devising credible contractual commitments.

The same reasoning would apply to the choice of a default rule governing deviations from 1S1V. However, in that case it makes little sense to ask whether 1S1V should be the default because any other default would be arbitrary: it is hard to imagine a corporate law rule providing that companies should go public with a disproportionate (how disproportionate?) voting right for the founder. In other words, once it is accepted that 1S1V should not be mandatory, it is the natural default.

Because the founder pays the price of control enhancement mechanisms adopted at the IPO stage, the 1S1V default will screen for those companies where founders are concerned either with non-pecuniary private benefits of control[91] or can credibly commit to limits on pecuniary private benefit extraction that the market can efficiently price. For these controlling shareholders, the price of a leveraged control structure would be lower than for those who choose a leveraged control structure without such limits.[92]

The preceding discussion addresses the initial choice of a default rule and a controlling shareholder's decision to opt out of it. But what about subsequent midstream changes? It is tempting to set the default procedural rules governing such changes against the controlling shareholder. However, for reasons identical to those supporting freedom of contract, whenever a controlling shareholder places stock with the investing public, we would not depart from the general rules governing charter amendments in the case of a midstream change proffered by a controlling shareholder. If a controlling shareholder retains sufficient voting rights after an IPO to force control enhancement mechanisms midstream, that possibility should be incorporated in the IPO price.[93] Conversely, if the controlling shareholder wants to commit

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[90] PACCES, *supra* note 41, at 581–85.

[91] *See* John Coates IV, *Explaining Variations in Takeover Defenses: Blame the Lawyers*, in 89 CAL. L. REV. 1301, 1305, 1343 (2001).

[92] To be sure, problems of credible commitment remain, even if a controlling shareholder does not opt out of 1S1V. So long as she maintains effective control, the risk of private benefit extraction remains, although with less incentive.

[93] In effect, the controlling shareholder retains a real option to further enhance her control. John Coates shows that in the U.S., the market does price such midstream changes: there is no price effect when a company adopts a poison pill; rather all companies are priced as if they have one. *See* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 275, 277 (2000).

not to introduce further control enhancement mechanisms without the investors' consent, she can do so credibly through an array of charter provisions including supermajority requirements or majority of the minority approval (conditional on effective enforcement).[94]

C. Are the Efficient Rules for Installed-base Companies Different?

The introduction of an unbiased takeover law for companies that are already public when the reform is adopted may call for a different approach. Because the articles of incorporation of existing pubic corporations generally will not address the issues that the new regime leaves to the individual companies to decide, what are formally default rules in an unbiased takeover regime may be actually "imposed" on existing companies, in effect shifting the burden of changing the rules from where it rests for IPO companies. Typically, opting out of the default rule by an IPO company is up to the discretion of owner-managers, but the same decision will require shareholder approval in an installed-base company. This is particularly a problem in those jurisdictions where, as is the case in some European countries,[95] the key rules depart from the takeover-unbiased defaults we advocate. Moving from a pro-management to an unbiased default in takeover law thus alters the status quo for existing companies. This may have unintended consequences with regard to efficiency and result in significant political economy barriers to takeover reform.[96]

The first problem is that installed-base companies may end up frozen into an inefficient regime. In principle, this may happen either because the new defaults are too difficult to opt out of when they do not fit the circumstances of a particular company or because they allow for opportunistic opt-outs by those in control. Given the criteria informing the choice of default rules for IPO companies, however, neither of these situations should occur save in exceptional circumstances. Moreover, the benefits of an unbiased takeover regime available to all present and future public companies are likely large relative to the cost of small frictions—the potential mismatch of the default rule to the particular company and the cost (and potential difficulty) that some installed base companies may face in securing shareholder approval to change the default. Thus, if the choice were to be based exclu-

[94] Although we rely on the founders' ability to contract with investors on anything when the stakes are sufficiently high, we recognize that the takeover screens set when the companies first go public may become inefficient at a later stage. Unless founders have chosen to make or request specific commitments and bet their own money on that choice, the rule governing adaptation of the company's charter to new circumstances should be the majoritarian principle that has traditionally guided the evolution of corporate contracts. Regarding the problem of midstream opportunism in implementing control enhancements, see Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 Va. L. Rev. 807, 810 (1987).

[95] *See* Mario Becht, *Reciprocity in Takeovers*, *in* Reforming Company Law And Takeover Law In Europe, *supra* note 41, 647, 649–50.

[96] *See infra* section III.D.

sively on efficiency considerations, we would *not* recommend different defaults for installed-base companies.

Consider first the situation in which the default rules are not efficient for a particular installed-base company. The central criterion for choosing the default rules is that they should be easy to opt out of when they are not efficient. This property would apply to installed-base as well as to IPO companies. Managers would be free to impose takeover restrictions so long as shareholders can be convinced that the restrictions would increase the company's value.

Similar reasoning applies to controlling shareholders claiming that the mandatory bid rule is a barrier to changes in control that also would benefit non-controlling shareholders.[97] In other words, installed-base companies suddenly facing the new takeover-unbiased regime would be in the same position as IPO companies that initially stick to the statutory defaults but want to change them later on. The only residual difference is the reliance of those who benefited from the pre-reform regime. On analysis, this is also not a significant problem from an efficiency perspective.

Controlling shareholders would not be concerned with reliance issues, at least where, as in Europe, the mandatory bid rule is already in place. Reliance, then, would only be a problem for management-controlled companies in those countries where shareholder choice is not the default screen on hostile takeovers. In this situation, shareholders' taking advantage of the change of regime may deprive managers of explicitly or implicitly bargained-for job security.

In our view, the claim of serious managerial reliance is unpersuasive for a number of reasons. First, management having significant firm-specific human capital investments at stake can at least partly protect them by contract; a reform based on default rules would not override contractual protections—including golden parachutes. In addition, managers have some discretion to take into account the impact that setting corporate strategy has on takeovers. That discretion would give them some bargaining power in securing additional protection for their firm-specific human capital investments if a pro-takeover default regime is introduced.[98] Finally, management's firm-specific human capital investments are likely to be small in the aggregate compared to the benefits to shareholders from a more efficient takeover regime. But the loss of the human capital investments to managers may be large enough to trigger collective political action by them, a concern we address in the next section.

Incumbents' opportunism may also generate inefficiency in the face of takeover reform. Under an unbiased takeover regime, previously mandatory

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[97] Note that there would be no problem with 1S1V because this is already a default rule everywhere and all the current opt-outs by existing companies would maintain their validity after the reform.

[98] Arlen & Talley, *supra* note 6, at 581–85.

provisions would become defaults, which then could be opted out of to take advantage of non-controlling shareholders. The takeover-unbiased regime we propose, however, is designed to curb opportunistic behavior. As developed in the previous section, the choice of defaults would be biased against the interest of those in control to avoid midstream opportunistic changes, whether they are managers or controlling shareholders. When applied to installed-base companies, this criterion corresponds to the solution long advocated by Professors Bebchuk and Hamdani for countering managerial opportunism in the face of corporate law evolution.[99] While incumbent managers are unlikely to consent to opting out of pro-management defaults, shareholder choice defaults provide sufficient guarantees against opportunistic opt-outs without displacing efficient ones. Especially in the current U.S. environment of predominantly institutional ownership and high shareholder meeting turnout,[100] managers could persuade shareholders to accept only efficient opt-outs.

A default mandatory bid rule is also biased against the interest of the controlling shareholder, but this may not be sufficient to counter the incumbents' opportunism. When the controlling shareholder has sufficient voting power to approve a charter amendment, she could unilaterally opt out of the mandatory bid rule. As we have argued earlier, opting out of the mandatory bid rule is not necessarily inefficient. But unlike IPO companies, controlling shareholders of installed-base companies could scrap the mandatory bid rule without paying a price for it,[101] thereby redistributing wealth from investors to themselves.[102] Therefore, while the case for restricting controlling shareholders' ability to opt out of the mandatory bid rule may be ambiguous from the perspective of efficiency, the distributional concerns are much stronger. In the next section, we address the political economy barriers to takeover reform that lead to considering redistribution, rather than only efficiency, in identifying the default rules for installed-base companies.

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[99] Bebchuk & Hamdani, *supra* note 63, at 491–93.

[100] *See generally* David Yermack, *Shareholder Voting and Corporate Governance*, 2 ANN. REV. FIN. ECON. 103 (2010); Gilson & Gordon, *supra* note 4.

[101] This concern motivated SEC efforts in the U.S. to block midstream dual class recapitalizations to force management to pay for the acquisition of control they did not previously have. *See* Gilson, *Evaluating Dual Class Stock*, *supra* note 94, at 808.

[102] As it allows for value-decreasing takeovers, this outcome can be inefficient in the presence of pecuniary private benefits of control, i.e. where the legal constraints on minority shareholder expropriation are weak and/or in the presence of control enhancement mechanisms. The former circumstance lowers the cost of expropriation, which increases the incentives to extract pecuniary private benefits. The latter increases the benefits of selling to a looter. *See* Lucian A. Bebchuk, *Efficient and Inefficient Sales of Corporate Control*, 109 Q. J. ECON. 957, 980 (1994), and Bebchuk et al., *supra* note 49, at 304–05.

D. Overcoming Resistance: A Special Default Regime for Installed-base Companies

Redistribution resulting from regulatory change is inherently an issue of political economy. Redistribution among participants within installed-base companies is thus *the* problem confronting the introduction of an unbiased takeover law in jurisdictions featuring a different regime. Resistance from those having entitlements in the status quo, rather than uncertainty over the efficient rules for installed-base companies, threatens to stifle takeover reform despite its overall desirability. To be sure, this phenomenon, which we refer to as the "Olson problem" after Mancur Olson's insightful analysis of the impact of interest groups on regulatory change,[103] applies to virtually any benevolent legal reform. Efficient reform is Kaldor-Hicks efficient,[104] typically harming the established economic and political elites that enjoy economic rents from the status quo in an amount less than the benefits to other participants in the corporate enterprise.[105] Although these rents are wasteful for society as a whole, the *rentiers* do not easily give them up. Those with a vested interest in these endowments constitute powerful pressure groups against legal change. Due to the homogeneity of their interests and the political influence that accompanies their rents, they can be very effective at lobbying against regulatory reform.

The Olson problem is acute in corporate governance, which distributes endowments among parties carrying conflicting interests. It is particularly acute in takeover law because it unavoidably allocates control entitlements among management, controlling shareholders, and non-controlling shareholders.[106] From a political economy perspective, the first two groups are more worrisome. Because they typically enjoy rents respectively from takeover restrictions and limited protection of minority shareholders, they can be expected to oppose an unbiased takeover regime whose defaults are pro-takeover and protective of minority shareholders. Conversely, institutional investors can be expected to oppose reforms transforming previously mandatory protections of their interests into default rules, although they may only be effective in resisting legal change where they hold sufficiently concentrated stakes to act as a coordinated interest group.[107] In this situation,

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[103] *See* Mancur Olson, The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities *passim* (1982); *Id.*, The Logic of Collective Action: Public Goods and the Theory of Groups *passim* (1965) (describing how well-organized interest groups may successfully organize resistance against welfare-enhancing reforms).

[104] *See supra* note 19.

[105] *See, e.g.*, Gilson, Hansmann & Pargendler, *supra* note 14, at 477–78.

[106] We address the relevance of the impact of takeover law on "stakeholders" *supra* text accompanying notes 19–20.

[107] The U.S. and the U.K.—the two iconic dispersed-ownership countries in corporate governance—historically differ in this respect. In the U.S., individual institutional investors historically have held smaller, more dispersed stakes in U.S. companies than U.K. institutional investors have held in U.K. companies. *Compare* Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance 223 (1994), *with* Brian

overcoming the Olson problem is crucial to making the introduction of an unbiased takeover law politically viable. Building on the previous work of Professors Hansmann and Pargendler with one of us, we advocate *regulatory dualism* as a solution.[108]

Regulatory dualism is based on a simple intuition. When the chance is high that vested interests would succeed in blocking the introduction of a new, more efficient reform, resistance may be avoided by allowing those having endowments in the existing regime to continue to be governed by it. At least nominally, the existing elites should be indifferent to introduction of the new regime, with the benefit that a more efficient regime at least becomes available for other businesses, particularly new entrants. The disadvantage is that inefficiency will persist as long as the installed-base is governed by the pre-reform regime, which will be considerable since installed-base companies at any point in time will dwarf the next round of new companies. Thus, the approach is most attractive in dynamic circumstances, where the goal is to encourage growth in new businesses.[109] Regulatory dualism has particular attraction for takeover reform, since takeovers are themselves an important dynamic mechanism.

We must be careful not to overstate how cleanly regulatory dualism operates; elites may still have something to lose. To the extent that the reform regime is successful, one result will be to foster competition leading to the natural erosion of rents and, of equal importance, an erosion of the corresponding political influence. Our proposal is premised on the expectation that, compared to the risk of full reform and the attendant sudden elimination of rents, the threat of future competition will be too small to justify the costs of lobbying against reform and the risk of losing. The experience with regulatory dualism in Brazil, Germany, and the EU (in the case of Brazil an intentional strategy and in Germany and the EU perhaps less instrumental) shows that this approach can provide an effective path towards evolutionary reform in corporate governance.[110]

How would regulatory dualism apply to an unbiased takeover regime? The obvious strategy is to set different default rules for installed-base and IPO companies. The former would be subject to default rules that are identical to the rules in place before adoption of the reform. The latter, in contrast, would be subject to the default rules described in section III.B. We emphasize that no group of companies would be bound by one regime. The benefit of regulatory dualism as opposed to, for example, grandfathering, is that existing companies and IPO companies have access to both regimes and the

R. CHEFFINS, CORPORATE OWNERSHIP AND CONTROL: BRITISH BUSINESS TRANSFORMED, 337–81 (2008). In recent years, the stakes of U.S. institutional investors have become significantly larger and more concentrated. *See supra* note 4.

[108] Gilson, Hansmann & Pargendler, *supra* note 14.

[109] *Id.* at 478–79.

[110] *Id.* at 482–512. *See also* Enriques, *supra* note 50, at 481 (providing a further example of successful regulatory dualism involving privatized companies in Italy).

choice is reversible at any time. The only difference is the default. Default Regime A, mirroring the status quo, applies to installed-base companies. Default Regime B applies to companies going public after the reform enters into force. We intentionally avoid labelling the two regimes as respectively 'old' and 'new'. The two regimes must be on equal footing and, most importantly, equally legitimate. The properties we have just described distinguish regulatory dualism from similar reform techniques, such as grandfathering companies subject to the old regime, menu choice between old and new rules, and simply allowing opting out of the old rules.[111]

What most prominently distinguishes Regime A from the takeover-unbiased approach is that the default rules chosen respect the existing endowments of the vested interests. The goal is to prevent them from acting to kill the reform by structuring the regime such that the expected costs to them of the new dualistic regime are lower than the expected cost of lobbying.[112] Because we want to avoid mandatory rules in order to also allow installed-base companies the opportunity to alter their chosen takeover regime as conditions change over time, the rules for opting out of the defaults should confer upon those who benefit from the status quo the same power to block future changes in the default rule as they have under the current regime. This reflects another key difference with the unbiased takeover Regime B. Not only are the default rules not necessarily biased against the interests of those in control (on the contrary, they often explicitly protect those interests), but also, they retain the existing barriers to other groups causing an opt-out of the default if it becomes inefficient with the passage of time. Thus, incumbents are not made worse off because of the reform, but neither are they made better off. Incumbents who were exposed to change in the default rule under the previous regime, for example, should remain so exposed.

This friction is undesirable because it restricts the dynamic character of an unbiased takeover regime, which is one of its important attributes. However, it is the price of making the more efficient Regime B politically viable and the price is capped: installed-base companies retain the option to buy out the endowments of incumbents and choose the unbiased takeover Regime B (or parts thereof) whenever there are sufficient gains from doing so.

We offer a final thought on the trade-off between economic efficiency and political economy in setting default rules for takeover reform. In the end, whether a regulatory dualism framework for reform is desirable de-

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[111] *See* Gilson, Hansmann & Pargendler, *supra* note 14, at 521–25 (discussing the advantages of regulatory dualism over grandfathering and other similar regulatory techniques).

[112] *See* text accompanying notes 62–64 (the choice of a default rule depends on the relative power of different corporate participants to alter the regulatory imposed default rule, but in any event, the altering cost is not zero). As Gilson, Hansmann & Pargendler, *supra* note 14, at 479, observe, the extent of elite power depends on the particular country and context. For instance, the reconcentration of equity ownership in the U.S. has given rise to a significant number of corporate level pro-shareholder changes in default rules. For example, a significant number of companies have eliminated staggered boards in favor of annual elections, a critical element of an effective poison pill. *See* Listokin, *supra* note 58, at 292–95.

pends importantly on one's expectations about both the speed of economic change and its source. The best case for protecting existing governance endowments in installed-base companies is where the rate of economic change is high and the source of the innovations driving change is outside the installed base. In this case, competition will reduce the future influence of the installed base. This is, in effect, a Silicon Valley story of disruptive change rather than one of continuing improvement by installed-base market leaders.[113]

IV. An Application to EU Takeover Law

A. *European Takeover Law: A Primer*

To illustrate how an unbiased takeover law would work, we compare it with the existing regime within the EU and show why the former would be superior to the latter. As throughout this article, we focus on three core issues of takeover law: whether (1) the board or the shareholders make the final decision on a hostile bid; (2) controlling shareholders are free to sell their controlling block; and (3) companies are free to deviate from 1S1V. While other pieces of European legislation have an impact on such matters, the Directive, albeit deferring to national laws to a wide extent, addresses each of them.[114]

With respect to the allocation of decision-making power on takeover bids, the Directive requires only that a member state allows individual companies to opt into the so-called board neutrality rule (BNR), if the member state does not itself impose it or adopt it as a default.[115] In spelling out the BNR, which requires boards to obtain shareholders' authorization of any action, other than seeking alternative bids, which may result in the frustration of a pending bid, Art. 9 expresses a clear preference for such a rule. However, because Art. 12 makes the BNR optional for member states, EU lawmakers' preference for it is, at best, an instance of expressive law,[116] and an ineffective one at that.[117]

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[113] *See generally* Clayton Christensen, The Innovator's Dilemma (2000); Ronald J. Gilson, *Locating Innovation: Technology, Organizational Structure and Financial Contracting*, 110 Colum. L. Rev. 885 (2010).

[114] *See* Luca Enriques, *European Takeover Law: The Case for a Neutral Approach*, 22 Eur. Bus. L. Rev. 623, 627–31 (2011). The Directive also contains so-called "traffic rules" on takeovers, such as those requiring that an offering document be published, setting a minimum offer period, imposing proration, etc. These rules help shareholders make the right decision about a takeover, while at the same time increasing the cost of takeovers: hence, they cannot arguably categorized as unbiased (*see id.* at 629–30). In line with the rest of our article, however, we take such rules as given for the purpose of our analysis.

[115] Council Directive 2004/25/EC, art. 9, 12, 2004 O.J. (L 142/21).

[116] *See generally* Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. Pa. L. Rev. 2021, 2024 (1996) (explaining the expressive function of law).

[117] *See generally infra* text accompanying notes 121–23.

Member states may also opt for a selective board neutrality rule, based on so-called reciprocity: a state that adopts the BNR may choose to allow its companies not to apply it "if they become the subject of an offer launched by a[nother] company which does not apply [the BNR] as they do."[118] In other words, if a member state opts in to the reciprocity regime, defenses are available to fend off a bid from a company that has itself opted out of the BNR or whose jurisdiction does not impose it.

The economic rationale for reciprocity is weak at best.[119] This defense provision, together with the optional character of the BNR, was the outcome of a political compromise motivated by the Olson problem: resistance of interest groups to any more effective pro-takeover policy.[120]

The optional character of the BNR has allowed some important member states previously relying on a board veto rule to retain that rule as a default. Such is the case in Belgium, Denmark, Germany, Luxembourg, the Netherlands, and Poland.[121] Hungary, in turn, moved from a pre-Directive mandatory BNR to a default rule allowing the board to adopt defensive tactics.[122] Finally, a number of member states have chosen to allow their companies to opt in to reciprocity, including France where reciprocity has been given a broad interpretation—reportedly, over one quarter of companies in the CAC-40 index (the market index for the largest publicly traded French companies) had opted in to it as of 2010.[123] The experience with the EU countries that have opted out of the BNR is that not a single company has exercised its right to opt in to the BNR through its articles of association.[124]

Similarly, there is no EU regulation concerning 1S1V in the Directive or elsewhere. 1S1V is the default in all member states, none of which ban all deviations from it.[125] However, the Directive requires member states to allow companies to opt in to the so-called breakthrough rule (BTR) if member

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[118] Arts. 12(3) and (5) of the Directive. Opt-in by individual companies is subject to shareholder meeting authorization to be given no earlier than eighteen months prior to when the bid has become public. Art. 12(5).

[119] Becht, *supra* note 95, at 659–62.

[120] *See, e.g.*, Joseph A. McCahery & Eric P.M. Vermeulen, *Does the Takeover Bids Directive Need Revision?*, 6 (TILEC Discussion Paper No. 2010-006, 2010), *available at* http://ssrn.com/abstract=1547861.

[121] *See* Paul L. Davies, Edmund-Philipp Schuster, & Emilie van de Walle de Ghelcke, *The Takeover Directive as a Protectionist Tool?*, *in* COMPANY LAW AND ECONOMIC PROTECTIONISM: NEW CHALLENGES TO EUROPEAN INTEGRATION 105, 139 tbl.3 (Ulf Bernitz & Wolf-Georg Ringe eds., 2010).

[122] *Id.* at 142. Italy also briefly opted for a board veto rule at the end of 2008, but reversed that choice less than one year later by making the BNR default. *Id.*

[123] *Id.* at 147–49. In Portugal reciprocity applies automatically to all companies, despite the Directive's requirement that it should be subject to individual companies' opt-in. *Id.* at 147.

[124] *See id.* at 145.

[125] *See* ISS, ECGI & Shearman & Sterling, *Report on the Proportionality Principle in the European Union* (External Study commissioned by the European Commission 15, 2007), http://ec.europa.eu/internal_market/company/docs/shareholders/study/final_report_en.pdf. While some countries, such as Germany, Italy, and Spain, prohibit multiple voting shares, no member state bans all dual-class shares structures. For instance, Germany, Italy, and Spain allow for the issuance of preference nonvoting shares (up to a threshold calculated as a propor-

states themselves choose not to impose it or adopt it as a default.[126] The BTR selectively reinstates 1S1V pending a takeover bid or once a takeover bid is successful. More precisely, restrictions on the transfer of securities or voting rights, whether contained in the corporate charter or in shareholder agreements, would not apply while a takeover bid is pending. Further, "[m]ultiple-vote securities shall carry only one vote each at the general meeting of shareholders which decides on any defensive measures."[127] In the event of a successful bid (leading to acquisition of 75% or more of the target voting shares), restrictions on the transfer of shares or on voting rights would be ineffective, subject to compensation, "at the first general meeting of shareholders following closure of the bid, called by the offeror in order to amend the articles of association or to remove or appoint board members."[128]

With the exception of the Baltic Republics[129] (and Italy between 2007 and 2008[130]) no member state has chosen to fully adopt the BTR whether as a mandatory or a default rule.[131] However, France has adopted a reduced-scope BTR as a mandatory rule,[132] and Italy has retained its 1998 provision declaring ineffective the shareholder agreements that restrict parties' freedom to sell their shares pending a bid for all the voting shares.[133]As with the BNR, no individual company has ever opted into the BTR where it is not mandated.[134]

Finally, the Directive imposes a mandatory bid rule by requiring the acquirer of a presumptively controlling block—whose minimum size is set by member states[135]—to offer to purchase the remaining shares on the same terms as paid to the selling controller. The mandatory bid rule effectively compels controlling shareholders wishing to part with control to share the control premium with minority shareholders. Neither member states nor individual companies have discretion to opt out of the rule.[136]

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tion of outstanding shares); and Denmark prohibits nonvoting shares but allows for the issuance of multiple voting shares. *Id.*

[126] The Directive, *supra* note 16, at 21 (art. 12).

[127] *Id.* at 20 (art. 11).

[128] *Id.*

[129] *See* Eur. Comm'n, Report on the Implementation of the Takeover Bids Directive 7 SEC(2007) 268 (Feb. 21, 2007).

[130] *See* Guido Ferrarini & Geoffrey P. Miller, *A Simple Theory of Takeover Regulation in the United States and Europe*, 42 CORNELL INT'L L.J. 301, 324–26 (2009).

[131] CHRISTOPHE CLERC ET AL., A LEGAL AND ECONOMIC ASSESSMENT OF EUROPEAN TAKEOVER REGULATION 80 (2012).

[132] *Id.* at 80–81 ("In France, the limitation of voting rights provided in the articles of association of a company subject to a takeover bid are [sic] suspended for the first general meeting following the closing of the bid if the offeror, either alone or in concert, holds capital or voting rights in excess of two-thirds of the offeree company.").

[133] *See* Decreto Legislativo 24 Febbraio 1998, n.24 (It.), art. 123(3).

[134] CLERC ET AL., *supra* note 131, at 123.

[135] The threshold across member states is normally thirty percent or one third of the shares. *See id.* at 55.

[136] To be sure, member states have broad discretion in identifying exemptions, an area in which there is great variation among them. *See* CLERC ET AL., *supra* note 131, at 61–65. One of us has even questioned to what extent the mandatory bid rule in the Directive is, in fact,

B. The Case for Revising the Takeover Bid Directive

The unbiased approach we propose would lead to a superior framework for regulating takeovers within the EU, especially, of course, for IPO companies.[137] First, under the current rules, individual companies cannot opt out of the mandatory bid rule, which, as we have argued, may unduly restrict takeover activity (i.e., when it applies to companies whose shareholders may otherwise strike a better bargain by opting out of it). Second, many member states have adopted rules contrary to what a takeover-unbiased approach would recommend.[138]

This outcome, together with the similar absence of companies opting into the BNR in member states where it is neither mandatory nor default, matches the theoretical and empirical prediction that companies typically will not opt in to pro-takeover rules. This was the basis for the choice of pro-takeover defaults in the previous section.[139]

An unbiased takeover law should include a default BNR and a default 1S1V, but not a default BTR. Moreover, the presence of the Olson problem is obvious. As a matter of fact, from the time the Directive was adopted, existing elites have successfully pressured member states to adopt or retain antitakeover rules.[140]

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mandatory, in light of the ample leeway member states' national laws, and enforcements agencies have in defining its contours and in deciding on specific fact patterns. *See* Luca Enriques, *The Mandatory Bid Rule in the Takeover Directive: Harmonization Without Foundation?*, 1 Eur. Comp. & Fin. L. Rev. 440, 445–46 (2004).

[137] Given the variations in takeover rules' outcomes that the current takeover framework leaves open for individual member states and the ensuing differentiation in domestic takeover laws, one may wonder why one would bother, as we do, to develop an unbiased takeover regime within the EU, when European businesses already have the freedom to (re)incorporate in any other member state under European law. First, we note that the current European regime is less rich in terms of menu rules than the one we propose. Given the absence of regulatory competition, as opposed to mere regulatory arbitrage in the EU, it is highly unlikely that any member state will supply the menu rules we put forth. Second, the Directive contains provisions (namely, the mandatory bid rule, which most companies opt out of) that are incompatible with our model. Finally, while it is possible to cherry-pick specific takeover law provisions under the Directive, this can only be done with regard to very specific issues (traffic rules and pricing of the mandatory bid) and by forgoing a domestic listing. *See* Luca Enriques & Tobias H. Tröger, *Issuer Choice in the EU and Its Impact on the Market for Corporate Law*, 3 Revue Trimestrielle de Droit Financier 4 (2008). A broader choice of takeover law rules would require reincorporation, thus bundling the choice of a takeover regime with a number of other corporate law provisions that may or may not be optimal for the individual company. Because of the persisting mandatory structure of European laws, "bundling," i.e. the fact that the choice of a takeover law regime is derivative of the choice of corporate law more generally makes regulatory arbitrage a poor substitute for choice of takeover rules at the individual company level.

[138] *See supra* text accompanying notes 121–23.

[139] Conversely, in the only European country where the BNR is merely default (Italy, which amended its takeover law to that effect in 2009), nine companies have opted out of it, including FIAT, a Blue Chip company traditionally leading, for better or for worse, in Italian corporate governance practices. *See* Clerc et al., *supra* note 131, at 78.

[140] *See supra* text accompanying notes 121–23.

Against this backdrop, a reform of the Directive to establish an unbiased takeover law in the EU would improve on the status quo.[141] In EU jargon, the reshaping we propose would be an application of the horizontal subsidiarity principle: the choice of the takeover regime would devolve to the level where this choice is made more efficiently: at the individual company level.[142] In addition, both default and menu rules should be identified at the EU level. This is also an application, albeit less intuitive, of the horizontal subsidiarity principle. Because the most efficient choice of the takeover regime is the one made at the level of the individual company, the default and menu rules, which enable that choice and make it effective, are better established at the EU level than at the member-state level. Member states have in fact stronger incentives to cater to the interests of incumbents (whether managers or controlling shareholders), and will therefore tend to undersupply rules favoring efficient choices at the individual company level.[143]

The goal in setting takeover regulation entirely at the EU level is to avoid the protectionist stance that would naturally emerge if default choices were made at the member-state level. Providing member states with discretion as to the content of defaults and menus exposes them to focused lobbying by interest groups who seek to preserve the status quo. Managers, for example, may lobby for a board veto default in countries mandating the BNR, while controlling shareholders may lobby for the absence of a mandatory bid as default. In this context, it is hard to imagine that menu rules supporting unbiased choice by IPO and installed-base companies would gain any traction at the member state level.

We contend that regulatory dualism at the European level can effectively counter this problem of political economy. Managers and dominant shareholders are less effective lobbyists at the European level than at the

[141] The European Commission appears to be satisfied with the status quo. In its conclusion, the Commission identifies as in need of review only one point of detail in the regulation of the mandatory bid: "acting in concert" (when shareholders cooperate in acquiring shares, which may trigger the mandatory bid rule, or in resisting a takeover bid). The Report also flags other issues related to the mandatory bid rule, such as national derogations, but the intention is to deal with them via infringement procedures or recommendations. With respect to the BNR and the BTR, the Commission's view is that the present framework is satisfactory and that no review is warranted. Hence, no overhaul of the Directive is to be expected any time soon. *See* Eur. Comm'n, *Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Region: Application of Directive 2004/25/EC on takeover bids*, COM (2012) 347 Final (June 28, 2012).

[142] We could find no study addressing whether it would be consistent with the principle of vertical subsidiarity for the Union to *require* member states to defer to private parties' choices, as we propose here. However, we can see no reason why such form of EU regulation should be contrary to the European Treaties. In fact, this would not be the first instance in which the EU requires member states to allow companies a choice between different regimes. *See* Luca Enriques, *EC Company Law Directives and Regulations: How Trivial Are They?*, 27 U. PENN. J. INT'L ECON. L. 1, 26–30 (2006).

[143] *See* Ferrarini & Miller, *supra* note 130, *passim* (arguing that "takeover regulation in both Europe and the United States becomes increasingly bidder-friendly with increasing geographic scope" and providing support for their thesis with regard to both the U.S. and Europe).

national level in resisting takeover laws that are not biased in their favor: in general, activist shareholders and institutional shareholders, who prefer an active market for corporate control, can counteract insiders' antitakeover pressures more effectively at the supranational level.[144]

C. *Implementing an Unbiased Takeover Law in the EU*

In order to make the introduction of an unbiased takeover law politically viable, legal reform should first mute the opposition from the constituencies carrying a vested interest in the status quo. To this end, the overhauled Directive should include two regimes. Regime A, applying by default to installed-base companies, should replicate the status quo in each member state. Regime B, applying by default to new-IPO companies, should be entirely takeover-unbiased. Keeping a suboptimal Regime A in place for installed-base companies allows a new, more efficient Regime B to be made available for all companies, old and new.

The implementation of regulatory dualism should take into account, however, the substantial variety in how the 28 EU member states have implemented the Directive. Thus, the Regime A supported by EU law will effectively consist of (i) different sets of default rules, depending on the member state where the company is listed; and (ii) additional default rules on matters previously regulated by mandatory rules. The latter applies most prominently to the mandatory bid rule.

Two specific applications of this framework—the BNR and the BTR—illustrate a regulatory dualism strategy. The BNR should become a default rule in those member states where it is currently mandated, and board veto should remain the default in those member states that have so chosen already.[145] Similarly, the BTR should not be the default except in those few member states (the Baltic Republics and, with regard to their limited-scope BTRs, France and Italy) that have not opted out of it.

Setting the default rules to correspond to the existing entitlements must be complemented by the appropriate procedural rules for altering the default regime. More precisely, the new regime should deal with three problems. First, managers' or controlling shareholders' opportunism should not drive the companies' choice. Second, because the optimal openness to takeovers is, in important respects, a function of time, industry developments, and evolving ownership structures, a company's choices should allow dynamic responses to changes in conditions: reversing the initial (implicit or explicit)

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[144] *See id.* On the role of British institutional investors in shaping the shareholder-friendly regime in the UK, see John Armour & David A. Skeel, Jr., *Who Writes the Rules for Hostile Takeovers, and Why? The Peculiar Divergence of U.S. and U.K. Takeover Regulation*, 95 GEO. L.J. 1727, 1767–76 (2007).

[145] By the same token, those member states that have adopted the reciprocity exception to the BNR should retain it along with the BNR default. *See supra* text accompanying notes 112–13.

choice should not be unreasonably difficult. Third, the lack of practicable alternatives to the default regime may lead to inefficient inertia.

Regulatory dualism can effectively overcome political resistance to the introduction of a takeover-unbiased law only if procedural rules permit those with an interest in maintaining the status quo the same right to block the decision to opt out of the status quo as they have under the current regime. This approach reflects a pragmatic recognition of the barriers to reform. The endowments to be protected under the mandatory bid rule are those of the investors who could face a forced redistribution of wealth by controlling shareholders opting out of the rule, for reasons of opportunism as well as of efficiency. To prevent this, installed-base companies should only be allowed to opt out of the mandatory bid rule with the approval of the majority of the minority. The same standard should govern opting out of pro-takeover rules, such as the BNR or the BTR, when they cease to be mandatory and become default.

The requirements are different, however, for opting into either the BNR or the BTR in those countries where they are *not* currently default or mandatory. According to the Directive, such countries already have to allow for an opt-in.[146] There would be no reason to make such an opt-in more difficult by requiring the approval, respectively, of management and of controlling shareholders, if that is not already the case under national company laws.

We believe that once the political economy problem is addressed in the fashion we have outlined above, the introduction of an unbiased takeover regime will outperform the current version of the Directive on three counts. First, a European regime that is more pro-takeover than the one currently in place will govern new IPO companies by default. We have labelled this Regime B.

Second, Regime B will be more unbiased than the status quo because companies can opt out of the pro-takeover default whenever it does not fit the circumstances: takeover restrictions become more efficient, for example, in post-crisis periods of increased idiosyncratic stock price volatility.[147]

Finally, and most optimistically, an unbiased takeover regime is a bet on the future and on the expectation that, under current circumstances, real economic growth will come from new companies rather than the installed base. The European Commission, with its efforts to encourage innovation and venture capital markets, shares this expectation.[148] Of course, this expec-

[146] *See supra* text accompanying note 115.

[147] *See* Merritt Fox, Edward Fox & Ronald J. Gilson, *Economic Crises and Share Price Unpredictability: Reasons and Implications* (American Law and Economics Ass'n, Working Paper 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=240712.

[148] *See, e.g.*, *Venture Capital*, EUROPEAN COMMISSION, http://ec.europa.eu/enterprise/policies/finance/risk-capital/venture-capital (last visited May 22, 2014) (describing the Commission's efforts "to unify the venture capital market in order to provide innovative small businesses with easier access to financing").

tation may prove to be wrong. However, even a new takeover Regime A, whose defaults are shaped by the political reality of the Olson problem, cannot make things worse. The Commission's decision to leave the Directive in place without significant reform is consistent with half of our proposal: it stops short of freeing up the dynamic sector of the economy, which our separation of the default rules governing installed-base and IPO companies would accomplish.

Thus, the EU should complement status quo-biased Regime A with a uniform Regime B, which will be the operative default for every company that goes public in any of the 28 EU member states after implementation. This regime should consist of primarily default and menu rules, chosen according to the criteria discussed in section II. Again, the default rules should be easy to opt out of if they are inefficient for a particular company, and they should be biased against the interest of those in control.

Finally, as we have argued throughout this article, defining an appropriate set of menu rules from which companies can craft a bespoke takeover structure is crucial to make opt-outs a viable alternative. This is especially the case in Continental Europe, where the mandatory structure of corporate law is deeply ingrained in the minds of lawyers and judges.[149] Here again, legislation at the EU level can play a role by requiring member states to introduce menu provisions currently unavailable under national law.[150] Two applications of this approach are the poison pill and a reformed BTR, which we briefly discuss below.

The reformed Directive should include the poison pill among its menu rules. The reason is that the poison pill is an unbiased device, whose antitakeover effect depends entirely on the rules governing its redemption.[151] The poison pill's advantage lies in the simplicity of its form; its complexity arises when specifying the timing of its redemption—something the Delaware courts have struggled with for some twenty-five years.[152] As a result,

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[149] *See* Katharina Pistor, *Legal Ground Rules in Coordinated and Liberal Market Economies*, *in* Corporate Governance in Context: Corporations, States, and Markets in Europe, Japan, and the US 249, 263–67 (Klaus J. Hopt, Eddy Wymeersch, Hideki Kanda & Harald Baum eds., 2005).

[150] In principle, EU law could simply prohibit member states from constraining freedom of contract on takeovers. But such a prohibition would be ineffective, both because it would be easy to circumvent and because it would say nothing about which menus should be available under national law. Supplying menu rules directly at the EU level is therefore the best strategy to prevent member states from undermining an unbiased structure for takeover law. Nevertheless, European regulation should not prevent member states from enacting their own menu rules in this area.

[151] *See* Gilson, *supra* note 24, at 39.

[152] In Delaware, for example, the case law provides an informal but contested menu, over which the Delaware Supreme Court and the Chancery Court have been at odds for twenty-five years over the tenure of three different Chancellors. *See supra* note 24. In an opinion written by Chancellor Chandler, the Court of Chancery recently commented that the Supreme Court had determined that a staggered board did not make a proxy fight unrealistic, even though the Chancery Court was not aware of a single occasion in which a bidder actually pursued proxy contests at two successive annual meetings. *See* Air Products and Chemicals, Inc. v. Airgas,

including the pill in a fully specified menu term is essential to its usefulness. For example, the Canadian Securities Administrators recently proposed regulatory menu terms for a valid poison pill. Under this proposal, a board would be allowed to keep a poison pill in place indefinitely so long as a majority of shareholders approve the pill within 90 days of its adoption and reaffirm this support in an annual vote.[153]

If the menu terms are carefully crafted, the availability of the poison pill can go a long way towards making all other defensive tactics (and particularly value-destroying ones) redundant. The poison pill is thus a useful device for IPO companies whose management wishes to retain the 1S1V default while reserving more discretion than the shareholder choice default provides. In this setting, a blockholder of a company with a pill in place remains more exposed to a takeover than if she held high voting shares in a two-class structure (an option available at the IPO stage) because the limits imposed by the menu terms would constrain the pill's impact compared to leveraged votes from the two-class structure.[154] The pill can also be more easily dismantled than collapsing a two-class stock structure, because redeeming the pill does not require changing the rights of outstanding stock. Thus, in theory, making a pill available provides an IPO company with a less entrenching (depending on the terms governing its use) solution than a dual-class stock structure. So long as the poison pill is or can be deemed to be incompatible with the current state of EU law or with the law of some member states,[155] a revised Directive should provide a menu term that fully specifies the terms of an acceptable poison pill.

An unbiased Directive could also enhance freedom of choice at the company level by offering a slightly different version of the BTR as a menu rule. The BTR is currently a menu rule in the vast majority of EU countries, but no company has ever opted into it. This suggests that the BTR is not useful in its current form. As emphasized by various commentators, the BTR

Inc., 16 A.3d 48, 57–59 (Del. Ch. 2011). Chancellor Chandler also expressed his disagreement with the Supreme Court's view. In this respect Chandler's position echoed the same disagreement voiced by his predecessor (*see* City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787, 797–99 (Del. Ch. 1988) (Chancellor William T. Allen)), and his successor (*see* Chesapeake v. Shore, 771 A.2d 293, 324–25 (2000) (then Vice Chancellor, now Chief Justice Leo E. Strine, Jr.)).

[153] Security Holder Rights Plans, 26 O.S.C.B. (proposed Mar. 14, 2013) (Can.) *available at* http://www.osc.gov.on.ca/en/SecuritiesLaw_ni_20130314_62-105_security-holder-rights-plan.htm.

[154] Note that the U.S. experience shows that a poison pill can be crafted to prevent proxy fights as well (by restricting its redemption by newly elected board members) and to make it difficult to redeem at all (through a "dead-hand" pill). The Delaware courts, however, quickly invalidated this overly clever legal effort. Carmody v. Toll Bros., 723 A. 2d 1180 (Del.Ch. 1998). We do not need to delve here into the details of what restrictions on the terms of the pill should characterize the menu rule we envisage. Of course, careful attention should be given to these aspects in drafting the menu rule.

[155] Jeffrey N. Gordon, *An American Perspective on Anti-Takeover Laws in the EU: The German Example*, *in* REFORMING COMPANY AND TAKEOVER LAW IN EUROPE, *supra* note 41, 541, 547.

is effective against only some control enhancements (e.g., dual-class shares), but not against others (e.g., pyramids).[156] In addition, whenever the BTR is triggered, the person whose control enhancement is removed is entitled to "equitable compensation of any loss suffered."[157] The latter provision has created significant uncertainty in the member states, which also may explain why most of them have opted out of the BTR.[158] However, if reinterpreted contractually within the framework of our unbiased approach, an individually crafted BTR may play a useful role as a sunset clause.[159] In a setting where the founder believes that the market will undervalue the company's stock because of its dependence on future growth options, a BTR's becoming effective at a specified date (e.g., ten years after the IPO) would both credibly inform the market of the reason for the departure from 1S1V and provide a timeframe in which growth options will have to materialize, in effect buying the founder time. While we have shown earlier that a leveraged control structure always gives the controlling shareholder an option to give it up if the price of the leverage as reflected in the market discount gets too high, opting into a sunset-style BTR may allow the controlling shareholder to avoid some or all of the discount that would reflect the anticipation of private benefit extraction.[160]

Conclusion

Crafting effective takeover regulation and reconstructing existing regulatory structures requires that we solve simultaneous equations. First, takeover regulation must be efficient; it must facilitate efficient takeovers and discourage inefficient takeovers. Devising screens that implement this distinction is difficult, because the determination must be made based on the circumstances of particular companies and particular bids. Second, takeover regulation must be politically viable, that is, it must address the Olson problem: the ability of incumbents to block regulation that dilutes their existing endowments. The unbiased takeover regulation presented here solves both

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[156] *See, e.g.*, Coates IV, *supra* note 41, at 683–85.

[157] *See* art 11(5) of the Directive.

[158] *See* Peter Mülbert, *Make It or Break It: The Break-Through Rule as a Break-Through for the European Takeover Directive, in* Reforming Company and Takeover Law in Europe *supra* note 41, 711, 735.

[159] On the utility of sunset clauses in order to combine flexibility with commitments, see Bebchuk, *supra* note 81, at 751–52.

[160] In order for the BTR to become an effective menu rule—at least more effective than it has been so far—the Directive should induce companies to contract on specific issues. This may require that the restrictions covered by the BTR be identified, compensation for their removal be defined and an expiration date be fixed as conditions for enforcing the new BTR as a standard term. For the reasons explained earlier (*see supra* text accompanying notes 71–75), corporate contracting cannot be expected to be so creative as to devise entirely tailor-made sunset clauses for companies that opt into takeover restrictions. However, when this would be efficiency enhancing, companies can well be expected to opt into an off-the-rack sunset-style clause featuring little uncertainty as to both its legal enforceability and its effectiveness against the specific restriction(s) in place.

equations. It accomplishes this by specifying that shareholders determine a takeover bid's success as a default rule. This would apply only to IPO companies: the existing takeover regime would remain the default for installed-base companies. A strategy of regulatory dualism would put an economically efficient takeover regime in place and rely on the dynamics of growth to bring along existing companies.