The Case for Managerial Signaling in Adjudicating Hostile Takeovers

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Abstract

In this paper, I put forward a new regime to strengthen efficiency, fairness and clarity in adjudicating hostile takeovers in Delaware. Under my proposed reform, in order to successfully articulate a cognizable “substantive coercion” threat to corporate effectiveness and policy, target managers will be encouraged to credibly signal their beliefs against the bid. In particular, they will be encouraged to commit that if the bid fails they will purchase, and hold for a specified time, a certain amount of at-the-bid price target’s stock. Alternatively, incumbents might commit to convert an equivalent economic value of their future stock-based compensation into at-the-bid price target stock, and hold it for the long-term. Once incumbents communicate their credible signal against the bid, courts will allow them to use proportionate defensive tactics, including a “poison pill”, to fend off the unsolicited bidder.

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INTRODUCTION

A central issue in the debate over takeover law has been whether boards should have the power to block unsolicited takeover bids. The allocation of power between boards and shareholders in deciding unsolicited bids has undergone many changes and much development in the past forty years, receiving the frequent attention of both lawmakers and takeover players. Legislators and courts have been busy developing a rich body of takeover doctrine, raiders have been developing takeover techniques and state-of-the-art financial instruments to finance multi billion dollar takeovers, boards have been developing a wide array of takeover defenses, and shareholders have become increasingly active in pressing firms to dismantle techniques of takeover defense. An army of lawyers and investment bankers has been busy assisting both boards and raiders while charging lucrative fees.

Despite disagreements over who – directors or shareholders – should decide unsolicited takeovers, there is a wide agreement on the importance of this matter. Takeover law essentially determines who will have the power to decide when the corporation is for sale. Board veto supporters argue that boards are better situated for this task due to their advantageous expertise, information, and long-term focus, coupled with an inefficient stock market in which shareholders are situated. But, recent successful shareholder campaigns to dismantle defensive tactics indicate that shareholders are not happy with giving boards the power to protect them from opportunistic bids. Shareholder-power supporters contend that shareholders will make a better decision than incumbents because the latter are likely to lose their jobs if a bid succeeds; hence they have a conflict of interest with shareholders. These advocates support their stance with empirical studies that show that insulation from the threat of hostile takeovers tends to lower firm value.

In Delaware, where most U.S. firms are incorporated, the Supreme Court adopted an intermediate standard of review for its takeover law doctrine in 1985, and in 1990 explicitly incorporated Professors Gilson and Kraakman’s concept of "substantive coercion". According to this concept, courts will allow a target board to use proportional defensive tactics, including a “poison pill”, against an unsolicited bid, if incumbents articulate a risk that shareholders will erroneously accept an underpriced offer.

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1 See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.1985).
3 The term "poison pill" describes a family of "shareholder rights" that are triggered by an event such as a hostile tender offer or the accumulation of voting stock above a designated threshold (usually 15 percent of outstanding stock) by an unfriendly buyer. When triggered, poison pills provide target shareholders (other than the hostile bidder) with rights to purchase additional shares or to sell shares to the target on very attractive terms. These rights impose severe economic penalties on the hostile acquirer and usually also dilute the voting power of the acquirer's existing stake in the firm. Although poison pills are considered to be absolute deterrents to a hostile takeover, they can almost always be cheaply and quickly altered or removed by target management. Therefore, hostile takeover activity has been moved directly into the boardroom, through the increasing use of proxy fights in conjunction with tender offers that are conditional on the bidder gaining control of the board or approval from the incumbent board. This hybrid proxy/tender offer approach is considerably more expensive, time-consuming, and risky
Unfortunately, as Ronald Gilson himself has noted, "only the phrase and not the substance captured the attention of the Delaware Supreme Court". The reason is that courts are inherently challenged in adjudicating “substantive coercion” on both their process-based and content-based reviews. Directors can fairly easily demonstrate good faith and reasonable investigation by getting the approval of independent directors, and by relying on advice from financial and legal experts. But the true independence of these institutions is doubtful. On the content side, showing that a bid is underpriced compared to the target’s value if it stays independent is largely subjective as well, because these same experts rely on highly subjective financial assumptions that are hard to attack.

Despite the flawed implementation of substantive coercion, the concept is important, as it is intended to protect shareholders from opportunistic bidders in situations where shareholders stand to get it wrong on their own. They may be mistaken due either to their lack of information or expertise, or to their short-term focus. It is therefore important that the board of directors, which is better positioned to evaluate the bid, be able to protect shareholders in these situations. The challenge, however, is that target boards have a significant conflict of interest with shareholders in deciding hostile takeovers.

In 2002, Professor Bebchuk argued that allowing conflicted boards to block unsolicited bids is undesirable and proposed that, once undistorted shareholder choice is ensured, they should be vested with the power to decide takeovers. He contended that in order to protect shareholders from accepting an opportunistic bid, managers should be allowed to signal them their beliefs against an unsolicited offer by committing to purchase, if the bid fails, a certain amount of at-the-bid price some specified number of target shares and hold them for a specified period of time. The Delaware courts, however, have not taken this route. A recent Delaware decision endorsed board veto power and ruled that a potent antitakeover tactic, the “poison pill”, has no set expiration date.

than the hostile tender offer of the eighties. Consequently, hostile takeover activity has declined sharply, and the campaigns that have been waged were long, drawn-out proxy battles. The array of takeover defenses includes charter amendments that require supermajorities (i.e., votes of 70 percent or even 80 percent of shareholders) to approve a merger; dual-class restructurings that, by creating two classes of stock, concentrate voting control with management; litigation against the hostile suitor (usually alleging violations of antitrust and securities laws); and purchasing the hostile bidder's foothold stock at a premium to end the takeover threat (so-called green-mail payments). Although these particular defenses often are effective at delaying the hostile bidder, they rarely are enough to keep a target company independent. The “poison pill”, however, is a "show-stopper", and hence I focus on it.

4 See Paramount Commc'ns, Inc. v. Time, Inc., supra note [ ].
5 See Ronald J. Gilson, Unocal Fifteen Years Later (And What We Can Do About It), 26 DEL. J. CORP. L. 491, 497 (2001).
6 See Paramount Commc'ns, Inc. v. Time Inc., supra note [ ], at 1152; see also Unocal Corp. v. Mesa Petroleum Co., supra note [ ], at 955.
8 Id., at 1002.
The new approach put forward in this article builds on Bebchuk’s proposal to encourage incumbents to signal their beliefs against the hostile bid by spending some of their own funds to purchase from the company at-the-bid price some specified number of shares and hold them for a specified period of time. Alternatively, my mechanism also allows incumbents to commit to convert equivalent economic value of their future stock-based compensation into at-the-bid price target shares, and hold them for the same period of time.

But in contrast to Bebchuk’s proposal, my reform aims to assist courts in adjudicating substantive coercion rather than to assist shareholders in deciding whether to accept an unsolicited bid. Even if it is possible, as I show in this article, to develop a formula for credible signaling, some one or some body needs to enter the values for the variables so the formula can establish a credible signal in specific cases. Given the inherent conflict of interest between managers and shareholders and given shareholders’ lack of information and expertise, only courts can play this role. Furthermore, even if shareholders had enough information or expertise to decide whether managerial signal was credible, arbitrageurs, who seek quick short-term profits, could dominate the target’s shareholders and distort their choice. Finally, should courts not allow incumbents to fend off the bidder under my proposed scheme, management willingness to signal at a certain level or lack thereof would aid shareholders to decide whether to accept the bid.

The reform would increase efficiency, fairness and clarity in Delaware’s adjudication of substantive coercion. It would improve efficiency by capitalizing on the fact that boards are best positioned to know whether an unsolicited bid stands to better long-term shareholder welfare. Such competency comes from the board’s advantageous information, expertise, and long-term horizon. At the same time, the proposed reform would resolve the conflict of interest between incumbents and shareholders by putting boards in the shoes of long-term shareholders and require them to credibly signal their genuine professional stand. Fairness would be improved because under the new regime, faithful boards would be better off as well as long-term shareholders, whose beneficiaries represent a substantial portion of the adult population. Clarity would be attained because managerial signaling would be conclusive in adjudicating substantive coercion.

The paper continues as follows. Chapter I reviews the debate over board veto in deciding hostile takeovers. Chapter II discusses the various problems with adjudicating substantive coercion today. Chapter III puts forward my proposal to reform substantive coercion and addresses potential objections. Finally, I conclude.
I. THE DEBATE OVER BOARD VETO IN DECIDING HOSTILE TAKEOVERS

Who – directors or shareholders – should have the ultimate power to decide whether the corporation should be sold to an unsolicited bidder? Contestants in this debate have been unable to reach any middle ground. For many, the takeover debate lies at the heart of a struggle between two competing models of corporate governance that divide academics, practitioners, and policy makers. The takeover debate gets to the heart of the corporate governance debate because it essentially determines who will have the power to decide whether the corporation is for sale.

Led by Marty Lipton, proponents of the traditional board-centric model of corporate governance argue that only the boards of directors, and not shareholders, should be arbiters of corporate policy. Letting boards decide takeovers, as well as all other corporate matters, is the only way to ensure the efficiency of the corporate form as a way to raise capital and to promote economic growth. Others in the corporate governance dialogue, most prominently Lucian Bebchuk, argue an opposing brief. In Bebchuk’s view, the traditional corporate model has failed, because of imperial, over-compensated executives and uninvolved boards of directors. Therefore, shareholders should be allocated more power to make corporate decisions. In the case of unsolicited takeovers, once undistorted shareholder choice is ensured – which can be done by making it necessary for hostile bidders to win a vote of shareholder support - boards should not have veto power.

A. The Traditional Debate over Who Should Decide Hostile Takeovers

As this article proposes a mechanism to assist courts in deciding when boards should be granted a veto power in blocking hostile bids, I first introduce the general arguments discussed in the literature for and against board veto in hostile takeovers.

1. Arguments against a board veto regime in deciding hostile takeovers

Board veto opponents perceive target board power to block unsolicited acquisition offers as a serious impediment to efficient corporate governance. They contend that shareholders, rather than managers, can better serve themselves in deciding hostile takeovers. There is no justification for treating shareholders paternalistically. In particular, there is no reason to attribute ignorance, irrationality or hubris to shareholders. It is often the case that “the stockholders know what they need to know…to make an

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13 A non-paternalistic view to shareholders was the underpinning reasoning of the seminal court decision in Basic, Inc. v. Levinson, 485 US 224, 234 (1988).
informed decision”. This view is supported by the fact that, on average, sophisticated institutional investors own more than 70 percent of the shares of the largest 1,000 U.S. public companies.15

Board veto opponents argue that the conflict of interest between incumbent managers and shareholders will encourage managers to block too many offers. Their interests in the face of a tender offer depend on the tradeoff between managerial takeover gains, resulting from share ownership in the target firm and golden parachute payments, on the one hand, and their potential losses in future compensation, reputation, perquisites and intangible benefits of control, on the other hand. For shareholders, resisting an initial tender offer bid depends on the tradeoff between securing the success of a premium bid and increasing their bargaining power to improve the bid. Cotter and Zenner show in their empirical study that resisting a tender offer is clearly and significantly less desirable for shareholders than for managers.17

Easterbrook and Fischel argue that resistance by a corporation's managers to premium tender offers, even if it triggers a bidding contest, ultimately decreases shareholder welfare.18 The reason is that the value of any stock can be understood as the sum of two components: the market price that will prevail if there is no successful offer (multiplied by the likelihood that there will be none) and the price that will be paid in a future tender offer (multiplied by the likelihood that some offer will succeed). Although board resistance might increase the price of a tender offer when it succeeds, such resistance also makes it less likely that such an offer will actually go through. Overall, shareholders would be better off if board resistance were all but proscribed.

This line of thought, according to which managers might block hostile bids that are likely to increase shareholder value, is supported by a series of empirical studies. First, Jensen and Ruback find evidence which indicates that corporate takeovers generate positive gains, that target firm shareholders benefit, and that bidding firm shareholders do not lose. Therefore, they argue that the market for corporate control is best viewed as an arena in which managerial teams compete for the rights to manage corporate resources.19 Second, empirical studies suggest that managerial resistance to takeovers destroys shareholder value. In the short term, when management resistance fails a bid, shareholders lose 21 percent of their share value on average.20 Consistent with this

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14 See Air Prods. & Chems., Inc. v. Airgas, Inc., supra note [ ], at 57.
16 In this paper, I refer to the set of managerial benefits that include future compensation, reputation, perquisites and intangible benefits of control as “private benefits of control”.
17 See James F. Cotter & Marc Zenner, How Managerial Wealth Affects the Tender Offer Process, 35 J. FIN. ECON. 63, 86 (1994) (reporting that “shareholders do not necessarily gain due to resisting a tender offer while managers gain from their resistance”).
18 Id.
20 See James F. Cotter & Marc Zenner, supra note [ ].
observation, and despite the possible increase in shareholder bargaining power, once management initially resists a hostile bid, the market responds unfavorably with 28 percent reduced increase following the bid announcement compared to a bid that is not resisted by management. In the long-term, Bebchuk, Coates and Subramanian found that, during the thirty months following the unsolicited offer, target shareholders stock return is, on average, 54 percent lower for targets that stayed independent compared to targets that were acquired.

The adverse consequences of insulation from the market of corporate control expand to undesirable managerial behavior ex-ante, before a bid has been placed. In particular, knowing that they will not be punished for poor performance by a hostile bidder, managers who have a veto power over takeovers tend to generate sub-optimal operating performance and over-consume private benefits of control. Furthermore, the insulation from takeover threats results in higher paychecks for executives, higher levels of managerial slack and higher tendency to engage in empire building.

Michael Jensen suggests that high leverage hostile takeovers (leveraged buyouts, or LBOs) alleviate the conflict of interests between managers and stockholders. According to his "free cash-flow" theory, such acquisitions can be powerful disciplining devices, because they force companies with ample cash flow but few potentially profitable investment projects to pay out the excess cash to shareholders. Managements that fail to pay out excess cash, instead investing it in diversifying acquisitions or in low pay-off projects, will cause the stock price of their companies to be below their optimal value, making themselves vulnerable to LBOs. LBOs force managements to sell unprofitable divisions, avoid low pay-off investments, eliminate wasteful corporate expenses and diversifying acquisitions, and boost operating efficiency in order to meet the interest charges on the high level of debt. These forced efficiencies create net economic gains for shareholders.

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21 Id.
2. Arguments for a board veto regime in deciding hostile takeovers

First, board veto supporters contend that a root cause for the desirability of board veto is that managers have better expertise than shareholders to decide the business and affairs of the corporation. Managerial expertise and the separation between ownership and control is a mainstay of American corporate governance and Delaware corporate law. Hostile takeovers present an extremely important decision for the future business of the corporation and for corporate governance, and the regime that governs this situation should be in line with the regime that controls other business decisions of the corporation.

Second, boards’ possession of private information about the target situates them in a unique position to protect shareholders from inadequate bids. Such private information includes secret and proprietary commercial information, strategic planning for the future business and organization of the corporation, and evaluation of future trends inside the corporation and its relation to external factors. Therefore, the argument goes, target boards are better equipped than shareholders to evaluate the future value of the target if it stays independent and boards would decide better than shareholders whether any given offer is worth accepting.

Even if private information is immaterial for stock prices, board veto is particularly warranted when stock markets are inefficient so that stock prices deviate from their fundamental values. Most financiers believe that stock markets are neither perfectly efficient, nor perfectly inefficient. Therefore, in reality, a financial market can not be considered to be extremely efficient, so at least sometimes stock prices will not fully reflect all of the publicly available information. Hence, boards should serve as the gatekeepers that prevent opportunistic raiders from taking advantage of stock market frictions in order to takeover inefficiently underpriced corporations, which will fair better if stay independent.

Third, practitioners and academic commentators who believe that target boards should have a veto power to resist hostile takeover bids have used the “bargaining power hypothesis” to support their view. This hypothesis states that a target with a veto power will extract more in a negotiated acquisition than a target without a veto power, because the acquirer’s no-deal alternative, to make a hostile bid, is less attractive against a board with a veto power. The Delaware courts endorsed the “poison pill” based on this justification, and have recently ruled that the pill has no expiration date.

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27 See DEL. CODE ANN. tit. 8, § 141(a) (stating that: “The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors”).
28 See Robert Charles Clark, Corporate Law (1986), 1.2.4 and 3.1.1.
29 See Guhan Subramanian, Bargaining in the Shadow of Takeover Defenses, 113 (3) Yale L. J. (2003), 621, 621. For early work putting forth this view, see, for example, Leo Herzel et al., Why Corporate Directors Have a Right To Resist Tender Offers, 61 CHI. BUS. REC. 152, 154 (1979); Martin Lipton, Takeover Bids in the Target’s Boardroom, 35 BUS. LAW. 101, 108 (1979); and William H. Steinbrink, Management’s Response to the Takeover Attempt, 28 CASE W. RES. L. REV. 882, 893 (1978). For work from the 1980s, see, for example, David D. Haddock et al., Property Rights in Assets and Resistance to Tender Offers, 73 VA. L. REV. 701, 705-06 (1987); Dale Arthur Oesterle, The Negotiation Model of
Fourth, board veto supporters contend that shareholders, including institutional investors, should not have power to decide takeovers because they tend to pursue short-term profits.\textsuperscript{32} A large percentage of a target company’s shares are often held by merger arbitrageurs who bought into the target stock when the bid was first announced, at a time when the stock was trading for a low price. These investors would be willing to tender into an inadequate offer because they stand to make a significant return on their investment even if the offer grossly undervalues the target in a sale.\textsuperscript{33} Institutional shareholders, who generally control more than 70 percent of the equity markets,\textsuperscript{34} hold their stock for the short-term,\textsuperscript{35} and therefore their concerns might be myopic as well. Boards should protect the long-term value of the corporation from short-term investors, and should not be pushed to focus on the short-term by threats of unsolicited bids.\textsuperscript{36}

Board veto supporters do not merely argue that shareholders are focused on the short-term but also that managers are focused on the long-term. Executive compensation arrangements encourage managers to focus on the long-term by introducing specific devices such as Long-Term Incentive Plans (“LTIP”)\textsuperscript{37} and Stock Ownership Policies (“SOPs”).\textsuperscript{38} Therefore, management teams have better incentives than shareholders to defend the long-term value of the target corporation.

\textsuperscript{33} See Air Prods. & Chems., Inc. v. Airgas, Inc., supra note [ ].
\textsuperscript{34} See Leo E. Strine, Jr. One fundamental corporate governance question we face: can corporations be managed for the long term unless their powerful electorates also act and think long term?, 66 BUS. LAW. 1 (2010), at 5.
\textsuperscript{35} For example, hedge fund turnover is estimated at around 300 percent annually. See Iman Anabtawi, Some Skepticism About Increasing Shareholder Power, 53 UCLA L. REV. 561, 579 (2006). Also, the average portfolio turnover at actively managed mutual fund is approximately 100 percent per year. See Brian Reid & Kimberlee Miller, Mutual Fund and Portfolio Turnovers, RES. COMMENT. (Inv. Co. Inst. Nov. 17, 2004) (on file with The Business Lawyer) (reporting a 117 percent average annual turnover and 65 percent median annual turnover in stock mutual fund portfolios).
\textsuperscript{36} See Martin Lipton and Steven A. Rosenblum, supra note [14], at 205-14.
\textsuperscript{37} LTIP is a reward system designed to improve executives’ long-term performance by providing rewards that may not be tied to the company’s share price. In a typical LTIP, the employee (usually an executive) must fulfill various conditions and/or requirements that prove that he or she has contributed to increasing shareholder value. The incentives for doing this are usually conditional company shares, which are distributed in two parts. The first part represents an immediate distribution of half of the shares, while the remaining half of the shares will only be presented to the executive if he or she stays with the company for a predefined number of years.
Finally, Professors Arlen and Talley argue that even if board insulation from takeovers is bad for shareholders, there is no practical alternative for board veto. In particular, eliminating board veto would give managers an incentive to search for ways to thwart hostile bidders such that it would be difficult or impossible for courts to regulate those actions. Because these alternative tactics might destroy significant value, a shareholder choice regime is not necessarily value enhancing even if shareholders are better than managers in evaluating and responding to hostile bids.

B. Shareholders Recent Actions Indicate their Opposition to Board Veto

In sum, while board veto supporters emphasize the target board’s superior expertise and information, which better positions their members to evaluate the desirability of an unsolicited bid, board veto opponents stress that shareholders have better incentives to decide unsolicited takeovers. Unlike managers, who are incentivized to defend the corporate bastion in order to maintain their private benefits of control, shareholders have stronger incentives to maximize their own wealth.

During the 2012 proxy season shareholders increasingly engaged in corporate governance reforms and companies became more inclined to engage with shareholders. Such engagement is a result of greater shareholder power proscribed by recent regulatory reforms, such as the Dodd-Frank Act, limits on broker voting and other measures. Specifically, shareholders filed more proposals than in prior proxy seasons, proposals on corporate political contributions and lobbying activities surged, and 1 out of 10 companies in the Russell 3000 became subject to increased scrutiny by proxy advisory firms as a result of unsatisfactory shareholder say-on-pay vote. Furthermore, the number of financial and board seat activist campaigns being announced in 2012 did not only increase but challengers are also increasingly willing to target larger companies. In a recent independent survey, 78 percent of senior corporate executives and activist investors have expressed an expectation that shareholder activism will intensify even more in the near future.

The hottest governance issue in 2012 in shareholder activism was the pervasive and successful shareholder attempts to dismantle the potent antitakeover defense of staggered boards. Staggered boards were exceptionally potent in maintaining board veto in unsolicited takeovers, as they required challengers in a proxy fights to win votes in two

42 See SCHULTE, ROTH & ZABEL, SHAREHOLDER ACTIVISM INSIGHT (2012), at 4.
43 See Evidenced by staggering average support level of 80 percent of votes cast recorded in the Russell 3000. See Tonello Id. According to data from FactSet Research Systems, there were 303 S&P 500 companies with classified boards at the beginning of 1999, and that number declined to 126 at the beginning of 2012. That is, during this twelve-year period, the fraction of S&P 500 companies with classified boards declined from over 60% to less than 20% today; The significant shareholder support for deciclassification proposals is consistent with empirical studies reporting that classified boards are associated with lower firm value and inferior outcomes for shareholders. Follow SRP 2012 annual report references.
consecutive shareholder meetings. Empirical studies report that staggered boards are associated with lower firm value and inferior outcomes for shareholders. Consistent with these studies, staggered board was the top defense targeted by shareholders and consequently the number of S&P 500 firms with classified boards declined from over 60 percent in 1999 to less than 17 percent at the end of 2012. In 2012, the average support level for de-stagging reached 80 percent of votes cast recorded and 87 percent of proposals that went to a vote passed.

Third, over the past decade less companies have been adopting “poison pills” and more companies seek shareholder approval of new poison pill adoptions and extensions. “Poison pills”, or “shareholder rights plans”, have been devised as a way for target boards to prevent takeover bidders from negotiating a sale of shares directly with shareholders, and instead forcing the bidder to negotiate with the board. The number of poison pills in force has been consistently and drastically declining. While almost 60 percent of S&P 500 firms had a “poison pill” in 1998, only less than 8 percent of them had a pill in force in 2012.

In addition to the general decline in “poison pill” prevalence, many pills became subject to a shareholder say. In late 2004, ISS, the world’s leading provider of proxy voting and corporate governance services, adopted a policy recommending a withhold vote for director nominees at companies that do not give shareholders a say on poison pills. Consequently, companies started adopting or extending poison pills subject to shareholder approval and this trend has been consistently increasing.

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46 See Factset Research Systems, Inc., supra note [ ].
47 Id.
48 Id. However, the percentage of poison pills involved in proxy fights have been consistently increasing due to an increased number of firms that adopted a pill in response to an announcement of an unsolicited acquisition offer.
49 Companies often tailor their policies to meet ISS guidelines and firms lobby for ISS support to fend off shareholder proposals. For example, its “Against” voting recommendation on “Say on Pay” in 2012 resulted in a significantly reduced level of shareholder support of 65% versus 95% support in executive pay arrangements for firms fortunate enough to receive a “For” ISS recommendation. See John D. England, Say on Pay Soul Searching Required at Proxy Advisory Firms, Pay Governance (June 2012), at 1-2. Also see Pui-Wing Tam & Gary McWilliams, H-P Garners Major Endorsement Deal— ISS Advisory Firm Backs Acquisition of Compaq, WALL ST. J., Mar. 6, 2002, at A3 (reporting that “many money-management firms take ISS’s reports into account before voting in a proxy battle”).
50 Or committed to seek shareholder approval within 12 months of adoption.
51 The ratio of companies seeking shareholder approval for poison pills has increased from less than 5 percent in 2005 to almost a quarter of new pill adoptions or extensions in 2009. See Factset Research Systems, Inc., supra note [ ].
Figure 1 summarizes the decline of both “poison pills” and staggered boards” among S&P 500 firms:

**Figure I - S&P 500 Poison Pill & Classified Board Trend Analysis 2003-2012**

Source: www.sharkrepellent.net

Finally, in 2012 shareholders became more sensitive to forms of wealth transfers associated with takeovers other than antitakeover defenses. In particular, shareholders confirmed their support for arrangements that limit “golden parachutes”. Golden parachutes typically provide for wealth transfer from shareholders to senior executives if such executives’ employment is terminated as a result of a takeover or a merger, known as “a change of control”. Shareholder efforts to limit such payments indicate that shareholder intolerance of managerial control over the takeovers process goes beyond their aversion to managerial control over antitakeover defenses.

II. THE PROBLEMS WITH ADJUDICATING SUBSTANTIVE COERCION

Courts that adjudicate takeover defenses must be able to improve on the market’s efforts to distinguish when management is right and when it is wrong when deciding on defensive tactics against unsolicited takeover bids. Otherwise, the aggregate market data would support a total ban on defensive tactics. Therefore, the main challenge in developing a doctrine that would properly account for the arguments for and against board veto in responding to unsolicited bids is defining the type of cognizable threats that give rise to defensive responses, and then defining the type of responses that are adequate in response to such threats.

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54 See Lucian A. Bebchuk, John Coates IV & Guhan Subramanian, supra note [37].
Even if one takes the position that the purpose of the corporation is solely to maximize shareholder welfare, it is unclear how much freedom we should allow boards to exercise in deciding takeover bids. Faithful boards would find flexibility helpful to protect shareholders from inadequate bids, whether these bids are coercive, manipulative, opportunistic or merely underpriced. On the other hand, leaving target boards with free reign to self-interested boards might tempt them to fend off bids that are expected to remove them from their offices but also to enhance shareholder value.

Because of the "omnipresent specter" of entrenchment in takeover situations, a decision to defend against a change-in-control transaction, such as a decision not to redeem a "poison pill", in the face of a hostile tender offer is reviewed under intermediate scrutiny, between the lax business judgment rule and the tough entire fairness review. Under the Delaware intermediate standard of review, the target board of directors may use defensive tactics to prevent a takeover only where it can show that (1) it had "reasonable grounds for believing a danger to corporate policy and effectiveness existed" (i.e., the board has to articulate a legally cognizable threat) and (2) that any board action taken in response to that threat is "reasonable in relation to the threat posed."

A. Substantive Coercion Threat under the Unocal-Unitrin Intermediate Scrutiny Standard

55 See eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 20 (Del. Ch. 2010).
56 See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 950 (Del. 1985); see Air Prods. & Chems., Inc. v. Airgas Inc., supra note [ ], at 50. A corporate board's decision not to pursue a negotiated transaction, such as a merger proposal, or even a decision not to engage in negotiations at all, is perceived as a business decision with no conflict of interests involved, and hence is reviewed under the deferential business judgment standard. See Gimbel v. Signal Cos., 316 A.2d 599, 608 (Del. Ch. 1974). The rationale for the rule is the recognition by courts that, in the inherently risky environment of business, Boards of Directors need to be free to take risks without a constant fear of lawsuits affecting their judgment. See Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) (setting out rationale for the rule).

On the other hand, the entire fairness standard is triggered where a majority of the directors approving the transaction were interested or appear on both sides of a transaction. Once the entire fairness standard is triggered, the corporate board has the burden to demonstrate that the transaction was inherently fair to the shareholders, by both demonstrating fair dealing and fair price. See Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (stating the directors must exhibit the "most scrupulous inherent fairness of the bargain" when they are on both sides of a transaction).

58 See Air Prods. & Chems., Inc. v. Airgas Inc. supra note [ ], at 92; also see Unocal Corp. v. Mesa Petroleum Co., supra note [ ], at 95; See also Yucaipa Am. Alliance Fund II, L.P. v. Riggio, supra note [ ], at 335 (stating that "[I]t is settled law that the standard of review to be employed to address whether a poison pill is being exercised consistently with a board's fiduciary duties is [ ] Unocal.").
59 For the current standard of review see Chesapeake v. Shore, 771 A.2d 293, 330 (Del.Ch.2000) (citing Unitrin, 651 A.2d at 1375.) (stating that: “To demonstrate the existence of such a threat, management must show (in detail) how its plan is better than the alternative (the hostile deal) for the target's stockholders. Only then, if management met that burden, could it use a pill to block a "substantively coercive," but otherwise non-coercive bid”); for commentary – see Gary A. Bornstein, Recent Developments in Poison Pill Litigation, 856 PLI/Lit 767 (2011), Paul H. Edelman & Randall S. Thomas, Selectica Resets the Trigger on the Poison Pill: Where Should the Delaware Courts Go Next?, 87 IND. L.J. 1087 (2012);
The first hurdle of Delaware’s intermediate standard of scrutiny can be grouped into three categories of cognizable threats, as were initially recognized in Paramount Communications v. Time:60 (1) structural coercion, which is "the risk that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions"61 (i.e., a situation where shareholders are pressured to tender as a result of a two-tiered offer where the back end gets less than the front end); (2) opportunity loss, which is the "dilemma that a hostile offer might deprive target shareholders of the opportunity to select a superior alternative offered by target management;"62 and (3) substantive coercion, which is "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value."63

Of these three classes of threats, a substantive coercion claim places the most demanding burden, for both the target's management and the reviewing court. Where management alleges that a bidder’s offer is structurally coercive, a court needs only to determine if the hostile bid favors tendering shareholders compared to non-tendering ones. This even becomes easier since courts provide offerors a safe harbor by identifying the characteristics of an offer that is not structurally coercive.64 Similarly, in order to identify an opportunity loss threat from a hostile offer, a court needs only to determine whether management's alternative is itself structurally coercive. However, an allegation of substantive coercion requires much more than reviewing a simple statement of management's immediate plans and the terms of a hostile offer.

To support an allegation of substantive coercion, two elements should be proved:65 first, the board of directors should reasonably determine that the unsolicited offer is underpriced. Second, the board of directors should reasonably determine that shareholders will mistakenly accept that offer because of 'ignorance or mistaken belief' regarding the Board's assessment of the long-term value of the target stock.66

Showing that an unsolicited offer is underpriced may be based on a good faith expectation of a target board that the offer can be reasonably improved either by having the board negotiating with the bidder, looking for a white knight, or by determining that the long-term intrinsic value of the target is higher than the bid price.67 However, the
legitimate response to those threats differs. Whereas the first two determinations could justify leaving a poison pill in place for some period of time while the board protects stockholder interests (by either negotiating with the bidder or by finding an alternative transaction), the intrinsic value contention may justify a pill with no “set expiration date”.

Making an under-pricing allegation requires a detailed court determination about the plausibility of the target board’s claims. In particular, a target's board should provide more than a standard statement that management and its advisers believe the hostile offer to be "grossly inadequate." Rather, management should set forth its plan in sufficient detail to permit the court independently to evaluate the plausibility of management's financial assessments and evaluation of the existence of alternative plans and negotiations. Furthermore, management should demonstrate how and when it expects a target's shareholders to do better.

A statement of management's plans for doing better than the unsolicited bid might provide details for how defensive tactics are expected to provide time to find a better deal for shareholders or how these tactics are expected to provide bargaining leverage to increase the bid price of the current offer. Alternatively, it should set forth a plan for how it will increase the market price of the firm's shares by independently managing the firm's operations with a plan to sell assets, to cut costs, or to follow another strategy for improving the company's performance. Either way, however, management’s statement must have enough information and support to permit the court independently to evaluate the plausibility of management's claim.

After showing that the bid is inadequate, the board of directors should show that it is reasonably concerned that the target stockholders might tender to the bidder in ignorance or based upon a mistaken belief regarding the Board's representation of the long-term value of the target stock. Here the board has the burden to show one of the following two concerns. First, that the terms of the offer could cause stockholders to mistakenly tender if they did not believe or understand (literally) the value of the management alternative as compared with the value of the hostile bidder. This may happen if the terms of the offer are, for example, uncertain.

The second type of legitimate concern is the risk that target’s short-term investors will tender into the bidder’s offer despite its inadequate price tag, leaving the minority "coerced" into tendering as well. This might happen if the majority of target’s investors are short-term such as arbs, hedge funds and event-driven investors, who bought into the stock when the stock was trading much lower than it is today, and would be willing to tender into an inadequate offer because they stand to make a significant return on their

Kraakman at id. It was taken up, and was more or less adopted, by then-Chancellor Allen in City Capital Assocs. Ltd. P’ship v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988).


69 See Air Pros. & Chems., Inc. v. Airgas Inc., supra note [ ], at 129.

70 See Ronald J. Gilson & Reinier Kraakman, supra note [ ], at 268.

71 See Air Pros. & Chems., Inc. v. Airgas Inc. supra note [ ], at 108.
investment.

B. Recent Lawmaking Decisions Expand Substantive Coercion

Despite the continued decline in prevalence rate of antitakeover defenses, such as “poison pills” and staggered boards, and despite widespread shareholder pressure to dismantle these defenses, recent lawmaking decisions have expanded the legally cognizable boundaries of a substantive coercion threat. Consequently, they have expanded the legitimacy of an indefinite use of a poison pill defense to protect shareholders. In Air Products v. Airgas, the Delaware Chancellor, William Chandler, reaffirmed that the Delaware Supreme Court has recognized substantive coercion. Recognizing substantive coercion threat allows target board not to abandon their conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy. 72

Chancellor Chandler held that even when courts determine that there seems to be no substantive coercion threat - that “stockholders know what they need to know (about both the offer and the Airgas board's opinion of the offer) to make an informed decision” 73 courts may not substitute their business judgment for that of the target board, as long as the target board acted in good faith, and articulated a reasonable basis to believe a bid is inadequate. Then, the target board may block the hostile bid using a poison pill, irrespective of stockholders' desire to accept it, and may use pills for as long a period of time as the board deems warranted. 74

Chancellor Chandler ruled that the Airgas board has successfully articulated a sufficient threat that justifies the continued maintenance of Airgas's poison pill despite the fact that Airgas defensive tactics have given the Airgas board more time than any litigated poison pill in Delaware history (over a full year) to bargain with the hostile bidder, to inform its stockholders about its view of Airgas's independent value, to demonstrate its stockholders that Airgas is on track to meet its projected goals, and to communicate to its stockholders Airgas's value in an alternative sale transaction. Moreover, the Delaware court has confirmed that Airgas's stockholder base is sophisticated and well informed, and that essentially all the information Airgas shareholders would need to make an informed decision is available to them.

Therefore, the Delaware Chancery Court in Airgas concluded that in adjudicating substantive coercion courts should not focus on weighting whether target firm’s shareholders are actually likely to mistakenly tender their shares to an inadequately priced bid. Nor is the function of courts to examine whether target shareholders are well informed or sophisticated enough to not be fooled into an inadequate bid. Rather, courts should focus on making sure that the target board acted in good faith and articulated a reasonable basis to believe that the bid price is inadequate. In doing so, Chancellor Chandler did not specify that courts should examine whether board incentives are more

72 Id., at 58.
73 Id., at 57.
74 Id., at 129.
or less aligned with shareholders under the circumstances.

In Versata Enterprises v. Selectica, the Delaware Supreme Court expanded the cognizable boundaries of a substantive coercion threat by upholding a novel form of the poison pill that has recently been developed in order to protect shareholders from having as few as five percent of them accept an unsolicited tender offer – an event that by itself might trigger the loss of the target’s Net Operating Losses asset. By doing so, the Delaware court in Selectica affirmed the first pill threshold that was deliberately “bust through” by a hostile bidder in twenty years.

In Yucaipa v. Riggio, the Delaware Chancery Court expanded the cognizable boundaries of a substantive coercion threat in the context of a threat posed by a block holder investor who is interested to accumulate shares and thereby to undermine an existing controlling shareholder. In the Yucaipa case, the Chancery Court upheld the legal validity of Barnes & Noble’s poison pill that aimed to stop a new investor, Ronald Burkle, from accumulating new shares against the will of Barnes & Noble founder and thirty percent shareholder, Leonard Riggio. Vice Chancellor Strine justified the pill as a proportionate response to the cognizable threat posed by Burkle’s strategic disagreements with Mr. Riggio, that became contentious when Mr. Burkle’s was dissatisfied from a $596 million interested party transaction between Barnes & Noble, Mr. Riggio and his wife.

The federal securities agency, the SEC, has recently announced that it considers a Section 13(d) rule-making petition that will equip target boards with faster radar to spot alleged substantive coercion threats, and thereby to place low-threshold “poison pills” in the face of existing threats. The rule-making petition advocates for counting derivatives toward the five percent threshold of a company’s stock at which a shareholder must publicly disclose her holdings. It also aims to shorten the reporting time from ten days to two days from attaining such threshold. Such a reform is expected to limit the stakes of outside shareholders that incumbent managers disfavor at levels like ten or fifteen percent, even if these investors do not seek control.

C. A Critique of the Current Standard of Review for Substantive Coercion

Showing a “substantive coercion” threat matters a great deal. The recent Airgas ruling, as well as former-Chancellor Allen’s decision in TW Services, appears to support the view that a well-informed board acting in good faith in response to a reasonably perceived threat may, in fact, be able to "just say no" to a hostile tender offer.

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75 See Yucaipa American Alliance Fund II, L.P. v. Riggio, 1 A.3d 310 (Del. Ch. 2010).
76 See Beneficial Ownership Reporting Requirements and Security-Based Swaps, Release No. 34-64628, 76 Fed. Reg. 34,579, 34,581 (June 14, 2011) (“[O]ur staff is engaged in a separate project to develop proposals to modernize reporting under Exchange Act Section[] 13(d)”; see also CBS MARKETWATCH, SEC Eyes Faster Disclosure for Activist Funds (Feb. 25, 2011) (“[T]he chief of the SEC’s Office of Mergers & Acquisitions told [the press] that [the Staff] will recommend to the Commission that they should shorten the number of days [blockholders] have before they must publicly disclose [their] stake in the company.”). See Air Prods. & Chems., Inc. v. Airgas, Inc., supra note [ ].
Hostile bidders can easily design their offer such that it would not be “structurally coercive” by making sure that non-tendering shareholders will not fair less than tendering ones. An opportunity loss risk, alleging that the hostile offer is likely to deprive target’s shareholders of the chance to get a better alternative, even if successful, can only gain a limited time for defensive tactics. However, successfully showing a “substantive coercion” threat may justify a pill with no “set expiration date”.

Despite its importance, the notion of substantive coercion threat is inherently vulnerable to serious impediments. First, it has been recognized that “substantive coercion” is a slippery concept. To note abstractly that management might know better than shareholders what shareholders should do cannot be a basis for rubber-stamping for management entrenchment in the face of hostile takeovers when shareholders, on average, suffer enormous opportunity losses when hostile offers are defeated. Consequently, the Delaware Court of Chancery in Airgas has attempted to cut back on a broad conception of substantive coercion. In particular, Chancellor Chandler did not go all the way and say that inadequate price alone is sufficient to justify defensive measures. Instead, he included notion that there must be a fear that shareholders will actually tender into the offer.

Showing “substantive coercion”, just like the first hurdle of Unocal in general, is essentially a process-based review, and directors satisfy this test by demonstrating good faith and reasonable investigation. Proof of good faith and reasonable investigation is commonly conducted and is materially enhanced by the approval of a board comprised of a majority of outside independent directors.

However, there are serious doubts that independent directors actually provide a particular type of objective, shareholder-minded monitoring. A recent empirical study shows that boards appoint directors who, while technically independent according to regulatory definitions, nonetheless may be overly sympathetic to management. This evidence casts serious doubts that independent directors exercise an objective business judgment rather than being biased to vote in favor of management and against a hostile bidder. In the Airgas case, for example, independent directors who were nominated by the insurgent, Air Products, voted for management and supported its defensive tactics against the insurgent. It supports the view that independent directors have such a strong management-friendly mindset, which forces them to support management even when

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79 See Air Prods. & Chems., Inc. v. Airgas Inc. supra note [ ], at 129.
80 See Ronald J. Gilson & Reinier Kraakman, supra note [ ], at 278.
81 Supra notes [37] and [38].
82 Supra note [ ].
83 See Paramount Commc'ns, Inc. v. Time Inc., supra note [ ], at 1152; see also Unocal Corp. v. Mesa Petroleum Co., supra note [ ], at 955.
84 See Air Prods. & Chems., Inc. v. Airgas, Inc., supra note [ ], at 49
such a stand will directly hurt major interests of the firm that made them independent directors. 86

Boards routinely try to persuade courts that they exercise reasonable investigation by relying on independent financial advisors and on independent legal counsels. However, the credibility of such expert opinions is inherently flawed and hence courts should give only a limited weight to such opinions. 87 First, financial advisors possess significant discretion in issuing opinions as they have a choice among several widely disparate justifiable estimates to support their conclusions. 88 Second, financial advisors and legal counsels suffer from conflicts of interest in issuing their opinions, which derive, for example, from their desire to retain and attract business. These conflicts encourage independent advisors to issue opinions that will favor the interests of the managers who hired them, rather than furnishing opinions that merely reflect their genuine professional stand.

Moreover, even when courts can exercise a meaningful judicial review of management’s financial and legal allegations of substantive coercion, they struggle with an inherent tension imbedded in this standard. On one hand, substantive coercion is precisely about concluding that shareholders will mistakenly accept an inadequate price. On the other hand, courts are not willing to involve themselves with substituting their judgment as to what is a “better” deal for shareholders for that of the target’s board. 89 To make things even blurrier, despite their respect of board judgment, courts are not willing to defer to target boards when the threat that boards perceive for shareholders is merely “mild”. 90

But the inquiry does not end with process. No matter how exemplary the board's process, or how independent the board, or how reasonable are the expert opinions, to meet their burden under the first prong of Unocal target boards must actually articulate some legitimate threat to corporate policy and effectiveness. 91 Put differently, the "process" has to lead to the finding of a threat.

86 The vote of Air Products’ independent directors in Airgas can also be interpreted to support the opposing view, according to which independent directors exercise strong independent judgment even if such judgment works against their appointees.
88 In the Airgas case the financial experts’ wide discretion is attacked by Air Products and Shareholder Plaintiffs critique on the experts endorsement of two main aspects of Airgas's five year plan: (1) the macroeconomic assumptions relied upon by management, and (2) the fact that Airgas did not consider what would happen if the economy had a “double-dip” recession. See Air Prods. & Chems., Inc. v. Airgas, Inc., supra note [ ], at 110.
89 See Paramount Commc'ns, Inc. v. Time Inc., supra note [ ], at 1153.
90 See City Capital Assocs. Ltd. P'ship v. Interco Inc., 551 A.2d 787 (Del.Ch.1988) (deciding that a potential loss of $2 per share constitutes only a "mild threat" posed by the tender offer which does not justify defensive tactics).
91 See eBay Domestic Holdings, 2010 WL 3516473, at 12 (finding that despite defendants' "deliberative" investigative process, defendants nevertheless "fail[ed] the first prong of Unocal both factually and legally").
Credibly supporting the crucial assumptions that show a substantive coercion claim can be extremely challenging. When management contends that the non-structurally-coercive hostile bid is underpriced compared to the alternative of staying independent, it asks its financial advisor to construct a financial model. Such model should show that the present value of the long-term cash flow of the target staying independent is higher than the unsolicited bid price. However, insignificant changes in standard assumptions, such as growth rate, discount rate and working capital, can cause significant changes in the results of the financial model. For example, a minor change in discount rate from 5 percent to 6 percent decreases the net present value of a constant annuity by 20 percent.

Showing that management alternative is superior to the bid price becomes even more speculative when target boards contemplate to perform a significant merger, such as in Time, or a defensive restructuring, such as in Pillsbury and Interco. Then, more non-verifiable but significant assumptions have to be added to the financial models. Such assumptions include synergies, organizational reform value, market response, cultural integration etc. Given the inherent difficulty to provide credible financial opinions, there is no real mechanism today that provides credibility for management allegations for substantive coercion.

The lack of credibility for how courts have been deciding substantive coercion became so severe, that Ronald Gilson, who initially offered the concept, noted that "only the phrase and not the substance captured the attention of the Delaware Supreme Court" such that the "mere incantation" of substantive coercion now seems sufficient to establish a threat justifying a board's defensive strategy.

### III. Reforming Substantive Coercion

Corporate takeovers present the general agency problem between managers and shareholders in especially stark terms. On one hand, there are strong reasons to respect the separation of ownership and control in the context of unsolicited takeovers. We want boards, as having greater expertise and superior information than shareholders, to use their inside information and business expertise to protect shareholders from unsolicited bids that are inferior compared to what management plan to generate for shareholders. Managers may be able to generate such superior results either by staying independent or by soliciting alternative bids or by bargaining with the bidder.

On the other hand, allowing managers to deploy such expertise also gives managers the discretion to favor their own interests at the expense of their shareholders. Managers are likely to loose their private benefits of control when they stay passive and

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92 See Paramount Commc'ns, Inc. v. Time Inc., supra note [ ], at 1153.
94 See Ronald J. Gilson, Unocal Fifteen Years Later (And What We Can Do About It), 26 DEL. J. CORP. L. 491, 497 (2001).
let hostile bidders to offer shareholders to tender their shares at a significant premium. This might encourage managers to fend off efficient takeover bids that are expected to enhance long-term shareholder value.

The function of corporate law in general and the function of Delaware’s intermediate standard in corporate takeovers in particular is to establish safeguards so managers use their authority in good faith to maximize long-term shareholder value rather than to support managerial entrenchment. When managers act this way, the outcome is socially efficient, because corporate assets will be sold only when the bidder can extract higher value than incumbent managers.

Unfortunately, I show that the specific safeguards that are offered by Delaware’s intermediate standard, as applied to substantive coercion, do not offer an effective, clear or credible way to alleviate the inherent agency problem in corporate takeovers. In essence, the procedures that the Unocal-Unitrin intermediate standard offers does not induce managers to reveal their genuine professional stand on the desirability of an unsolicited bid. Instead, managers are encouraged to use corporate assets to hire outside directors, as well as financial and legal experts, that favor management. Under the current standard, there is no real and clear cost for self-interested managers that selfishly abuse such procedure to resist a value-increasing hostile bid. Moreover, financial experts enjoy large latitude in designing the subjective opinions and the checks and expertise that courts can exercise are limited.

Therefore, the law on takeovers should be reformed such that managers will be induced to reveal their genuine professional stand on the desirability of the hostile bid, and that courts will be able to better adjudicate the substance of managerial stand. Because takeovers involve such high stakes for the personal wealth of both shareholders and managers, managers should be required to express their genuine opinion about the desirability of the unsolicited bid with their own money rather than with the corporate money alone.

Reforming the law of substantive coercion is important not only because it is likely to turn the scale in the theoretical debate between the competing models in corporate governance. It will also decide practical and economically significant matters – takeovers are on the rise and are expected to grow, shareholders have been unprecedentedly active in successfully pushing companies to strip themselves from takeover defenses, and lawmakers have recently came up with rulings that affect the takeover landscape a great deal.

A. A New Approach to Adjudicate Substantive Coercion

Therefore, I put forward a proposal that will make managers put their money where their mouth is by credibly signal their beliefs as for the desirability of the unsolicited bid to their shareholders. Professor Bebchuk has already suggested that incumbents that view the target’s independent value as significantly higher than the bid price could credibly signal their estimate by committing themselves, in the event that the
bid fails, to spend some of their own funds to purchase from the company at-the-bid price some specified number of shares and hold them for a specified period of time.\textsuperscript{95}

Whereas Bebchuk’s proposal aimed to disallow defensive tactics, let shareholders decide on the bid and let incumbents try to convince shareholders to vote against the bid, the proposal detailed below aims to integrate managerial signaling into the law governing substantive coercion. By doing so, managers are encouraged to convince courts to allow the corporation to use defensive tactics. Obviously, if courts are not convinced by the signal, shareholders might still be persuaded by their managers’ signal, so managerial signaling has two chances to succeed under the reform proposed below.

The reform proposed in this article applies when a target board of directors is faced with a tender offer directed to the stockholders of the corporation, and articulates before the court that the unsolicited bid poses a cognizable substantive coercion threat to the corporate enterprise and therefore the board should be allowed to address that perceived threat by placing or maintaining defensive tactics. Then, the target board may commit its top-five executives to signal their beliefs against the hostile bid by committing to purchase, if the bid fails, and hold for the long-term, a certain amount of at-the-bid price target’s stock. Alternatively, incumbents will have to commit to convert an equivalent economic value of their future stock-based compensation into at-the-bid price target stock, and hold it for the long-term.\textsuperscript{96} Such stock holding commitment will apply in addition to any other stock holding requirement, such as applicable vesting schedules, stock ownership policies, retention policies, or holding period requirements.

The managerial burden of signaling, under the proposed reform, will be on the target’s top-five executives. For purposes of the reform, the definition of top-five executive team should follow the SEC rules in this regard. The SEC defines this group to include the CEO, CFO and the other three highest paid of the remaining executive officers. I chose the top-five executives to perform the signaling task for several reasons. First, they extract significantly more pecuniary private benefits of control than non-executive directors and proportionately less non-pecuniary benefits, which are harder to quantify.\textsuperscript{97} Second, the top-five executive team is most involved in the target’s business decisions and hence is more likely to evaluate correctly the target value if stays independent. Unlike non-executive directors, who devote about 17 hours per month to the governance of the corporation,\textsuperscript{98} the top-five executives are full time employees of the target.\textsuperscript{99} Third, I chose the top-five executives and not only the CEO to chip-in to the

\textsuperscript{95} See Lucian Bebchuk, \textit{The Case Against Board Veto in Corporate Takeovers}, 69 UNI. CHI. L. REV. 973, 1001 (2002).

\textsuperscript{96} i.e. if bid is at 120, the stock price is 100, and the manager is supposed to be granted 100 stock, she would be granted only 83.3 stock.

\textsuperscript{97} While the former’s total compensation (including retainer, meeting fees, and equity grants) for board service was 216,700$, the latter’s total compensation stood on $3,935,000. \textit{See Deloitte Inc. 2012 director compensation report} (Dec. 2012); \textit{see Equilar Inc. 2012 Executive Compensation outlook Report Extended}, (Feb. 2012), at 13.

\textsuperscript{98} Such amount of hours reflects the time commitment of typical directors of the largest multinational corporations. \textit{See KORN/FERRY INT’L, 33RD ANNUAL BOARD OF DIRECTORS STUDY 23} (2006).

\textsuperscript{99} \textit{See Kelli A. Alces, Beyond the Board of Directors, 46 WAKE FOREST L. REV. 783, 783} (2011).
managerial signaling effort because executive compensation reporting is directed primarily to every one of them. Also, in some firms, members of the top-five executive team other than the CEO capture a significant fraction of the team’s pecuniary private benefits of control. Finally, it is better to exclude non-executive directors from the signaling group, so they can play a constructive role in alleviating potential collective action problems within the signaling group.

I propose a menu of two alternatives for managerial signaling. Managers may spend some of their own liquid funds in order to purchase the signaling stock, or alternatively, incumbents may commit to use their future stock-based compensation in order to produce the same signal. For example, under the first signaling option, the top-five executive team may signal by committing to hold 100 target shares at the bid price, and hold it, say for 5 years, if the bid fails. Let’s assume that the bid price is $1. Under the second option, the same team will signal by committing, if the bid fails, to convert a $100 value of its future stock-based compensation into $1 target stock, and hold it for 5 years as well. Let’s assume that in the end of the year the team will be granted $100 worth of restricted stock and that the target stock price at that time will be only 50 cents. Then, the team will have to commit, if the bid fails, to be granted only 100 shares instead of 200, and hold them for 5 years as well. The two options that I propose are economically equivalent, because both of them commit the team to purchase some specified value of at-the-bid price target stock and hold it for the same period of time. The advantage of adding the second option is to avoid situations where liquidity-constraint executives will refrain from signaling, even when they genuinely evaluate the bid as detrimental for long-term shareholders.

Courts should develop standards for the actual value of target stock that the target’s five top executives should hold as a credible signal of their belief against the hostile bid. A standard that is too rigid would elicit too few management teams to signal as the cost of signaling will be too high even for managers who believe that fending off the offer is beneficial for long term shareholders. A standard that is too low would elicit too much signaling, which might confuse courts to believe that too many unsolicited bids are substantively coercive.

According to the formal model developed in Appendix A, courts should consider it credible when the senior management team chooses to hold signaling stock at the level that will be chosen by managers who perceive the independent value of the corporation as precisely equals the hostile bid price. Such signaling level should correspond the point where, for such managers, the economic value associated with managerial cost of holding

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100 Despite the increased fraction of the aggregate compensation of the top-five executive team that is captured by the CEO, the variation in such CEO pay slice is high. See Equilar Inc., supra note [ ], at 13 (reporting that the median CEO pay slice has recently reached a record high of 44 percent among S&P 500 firms); See Lucian A. Bebchuk, K.J. Martijn Cremers & Urs C. Peyer, The CEO pay slice, 102 (1) J. Fin. ECON. 199, 206 (2011) (reporting that the standard deviation of such CEO pay slice equals to 11.4 percent. This reflects a panel dataset of 12,011 firm-year observations that represent 2,015 different firms and 3,256 different CEOs between 1993 and 2004).

101 I assume a zero discount rate. Courts, when determine the threshold for credible signaling, may relax this assumption.
(but not buying) the signaling stock for five years equals the expected value of future managerial private benefits of control.

The intuition for this result reflects the maximum willingness of incumbent managers to pay for maintaining their private benefits of control. If the management team perceives the bid price as reflecting the independent value of the target, then it will be worthwhile for managers to protect their private benefits of control and fend off the unsolicited bid by committing to hold some specified amount of signaling stock so the costs associated with holding such stock do not exceed the private benefits that they protect. At the margin, the benefit from protecting the value of private benefits of control should precisely equal the costs associated with holding the signal stock.

Quantifying the optimal amount of signaling stock requires a three-step inquiry. First, courts should estimate the expected value of net future private benefits of control for the top-five incumbent executives. Second, courts should estimate the personal costs associated with the top management team holding signaling stock for five years. Third, courts should determine what is the specific amount of signaling stock that managers should hold in order to equate the costs associated with holding such stock to their future private benefits of control.

Quantifying managerial net private benefits of control should be based on: (i) an estimation of a pecuniary component. Such component contains the actual sums that the target’s top-five executives are expected to be compensated if the target firm stays independent, minus their expected aggregate income should the target be taken over, taking into account statistics about managerial speed and chances to find comparable employment; and (ii) a non-pecuniary component, which should represent managerial reputation, publicity and disruption costs associated with stepping down from their current executive positions in the event that the target firm will be taken over.

The second element that should be considered in order to quantify the minimum amount of signaling stock is the economic costs associated with having the top-five incumbent executives hold signaling stock for a specified period of time. Such managerial costs include:

1. **Liquidity costs**, which represent the economic value managers incur as a result of not being allowed to convert their signaling stock into cash in hand for the time of the holding period; (ii) diversification costs that managers incur because holding their signaling stock forces them to hold an undiversified personal securities portfolios; and (iii) risk aversion costs resulting from the fact that management belief of the target’s independent value is only a probabilistic (stochastic) estimation based on their subjective professional stand and assumptions on the expected value of the target if it stays independent. Managers are risk averse agents and hence they place a discount on the probabilistic future value of their signaling stock.

Finally, courts should decide the specific amount of signaling stock that managers should hold in order to be considered credible, and for how long. For example, say that a court runs the exercise proposed herein. It estimates that the top-five executives stand to

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collectively pocket $1m in net private benefits of control should the target stays independent. It also evaluates that collectively holding $10m worth of target shares for five years will cost the top management team a sum of $1m if it believes that the bid price equals to the target’s value if stays independent. Therefore, if the target’s management team commits to hold collectively $10m worth of at-the-bid-price vested target shares for five years, if the bid fails, the target board will be presumed to meet its burden of proof to show substantive coercion.

I suggest that courts announce the actual signaling level that will be deemed credible to show substantive coercion. The formal model in Appendix A shows that when courts and target boards observe managerial net private benefits of control as well as liquidity and risk aversion costs of signaling, they infer the same minimum level of credible stock signaling. However, in reality target boards may have different good faith estimates than courts as for such value, and, hence, target boards deserve transparency as for what courts perceives as credible signaling. As the formal model suggests, such disclosure is not expected to induce signaling from boards that do not perceive the bid as threatening the long-term value of their shareholders. The reason for this result is that the signaling costs for such management teams will be too high in comparison to the benefits they will generate from protecting the corporate bastion.

In order for managerial mechanism to work in this accurate fashion, managers should know that their behavior clearly decides the outcome. Namely, that iff when the top management team commits to credibly signal courts allow them to fend off hostile bids. This represents a clear deviation from the current legal regime, which allows corporate boards to use a "poison pill" for as long a period of time as the board deems warranted, without incurring any personal managerial commitment.  

Therefore, I offer that when managers do not signal and the case is decided on substantive coercion, courts should thrust the corporation into a Revlon mode and allow defensive tactics only insofar they serve to maximize the inevitable sale price of the corporation. However, when target boards induce their top-five executives to commit to credibly signal against the unsolicited offer, the target board will be presumed to meet its burden of proof to show substantive coercion and, hence, will be allowed to fend off the hostile bid.

B. Implementation

The most direct method for implementing the signaling mechanism put forward in this article into Delaware law would be through the Delaware Supreme Court, the institution that created and developed the law on substantive coercion. A new precedent of the Delaware Supreme Court, embracing the proposed signaling mechanism, will be binding upon all Delaware’s trial judges, even if they disagree. Hence, it is expected to stop “substantive coercion threat” from being a slippery slope concept. The new precedent should state that a target board successfully articulates a threat to the

103 See Air Prods. & Chems., Inc. v. Airgas, Inc., supra note [ ].
104 Id, at 57.
corporation’s effectiveness and policy iff it credibly signals its belief against the hostile bid. Courts will commence a mini-trial, if necessary, and consult with experts, to decide the minimum amount of at-the-bid price of future stock compensation the target’s top-five executives should commit to hold, if the bid fails, in order to credibly signal their beliefs. Such minimum amount should reflect the maximum willingness to signal for managers who perceive the target’s value if stays independent as equals to the bid price.

Because Delaware’s law on substantive coercion and on hostile takeovers has been evolved mostly through case law, a judicial implementation of a signaling mechanism will be a natural step in reforming it. Delaware takeovers case law has been created, extensively interpreted, discussed and evolved during the past four decades. Revising the Delaware takeovers law, and in particular the law on substantive coercion, through the Delaware judicial system, will fit into and adjust well to all other aspects of current Delaware takeover law.

However, the proposed reform might be perceived for the Delaware Supreme Court as too big of a leap for what a judicial precedent on takeovers may take. According to the stare decisis doctrine, the already existing doctrine on substantive coercion, which was created by the Delaware Supreme Court, is binding on the Delaware Chancery court, but has only persuasive authority on new cases brought in front of the Supreme Court itself. Clearly, the reform put forward in this article will not relate to matters of first impression because the body of existing Delaware common law on substantive coercion is fairly rich. Also, the proposed reform cannot be adopted by way of clarifying ambiguities and inconsistencies in the current Delaware common law. Although the current case law of substantive coercion has merely a persuasive power on the Delaware Supreme Courts, the Delaware judges may find it too much of a stretch of their powers to require such a reform in line with the limits of stare decisis. Moreover, as indicted below, the proposed reform will better implemented if some revisions will be made to SEC Rules 10b-5 and 14e-3, which are obviously beyond the powers of the Delaware Supreme Court.

Delaware legislatures could preempt Delaware’s Supreme Court choice on this issue by imposing managerial signaling through a revision to Delaware’s corporate code. Because the Delaware legislator does not face the limitations of the stare decisis doctrine, it might be a better avenue to achieve managerial signaling in the law of substantive coercion. For example, in 1988 the Delaware legislators did not hesitate to meaningfully intervene in the doctrine of hostile takeovers by enacting Section 203 to Delaware’s corporate code,\(^{105}\) the most important antitakeover law in the U.S.

Moreover, revising the Delaware law to mandate managerial signaling in the face of unsolicited takeover bids is complex and detailed. A legislative branch may be a better institution than a judicial branch to perform such task, address all relevant interest groups, hold hearings, conduct necessary research and draft a new section in the law that

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\(^{105}\) Section 203 to the Delaware General Corporation Law stands as a barrier to hostile takeovers, delaying deals for three years unless the bidder can get to an onerous 85% of the target’s shares in its initial tender offer. See DEL. CODE ANN. tit. 8, § 203 (2001 & Supp. 2008).
will address all aspects of current Delaware law. For example, a legislative reform may set up the process and procedures for holding a mini-trial that will decide the threshold for credible managerial signaling that will be deemed to successfully articulate substantive coercion.

The federal legislators could preempt Delaware legislators and Delaware courts altogether to introduce a federal regulation embracing the proposed managerial signaling mechanism. They may do so as an addition to the Williams Act, which regulates disclosure, anti-fraud rules and process for tender offers. The Williams Act was enacted in 1968 in order to protect shareholders against abuse of tender offers by bidders. It is time to complement this federal act by adoption of another federal act that will protect shareholders from potential abuse of target boards. The proposed mechanism can fit as a revision of the Williams Act, as the act already aims to provide the offeror and management equal opportunity to fairly present their cases.

A federal regulation of optional managerial signaling will have two distinct advantages. First, the federal regulator will be able to make the necessary revisions that I recommend for federal SEC Rules 10b-5 and 14e-3. Second, the federal regulator will bind all states and hence will induce managerial signaling in states other than Delaware. As the Williams Act governs tender offers in all states and aims to protect shareholders, mandating the process for how managerial signaling should work is beneficial for shareholders in all states. When state laws allow boards to decide takeovers, managers will save costs and not signal regardless of such a rule. When state laws provide shareholders the right to decide takeovers, managerial signaling will provide shareholders with valuable information for whether to accept the bid. When state law provides courts with authority to decide whether to allow boards to block unsolicited bids, managerial signaling will provide precious information to courts.

The shortcomings of federal intervention relate to the way substantive coercion is institutionally decided under current arrangements. First, the proposed mechanism does not only offer a process for managerial signaling, but rather aims to prescribe substantive implications for signaling. The Williams Act, as currently stated, focuses on disclosure and process rather than on substantive takeover law, which was left for states. Second, federal intervention blocks state competition, which has been at the core of corporate law in general, including takeover law. Third, some of the states do not follow Delaware in adjudicating substantive coercion, and therefore mandating procedure for managerial signaling in jurisdictions where boards are allowed “to just say never” seems to be misplaced.

Finally, managerial signaling in the face of unsolicited bids can be implemented through a provision in companies’ bylaws. Such provision should aim to serve shareholders rather than courts, and hence, state that the proposed signaling mechanism will be implemented in the face of unsolicited bids, regardless of a pending lawsuit. Shareholders should favor such a bylaws provision because it will serve them in their

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own assessment of the desirability of the hostile bid. As Professor Bebchuk suggested, target boards could already credibly signal their beliefs as for a pending unsolicited bid by committing to purchase some specified amount of at-the-bid price target stock, if the bid fails, and hold it for a specified period of time.\textsuperscript{107} Such bylaws amendment may stipulate a case-by-case exemption if majority of shareholders approve. It may allow for more firm specific adjustments. For example, firms with significant block holders may find it more effective to extract information directly from such block holders rather than from the board.

A combined implementation approach seems to be the first best solution. Only federal regulators are authorized to revise SEC Rules 10b-5 and 14e-3. Addressing the process and disclosure of the proposed mechanism by the federal regulators would fit the best the current arrangements and allocation of powers. However, state courts and legislators, who have created, developed and interpreted the rich body of current hostile takeover laws, should regulate the substantive aspects of managerial signaling put forward in this article. In addition, shareholders should be encouraged to push firms to adopt bylaw provisions that will induce managerial signaling and provide shareholders with credible information as for the desirability of pending hostile takeover bids.

C. Removing Legal Risks in Existing Laws

In order to make it lawful for the top-five executives to signal their beliefs against a pending tender offer, SEC Rules 10b-5\textsuperscript{108} and 14e-3\textsuperscript{109} might need to be adjusted. Both rules require insiders in possession of material, nonpublic information relating to a tender offer either to disclose the information publicly or to abstain from trading in the securities involved in the tender offer. Rule 10b-5 and the Supreme Court’s "misappropriation" theory of omissions\textsuperscript{110} limits the prohibition to situations where the use of such information constitutes a breach of a duty owed to the source of that information. Rule 14e-3 holds information about a tender offer to an even higher standard. This rule imposes a disclose or abstain standard regardless of the identity of the person in possession of the information or whether the trade would constitute a breach of a fiduciary duty.

There are good reasons to believe that the top-five executives under the arrangement proposed in this article may be in full compliance with SEC Rules 10b-5 and 14e-3 as currently structured. First, incumbent managers under the mechanism will disclose all material non-public information that relates to their signaling stock, both in order to make their signal more credible and in order to comply with the said rules. Second, Rules 10b-5 and 14e-3 may not apply to the proposed mechanism because such mechanism does not require target’s top-five executives to make any trade, but rather it requires them to refrain from a future trade. Specifically, it only suggests these executives commit to hold vested stock that they will be granted to them anyway, as part of their

\textsuperscript{107} See Lucian Bebchuk, supra note [ ].
\textsuperscript{108} See 17 C.F.R. 240.10b-5.
compensation, in the future. Third, SEC Rule 10b5-1 created an affirmative defense if the insider can demonstrate that the trades conducted on behalf of the insider were conducted as part of a pre-existing contract or written binding plan for trading in the future.\textsuperscript{111} The signaling commitment for refraining from a future trade may constitute such a pre-existing contract. Fourth, Rule 14e-3 may not apply to the mechanism in this article, because such mechanism explicitly cuts the connection between the tender offer and the signaling stock. It stipulates that the commitment to hold signaling stock is void if the bid fails. Finally, the extent of non-public material information in connection with the tender offer is very limited to begin with because the proposed mechanism kicks in only after the tender offer has been publicly launched and the defensive tactics against it are already litigated.

Still, I suggest creating an explicit affirmative defense for insiders that follow the signaling mechanism put forward. First, it is hard to assure executives that they disclosed all possible non-public material information before committing to hold the signaling stock. This is the reason why U.S. public firms limit their executives to trades with their firms stock only during predetermined short “trading windows” following the release of quarterly earnings or according to plans created in advance, when the executive was not in possession of material nonpublic information.\textsuperscript{112} Second, the holding of signaling stock might involve a trade, when signaling stock is underlying stock of stock options.

Therefore, I suggest that SEC Rules 10b-5 and 14e-3 should create an affirmative defense for executives who choose to signal pursuant to the proposed mechanism. Specifically, courts that adjudicate substantive coercion should be authorized to require firms, in the event of signaling pursuant to the proposed mechanism, to issue supplementary abbreviated reports that will cover all material non-public information since their latest quarterly reports. Executives that commit to hold signaling stock will be protected from lawsuits for breaches of Rules 10b-5 and 14e-3 in the same way that they would have been protected immediately after filing of quarterly reports.

\textbf{D. Outcomes of the Proposed Reform}

The proposed reform is expected to enhance efficiency in adjudicating and in shareholder voting on hostile takeovers. The source of value created is the credible private information that top management will signal, whenever it articulates substantive coercion threat, about the independent value of the target.\textsuperscript{113} Such private information will better reflect management prospects with regards to three potential scenarios: when management plausibly expects to better the terms of a pending hostile bid by bargaining with the offeror, when management wants to secure a competitive bid, or when incumbents think that they will manage the company better than the market expects. This

\textsuperscript{111} See 17 C.F.R. 240.10b-5.1.
\textsuperscript{113} The proposed reform thereby recognizes the “hidden value” model. See Ronald J. Gilson & Reinier Kraakman, \textit{Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?}, 44 Bus. Law. 247, 256-260 (1989) (stating that “We argue that they reflect an often unstated "hidden value" model, in which a firm's true value is visible to corporate directors but not to shareholders or potential acquirers”).
information will assist courts to allow boards to block unsolicited bids only when management resistance is warranted. It will also assist shareholders, if courts do not allow boards to block the bid, to identify better who will do a better job on maximizing the value of their shares, and hence, maximizing the value of the corporate assets. Overall, the mechanism will improve the process that determines who will be allocated with the right to manage the corporation’s recourses.

The signaling mechanism put forward will enable managers to focus on the long-term and thwart bidders that try to take advantage of short-term mispricing, even when incumbents electorates do not think long-term. 114 “The tyranny of quarterly earnings” and management game to meet or beat analyst quarterly earnings forecasts has eroded the integrity of corporate America and has destroyed firm value. 115 It has been argued that in recent years the practice has become so enshrined in the culture of Wall Street that the men and women running public companies often think of little else but about short-term "success". Moreover, a frequent complaint is that a constant threat of hostile takeovers forces managers to stress short-term policies at the expense of more valuable long-term plans.

The reform will shift the pressure exerted by hostile takeovers from being short-term focus into long-term. It will happen because, when signaling, the top-five executives commit to hold target stock, if the bid fails, for the long-term. For incumbents, signaling will pay off only if they expect to increase the long-term stock price. Furthermore, holding signaling stock for the long-term incentivizes incumbents to maximize the long-term value of the target. Credible signaling under the reform advocated herein is expected to insulate target boards from unsolicited bidders through judicial determination, regardless of shareholder choice, which might be short-term oriented as well. Knowing the effects of signaling on managerial and judicial time horizons, bidders will be deterred from launching hostile takeovers motivated by short-term stock mispricing in the first place.

Regardless of time horizon concerns, the reform is expected to improve efficiency, both ex-ante, before incumbents decide whether to exercise credible signaling, and ex-post, after management decides whether to signal. Ex-ante, target boards will be discouraged from running companies in ways that represent substantial under-performance from the perspective of public shareholders. It will happen because credible signaling is too expensive for “bad type” managers, and because lack of signaling results in thwarting the target into a Revlon mode. Because signaling is cheap and desirable for

114 See Leo E. Strine, Jr. One fundamental corporate governance question we face: can corporations be managed for the long term unless their powerful electorates also act and think long term?, 66 BUS. LAW. 1 (2010).


“good type” managers, the mechanism should improve the selection of bidders who will now know that “good type” incumbents will successfully fend them off.

Ex-post, the reform will better shareholder welfare. When signaling succeeds and hence the bid fails, the reform requires managers to hold their signaling stock for the long-term. Therefore, managers would be discouraged from extracting private benefits of control or run the firm in ways that does not reflect long-term shareholder value maximization. Because of the valuable information that signaling provides to courts in adjudicating substantive coercion, the selection of the successful bidders will be more efficient as well, and it will be more likely that the bidder will do better than incumbents in managing the target recourses.

The economy as a whole is expected to gain from this reform not only by allocating assets more efficiently but also by reducing systemic risk. Systemic risk is expected to be lower because more credible information will be available for investors, hence lowering the speculative and volatile component of stock pricing. Currently, financial information disclosure under GAAP is imposed on companies so as to provide investors with a minimum level of historical and present financial data used while analyzing companies for investment rationales. The reform will induce incumbents to release a different type of business information to the markets. In particular, the reform should induce incumbents to release their subjective credible bottom line projections of the long-term economic prospects of the target. Such assessment will be based on incumbents inside information and economic expertise. One can look at stock prices as reflecting hard information of the firm assets, obligations, operational results and financing together with projections of future business results. Volatility of stock prices should reflect surprises in current financial results compared to past projections or change in projections of future results. Providing investors with new quality information as for the future economic health of target should reduce future surprises as for such results, and hence, to reduce stock price volatility.

Furthermore, the reform is expected to improve fairness. Target shareholders and incumbents who extract relatively low levels of private benefits of control stand to be the big winners of the proposed reform. Target shareholders will be better off because the reform will improve adjudication of substantive coercion in order to allocate control over the target resources to the management team that is expected to generate more value for shareholders. Target shareholders in public firms are typically institutional shareholders - pension funds, insurance companies, asset managers, mutual funds, and hedge funds. The beneficial owners of these institutional investors include individuals with retirement savings, life insurance and other direct and indirect equity investments, who represent between one half and one third of the adult population of most developed countries. Protecting these millions of savers from powerful boards and powerful bidders is likely to

117 For the general positive market effect of open market managerial purchases – see J.C. Brau and A. Holmes, Why do REITs repurchase stock? Extricating the effect of managerial signaling in open market share repurchase announcements, 28 J. REAL EST. RES. 1 (2006).
118 Among Russell 3000 companies, median institutional ownership is 80.4%. Institutional investors include asset managers, mutual funds, pension funds and hedge funds.
increase the welfare of significant proportion of the general population. Also, faithful incumbents are expected to be better off. Signaling becomes cheaper when private benefits of control are lower. Therefore, faithful boards that extract lower levels of private control are better positioned to credibly signal their views against unsolicited bids, and hence stay in their managerial positions.

Finally, the proposed reform will improve legal clarity and certainty in the law of substantive coercion. The reform proposes that once courts determine the threshold for credible managerial signaling incumbents decision whether to embrace it or not should decide the result of the legal proceeding. After courts develop standard for deciding the credible signaling standards, takeover players, and especially incumbents, will be able to predict the viability of takeover defenses. This, in turn, might elicit some managers to signal their faith in the future independence of the target in advance.

E. Potential Objections to the Proposed Reform

I project that the proposed reform stands to improve efficiency, fairness, and clarity in adjudicating substantive coercion. I support my projections with a formal mathematical model and with intuitive explanations that detail the driving forces behind the new approach. Critiques might attack my explicit and implicit assumptions about how the proposed reform will actually work in the real world and might also attack the fit of such a reform to current Delaware corporate law jurisprudence.

1. The proposed reform departs from first principles of Delaware corporate law jurisprudence

Critiques may find the reform put forward in this article departing from a first principle of American corporate law, according to which, corporate executives are never required to use their own money in order to justify their business decisions. Moreover, in Delaware and in most other states, executives are no longer personally liable for taking negligent business decisions. Therefore, the argument goes, incumbents may be allowed to signal their beliefs against a hostile bid, and courts may consider this in its variety of considerations in adjudicating substantive coercion, but managerial signaling should not be decisive in adjudicating substantive coercion.

However, U.S. public firms already require their senior executives and directors to use their own money and hold their personal stock of their companies for the long-term. Firms require managers to do so in order to align their interests with those of shareholders, just like the suggested signaling mechanism aims to do. Also, executives

119 § 102(b)(7) to the Delaware General Corporation Law from 1985 validated charter amendments that release corporate directors from damage claims for breach of their duty of care. The vast majority of states followed Delaware’s lead in authorizing the release of damage claims for a breach of the duty of care. In Delaware, well over 90 percent of public corporations passed charter provisions eliminating liability to the full extent permitted by the statute. See Roberta Romano, Corporate Governance in the Aftermath of the Insurance Crisis, 39 EMORY L. J. 1155, 1160-1161 (1990).

120 See Nitzan Shilon, supra note [ ], at 16 (reporting that firms have widely adopted Stock Ownership Policies, reaching an all-time high of some 85% prevalence among all S&P 500 firms in 2010).
and directors always owe personal liability for breach of their duty of loyalty to make a good-faith effort to advance the interests of the company. Such duty applies under Delaware’s intermediate standard doctrine of hostile takeovers as well as in all other corporate transactions in which managers have personal financial interest. Therefore, imposing personal financial consequences on conflicted managers in connection with a hostile takeover is in line with existing American corporate law jurisprudence.

Board veto proponents might argue that the proposed reform departs from Delaware board-centric philosophy because it states that if incumbents do not signal, such as they choose under the current regime, they will stand to lose their veto power. However, the proposed reform strengthens board power in deciding hostile takeovers. The suggested signaling mechanism stipulates that when managers exercise signaling at a credible level courts will be compelled to allow incumbents to fend off hostile bids. Under current Delaware takeovers doctrine, no single managerial behavior compels courts to allow target boards to reject unsolicited bids. Therefore, the proposed reform balances between bolstering managerial liabilities through signaling and bolstering their powers through stronger court deference to them in deciding hostile takeovers.

2. The suggested reform will not elicit credible managerial signaling

Commentators might argue that, in the real world, the proposed reform does not stand to elicit managers to reveal their true beliefs as for the desirability of pending unsolicited bids for their shareholders. First, perhaps diversification and liquidity costs associated with signaling rarely exist. A recent study shows that the median CEO voluntarily holds almost three times more stock than the amount required by her Stock Ownership Policy and therefore this excess might be used for signaling purposes.121

However, incumbents who commonly choose to hold significant amount of their firms’ stock do not necessarily aim to commit to hold it for the long-term. For example, the top-five executives of Lehman Brothers and Bear Sterns sold stock worth $1.1 billion and $850 million respectively during 2000-2008.122 Also, the difference between the bid price and management belief in the target value if stays independent should take up a significant fraction of signaling costs and should differentiate between incumbents who believe in the desirability of protecting shareholders against the bid and incumbents who do not credibly believe in that.

Second, the complex deliberation embedded in applying the reform is highly cumbersome and might result in courts failing to translate the hypothetical levels of signaling into actual levels of credible managerial stock signaling. Specifically, the proposed reform requires courts to calculate the minimum level of credible signaling by estimating managerial net future private benefits of control, managerial personal costs of holding the signaling stock, and then calculating the specific amount of signaling stock that managers should hold in order to equate such costs associated with holding signaling

121 Id., at 24.
stock with their future private benefits of control. Each of these calculations is complex and subjective, and hence, is more vulnerable to significant mistakes by courts.

Nonetheless, making the necessary calculations under the proposed reform is expected to be more credible than current court estimations of substantive coercion. Currently, courts hear experts who opine directly on the independent value of the target if stays independent, a determination that must be based on such vulnerable assumptions, that may justify an extremely broad range of valuations. Conversely, the reform avoids any court determination of the independent value of the target and leaves it for incumbents to consider. Rather, court estimations under the reform relate to relatively minor economic values that can be verified against open market transactions. Such open market transactions may include data on ousted managers hiring market, incumbent voluntary holdings of target stock, and objective personal indicators such as managers’ age, wealth, status, etc.

Third, entrenched management teams might signal the undesirability of hostile bids even when the bids stand to increase long-term shareholder value. Entrenched managers might do so because they might manage to compensate themselves for their signaling costs by making their boards increase their future compensation. This is troubling because it runs afoul the proposed mechanism, which aims to identify entrenched managers by making it too costly for them to credibly signal.

Despite entrenched incumbents’ power and influence over boards, it is particularly important to avoid despair and rather to impose mechanisms that will align the interests of these insiders with those of shareholders. The fear that managers will be able to undo actions that are profoundly unpleasant to them did not deter policy makers from imposing actions that should serve shareholders. For example, despite similar concerns, recouping excess-pay clawbacks seemed important enough to the Dodd-Frank regulators that they imposed it in all publicly traded firms.123

Fourth, collective action problems among the top-five executives of the target might result in their sub-optimal willingness to signal as a group. Individual executives might find it desirable to free ride on their peers’ efforts to signal. At the margin, an individual executive bears the full signaling costs but reaps only a fraction of the group’s benefits. Individual executives will try to convince their peers that their individual circumstances of liquidity constraints, expected tenure, diversification costs and other costs are greater than those of the other members of the team, and hence, they should be responsible for lower fraction of the group’s signaling efforts. Knowing that, bidders might try to challenge the leadership of the CEO and to cause controversies within the management team.

The board of directors should solve executives’ collective action problems. The board of directors is a mechanism designed to resolve the collective action problem of the corporation. Usually it is expected that the board will aid in resolving shareholder

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collective action problems. Here, however, the board, whose majority non-employee members are not expected to signal, may well serve as a mechanism to resolve the potential collective action problems of target’s top-five executives. Moreover, standards for signaling sharing are expected to evolve over time, and will assist boards to determine how to allocate the signaling burden among its executives.

Fifth, managers might mistakenly over-estimate their willingness to signal due to their irrationality and psychological diversions. Kahneman and Tversky’s\textsuperscript{124} analysis of “endowment effect” suggests that humans are loss-averse. Therefore, incumbents will overvalue their private benefits of control when deciding whether to eliminate the risk of loosing them. Hence, managers will be willing to exercise too much signaling. Likewise, managerial “cognitive dissonance”\textsuperscript{125} might cause managers to reconcile their own attempts to increase firm value with the contradicting idea of the bidder to oust the incumbents by thinking that the bidder is unaware of the hidden value of the corporation under their management. This might cause incumbents to overvalue target’s independent value, which, again, suggests that managers will be willing to exercise too much signaling. Similar results are provided by over confident incumbents. A large body of evidence from applied psychology shows that corporate executives routinely overestimate their ability.\textsuperscript{126}

However, managerial psychological diversions might assist in countering other psychological factors that might push managers to be willing to signal too little. For example, managers are typically risk-averse individuals, and therefore will be hesitant to commit to hold large fractions of the target stock for the long-term. Executives are typically already disproportionately invested in the firm through their career concerns of reputation and success, compensation, and firm stock that they are required to hold before vesting and afterwards. Therefore, risk-averse executives might find it too costly to credibly signal. Their psychological diversions will push them to move in the right direction toward an optimal level of willingness to signal.

Finally, financial economists might suggest that managerial signaling should evolved naturally, without any court interference or determination, and that a court involvement might drift things away from credible signaling. To their support, they might indicate that the model introduced in Appendix A suggests that a separating equilibrium, in which only managers that believe the bid does not maximize long-term shareholder value, will signal. Their signaling level in equilibrium equals to the level of signaling advocated by this article. Courts, who have less information than the players in this model, might mistakenly expect erroneous signaling levels.

\textsuperscript{125} Theory of cognitive dissonance holds that contradicting cognitions serve as a driving force that compels the mind to acquire or invent new thoughts or beliefs, or to modify existing beliefs, so as to minimize the amount of dissonance (conflict) between cognitions. See Leon Festinger, A Theory of Cognitive Dissonance, (Stanford University Press, 1957).
\textsuperscript{126} See Ulrike Malmendier & Geoffrey Tate, CEO Overconfidence and Corporate Investment, 60(6) J. Fin. 2661 (2005).
However, I object this view on both theoretical and practical grounds. As a theoretical matter, entrenched boards might take advantage of their informational advantage to fool courts to believe that suboptimal level of managerial signaling is actually credible. When courts do not have the opportunity to gather the expert information and to form their own crystallized view over the determinants of signaling, chances are higher that they will be misled to give credibility to suboptimal signaling. As a practical matter, we do not observe managerial signaling today. Beyond the illegality of such action today, discussed above, managers might be hesitant to incur significant personal recourses and signal out of the fear that market participants might not be that sophisticated enough to identify credible signaling. This reality will be different when they know that courts make the effort to determine what would be considered a credible managerial signal.

Overall, some of the critique, such as the one that argues that entrenched insiders will be able to make themselves whole of signaling costs, raises concerns that incumbents will be willing to signal too much. Some of the critique is concerned about the opposite consequence, such as the concern that fear that collective action problems will induce too little signaling from individual incumbents. Other concerns, such as the potential for significant errors in courts implementation of the reform, do not suggest a specific bias in adjudicating substantive coercion under the proposed mechanism. Taking the universe of potential critique as a whole does not indicate that adoption of the proposed mechanism will result in a biased adjudication of substantive coercion.

**Conclusion**

This Article has offered a new approach to adjudicate substantive coercion. This doctrine has been extensively developed in the Delaware courts over the past four decades, and it has engaged legislators, courts, shareholders, takeover players, and distinguished experts. I suggested that the impact of takeover law, and especially of substantive coercion doctrine, on shareholders, bidders, boards and credit markets is significant as it fundamentally affects billions of dollars deals.

I suggested that there are good theoretical and empirical reasons for concluding that adjudicating substantive coercion has been extremely challenging and destroyed significant economic value. I offered that the source of the problem was that currently, showing a threat that target shareholders stand to mistakenly accept an underpriced bid lacks credibility. The current standard incentivizes incumbents to show substantive coercion threat even when they do not genuinely believe so. Moreover, the current standard encourages incumbents to use the target coffers in order to hire independent directors, as well as financial and legal advisors, in order to show a substantive coercion threat. However, the true independence of these directors and experts is seriously questionable, and the result is that hardly any substance of substantive coercion as suggested by Gilson and Kraakman has actually left its imprints on the current adjudication of this concept.

I demonstrated that the conclusion that courts have been challenged by the concept of substantive coercion has significant implications. Commentators have
suggested that instead of allowing boards to articulate a substantive coercion threat, things will be better if courts would allow shareholders to decide directly the desirability of unsolicited bids. Bebchuk contended that when undistorted choice is in place, shareholders would get it right if incumbents will signal them, in the appropriate cases, their beliefs against the bid. They may do so by committing to hold, if the bid fails, a certain amount of at-the-bid price target shares, and hold it for a specified time.

However, I showed that substantive coercion is an important concept, because it refers to those value-destroying takeover bids that shareholders stand to erroneously accept. Therefore, I suggested to sustain the concept, but to enhance the credibility of its adjudication. I built on Bebchuk’s signaling suggestion and presented a mathematical model to show that, if courts require managers to signal their beliefs about the desirability of the bid, only incumbent teams that believe the bid to be value destroying will actually signal against it. I also showed that attaining this result requires legal reform in the doctrine of substantive coercion as well as in SEC Rules 10b-5 and 14e-3.

I presented the formula for credible signaling, and provided a proof for the equilibrium that supports it. Financial economists can thus make an important contribution to improving takeover law by exploring the ways to quantify the variables that determine such minimum threshold: managerial private benefits of control, liquidity and risk aversion costs associated with holding the signaling stock, and the relation between voluntary holdings of target stock and such costs.

This Article, I hope, will contribute to the notion of enhancing credible communication in corporate governance and to the adoption of financial economic tools in corporate law adjudication. Reforming substantive coercion with the managerial signaling put forward would much benefit shareholders, faithful boards and value-enhancing bidders and will improve corporate performance.
A Managerial Signaling Model in the Face of Unsolicited Takeover Bids

1. An unsolicited bidder approaches target shareholders, and offers them to tender all of target’s shares at a total price of B.\textsuperscript{128}

2. Let $\alpha \in [0,1]$ be target’s top-five executives signal of their beliefs as for the desirability of the hostile bid. $\alpha$ is the fraction of the target outstanding shares, that the top-management commits to purchase at-the-bid price and hold for the long-term, in the event that the bid fails.\textsuperscript{129} $\alpha$ is observed by courts and target shareholders.

3. Let $V$ be the target value if staying independent. Unlike incumbent managers, court and target shareholders are unable to observe $V$.

4. If court is persuaded that $\alpha$ is big enough to credibly signal incumbent’s belief that $B<V$, it allows the board to fend off the raider.

5. There are two possible types of managers, $\theta_G$ and $\theta_B$, as follows:
   
   i. $\theta_G$ - “Good type managers”, who produce a relatively high $V$, $V(\text{high})$, satisfying $V(\text{high})>B$. The probability for “good type managers” is $1-\lambda$.
   
   ii. $\theta_B$ - “Bad type managers”, who produce a relatively low $V$, $V(\text{low})$, satisfies $V(\text{low})<B$. The probability for “bad type managers” is $\lambda$.
   
   iii. A-priori, prob. ($\theta_G$) = prob. ($\theta_B$) = 0.5.

6. Let $P$ be the net sum of managerial private benefits of control. $P$ is known to both court and target managers. If court allows defensive tactics, managerial ability to extract private benefits of control is unchanged. Conversely, when courts decide that managerial signal is not credible enough to successfully articulate a cognizable substantive coercion threat, then managers loose all of $P$.

7. Managers suffer from liquidity constraints and are risk averse.

8. Let $C_i(\alpha)$ be the aggregate cost of signaling for the target’s top-five executives. Index $i$ is either $\theta_G$ or $\theta_B$. Such cost consists of liquidity costs, risk aversion costs and the difference between $B$ and $V$. Liquidity costs and risk aversion costs are similar between good and bad type managers but good type managers observe a higher $V$ than bad type managers. Hence, $C_B(\alpha) > C_G(\alpha)$ for any $\alpha$. Also, standard assumptions apply here, satisfying: $C_i(0) = 0$, $C'_i(\alpha) > 0$, $C''_i(\alpha) > 0$, $C'_B(\alpha) > C'_G(\alpha)$ for any $\alpha$.

9. Court forms a belief, $\mu(\alpha,P,C(\alpha))$, as for the relationship between $\alpha$ and $V$, and in particular decides if $\alpha$ constitutes a credible signal for target managers to be of type $\theta_G$. Accordingly, court holds a judicial decision, $D(\mu)$, whereby it holds that

\textsuperscript{127} The model herein is based on Michael Spence, \textit{Job Market Signaling}, 87 (3) QUAR. J. ECON., 355 (1973).

\textsuperscript{128} The model can also explain offers for less than all of target’s shares, provided that the offer is not structurally coercive.

\textsuperscript{129} Such shares may be attained when incumbents commit to convert an equivalent economic value of their future stock-based compensation into at-the-bid price target stock, and hold it for the long-term, as explained in the article.
target board has successfully articulated a cognizable substantive coercion threat to the target’s effectiveness and policy iff it is more likely that target managers are \( \theta_B \) than \( \theta_G \).

10. Bad-type and good-type managers maximize their utility functions, respectively:

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\begin{align*}
u_B(\alpha) &= P(D(\alpha)) - C_B(\alpha) \\
u_G(\alpha) &= P(D(\alpha)) - C_G(\alpha)
\end{align*}
\]

11. \( \alpha \) and \( D(\mu) \) do not affect \( V, \theta \) or \( P \).

Solution of the model - General:

A signaling choice, \( \alpha \), a court decision function \( D(\mu) \) and a belief function \( \mu(\alpha, P, C(\alpha)) \exists \{ \theta_G, \theta_B \} \) giving courts’ probability assessment that managers are of a certain type after observing \( \alpha \) is a Bayesian equilibrium (BE) if

(i) \( \alpha \) is optimal given \( D \).
(ii) \( D \) is optimal given \( \alpha \).
(iii) Consistency between court beliefs \( \mu(\alpha, P, C(\alpha)) \) and strategy \( D(\mu) \).

Managers choose \( \alpha \) to maximize their utility function \( U_i(\alpha) = P(D(\alpha)) - C_i(\alpha) \). As shown in Figure AP-1, managerial utility function’s slope is lower for “good type managers”, because any incremental increase in \( \alpha \) increases \( P \) identically for good and bad type managers alike, but increases costs more significantly for bad type managers as \( C' B(\alpha) > C' G(\alpha) \) for any \( \alpha \).

Figure AP – 1 – Managerial Utility Functions
A Perfect Information Solution of the Model

Now court observes V and, hence, infers that incumbent managers are either $\theta_G$ or $\theta_B$. Therefore, it holds an optimal D regardless of the level of managerial signaling. Because signaling is costly and because target boards know that court has perfect information, both good-type and bad-type managers choose $\alpha^*=0$, as depicted in Figure AP - 2.
An Asymmetric Information Solution of the Model – Separating Equilibrium

In a separating Bayesian Equilibrium, \( D^*(\alpha^*_G) = \theta_G \), \( D^*(\alpha^*_B) = \theta_B \). Also, \( \alpha^*_B = 0 \) and \( \alpha^*_G \in [\alpha', \alpha''] \).

Now courts are unable to observe \( V \) and, hence, are unable to infer the type of incumbent managers. However, court observes \( P \) and all characteristics of signaling costs other than \( V \). Therefore, it is able to infer the utility function of hypothetical target’s marginal managers, who are able to generate \( V = B \). Hence, courts infer the maximum willingness to signal of such marginal managers.

Courts form their belief, \( \mu(\alpha, P, C(\alpha)) \), as follows:

iff \( \alpha^* \geq \max \alpha^* \) (marginal incumbent managers), then \( \theta = \theta_G \), and

iff \( \alpha^* < \max \alpha^* \) (marginal incumbent managers), then \( \theta = \theta_B \).

Good-type managers will choose to signal, in equilibrium, at the minimum credible level, which equals to \( \max \alpha^* \) (marginal incumbent managers). Signaling in excess of that level will be costly for incumbents but not generate any marginal benefit. Signaling at a lower level will mistakenly identify \( \theta_G \) as \( \theta_B \). Figure AP – 3 illustrates that for \( \theta_G \), providing a credible signal always dominates a decision not to signal at all.

\[130\] Add a text box with \( \alpha^* = 0 \) at the origin.
It essentially builds on the result that, for $\theta_c$, $P > C_G(\alpha^*)$ for any $\alpha^* < \alpha''$. Figure AP-3 illustrates that it is always true that $\alpha^* < \alpha''$. This outcome results from the property that the maximum willingness to signal for $\theta_G$ (which is $\alpha''$) is always higher than the maximum willingness to signal for the marginal incumbents who only generate $V=B$. This happens because signaling costs are lower for $\theta_G$ than for the said marginal incumbents. For $\theta_G$, the nominal costs of holding the signaling stock, $(B-V)$, is negative, while this sum equals to zero for the marginal incumbents and all other signaling costs are identical.

Figure AP – 3: Separating Equilibrium

131 Place between the two existing curves an indifference curve of incumbent managers for whom $V=B$. 

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