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In Their Defense: Arguments in the Debate over the Use of Corporate Takeover Defenses and their Policy Implications

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Introduction

In the marketplace, one of the realities a publicly-traded company faces is the possibility of being the subject of a takeover. In a takeover, an individual or a company will attempt to acquire another company, known as the target. If this is attempted against the will of the target company's management, then the takeover is considered "hostile." These takeovers frequently result in the dismissal of the incumbent managers and vast operational changes in the acquired company. The benefits and drawbacks of takeover activity are subject to debate, and as such there is disagreement over whether managers should be allowed to use preventive measures to defend themselves against takeovers. One side views a market for corporate control without takeover defenses as being most beneficial to shareholders while the other side argues that the shareholders' interest can be best served by having protections in place to fend off a takeover attempt. In this paper, I will begin with a brief history of the development of the takeover market and outline the current structure of the federal and state regulations that govern it. I will then provide a review of the major arguments and the evidence supporting each side of the debate on whether or not managers should be allowed the discretion to decide whether a takeover is defended against. Lastly, I will review the implications this debate has on U.S. takeover law.

Background on Takeovers and Takeover Law in the U.S.

The takeover market has been noted to be cyclical, with six different waves of merger activity having occurred in its history (Davidoff, 10). The first takeover wave occurred from 1890 to 1907, during which many trusts were formed, leading to regulations such as the Sherman Antitrust Act and the Clayton Antitrust Act (Davidoff, 11). The second wave occurred after World War I and ended with the Great Depression, resulting in the creation of the Securities and Exchange Commission (SEC) as well as the Securities Act and Securities Exchange Act to regulate securities (Davidoff, 12). The third wave happened from 1960 to 1971 during which the "hostile" offer rose to prominence (Davidoff, 12). These offers often took the form of unsolicited cash tender offers where shares were purchased directly from the shareholders of a target company, the company which the bidder was attempting to acquire (Davidoff, 12-13). At the time, target companies generally did not have the means to defend against these hostile bids (Davidoff, 13). That would change during the next takeover wave. The fourth wave occurred from the late 1970s to 1989 and featured corporate raiders such as T. Boone Pickens who would try to take over a company in order to break it up or restructure it (Davidoff, 14). However, companies had become equipped with defenses against the rising threat of hostile takeovers, one of the most important of which was the poison pill, which gives the board of directors the power to consent to whether a deal takes place or if it is rejected (Davidoff, 14-15). A poison pill is a provision that triggers an issuance of stock at a discount to all target company shareholders except the unwanted acquirer, thus diluting the stock of the acquirer (Subramanian). Two more takeover waves have since occurred, one during the technology boom of the late 1990s and the latest occurring from 2004 to 2008 (Davidoff, 15-18).

The SEC and courts were given authority over takeovers and tender offers through the passage of the Williams Act in 1968 (Hazen, 127). The Williams Act was passed in response to the growing use of tender offers in takeover attempts which preceded it (Rosenzweig, 225). It amended the Securities Exchange Act by creating new rules to protect target shareholders in the event of a takeover (Hazen, 127).

Under rule 13(d) of the Williams Act, anyone who owns more than 5% of an issuer's securities must file a statement with the issuer of the securities and the SEC disclosing the purpose of the acquisition as well as the number of shares owned by the acquirer within ten days of the acquisition (Hazen, 128). The acquirer must also disclose any plans to liquidate the company or make major changes to the business (Magnuson, 213). Under rule 14(d) a tender offer cannot be made for more than 5% of a company's stock unless the acquirer files with the SEC and complies with the rule 13(d) filing requirement (Hazen, 129). Shareholders who sell their shares may withdraw them during the seven days after the offer is made and the tender offer must remain open for twenty days (Magnuson, 213). The SEC has also adopted an "all holders" rule requiring that a tender offer be open to all shareholders, which prevents a target company from defending against a tender offer with a counter tender offer to all shareholders excluding the bidder (Hazen, 135). It also requires that all shareholders must be paid the same price when selling their shares to the bidder (Magnuson, 213-214).

In *Smallwood v. Pearl* in 1974, a tender offer was held to include "any public invitation to a corporation's shareholders to purchase their stock" (Hazen, 130). Rule 14(e) makes misstatements made in a tender offer unlawful and in *Electronic v. International* in 1969, it was held that if a hostile bidder has made misstatements during a tender offer, the target company could seek an injunction against the bidder (Hazen, 131). In 1977, the Supreme Court in *Piper v. Chris-Craft* held that a defeated bidder has no standing to sue its opponents for damages if they have made misstatements but indicated that there is an implied private right of action under rule 14(e) if it is in the interest of the target company's shareholders (Hazen, 131-132). In *Polaroid v. Disney*, the Third Circuit Court held that the target company could sue to put a stop to a tender offer in a case where a bidder has made misstatements (Rosenzweig, 227). However, in *Lewis v. McGraw* and *Panter v. Marshall Field*, it was held that shareholders are not able to sue the target's managers for making misstatements to deter a tender offer since shareholders could not have relied on the misstatements (Hazen, 132).

The Williams Act was not intended to favor either the managers of the target company or the bidder in a takeover (Rosenzweig, 225). Its purpose was to ensure that shareholders had adequate information by which they could make a decision regarding a takeover bid (Mallette, 148). The SEC is given the authority to investigate violations of the Williams Act and file lawsuits against violators (Rosenzweig, 227). However, it does not necessarily override the states' ability to regulate takeovers (Mallette, 148). As such, the states play a large role in the regulation of the takeover market.

In the 1960s and 1970s, 30 states began to impose takeover regulations within their borders, many of which were sympathetic with the target company's managers, requiring more disclosure and instituting waiting periods and state hearings in the event of a tender offer (Hazen, 132-133). In *Edgar v. MITE*, the Supreme Court found that an Illinois statute with such provisions was unconstitutional as it overstepped state boundaries, intruding on interstate commerce as well as being too one-sided toward incumbent managers (Hazen, 133). After the *Edgar* case, state statutes generally sought to regulate the governance of companies such as in the case of an Indiana statute which restricted the voting privileges of shareholders with more than 20% of the company's shares (Rosenzweig, 231). The validity of the statute was upheld by the Supreme Court in *CTS v. Dynamics* (Magnuson, 218). After this, many other states followed suit and enacted laws allowing the use of takeover defenses by incumbent managers (Mallette, 148). A New York statute prohibited an acquirer from merging companies for five years after gaining control of the target company unless the target initially agreed to the takeover (Magnuson, 218). Similarly, a Delaware statute required a three year waiting period for a merger by cash-out of the remaining minority shareholders after control of a company has been gained (Rosenzweig, 232).

Delaware, being the site of 50% of incorporations of publicly traded companies, plays a large role in state takeover regulation (Davidoff, 281-282). Several cases have had a large impact on how much discretion to fend off hostile takeover bids incumbent managers are allowed. In *Unocal v. Mesa*, Delaware courts developed a "proportionality test" whereby the board of directors of a target company must show that an acquirer of the company's stock posed a reasonable threat to the company's policy and that the defense was a reasonable response to that particular threat (Hazen, 135). This became known as the *Unocal* test and was applied in *Moran v. Household Int'l* to allow the use of the poison pill defense (Magnuson, 215). *Unocal v Mesa* also did not require that target boards of directors seek the approval of their shareholders before defending against a takeover (Magnuson, 215).

In *Revlon v. MacAndrews*, the Delaware court held that the duties of the target board once the sale of a company is inevitable is to maximize the value for shareholders by obtaining the highest price for their shares (Magnuson, 215). It revised the *Unocal* test so that the reasonableness of a takeover defense was to be assessed in terms of the shareholders' interest rather than the risk that the company would change hands (Rosenzweig, 230). In *Paramount v. Time*, the court held that certain defenses are justified if nonmonetary factors, such as lack of information available to shareholders or the timing of the offers, are considered by the board of directors (Magnuson, 215). In *Unitrin v. American General*, the Supreme Court of Delaware allowed the use of takeover defenses as long as they are not considered "draconian" (Magnuson, 216).

Arguments against Takeover Defenses

Those who argue against the use of takeover defenses favor an open market for corporate control. The market for corporate control is defined as hostile takeover activity where, by offering the shareholders of the target company the highest premium for their shares**,** bidders compete to gain the right to manage the company's assets in order to realize higher value from them than the current managers (Martynova, 2173). In the debate, there are several arguments this side uses to justify keeping this market free from takeover defenses. These arguments include that takeovers have many positive effects such as forcing the managers of the company to focus on their duty to shareholders, the gains to shareholders of the target company resulting from the tender offer, and the productivity gains resulting from takeovers. They also point to the negative effects that result from the adoption of takeover defenses as further evidence that an open market for corporate control is preferable.

Gains to Target Shareholders

One of the main arguments against the use of takeover defenses is that they make takeovers less likely, which deprives shareholders of the opportunities a takeover attempt presents. These opportunities include gains to shareholders which result from the premiums which are offered for their shares as well as increases in the stock price before the takeover occurs.

It is argued that takeovers and buyouts are good for shareholders because they result in large gains for the shareholders of the target company. Takeovers have been found to have accounted for gains of 30 to 50% in the 1980s (Jarrell). In the event of an actual takeover attempt, the would-be acquirer offers shareholders of the target company a premium for their shares (Kesten, 1613). Since the bidder is offering a higher price for the target shareholders than they would receive in the market, this results in large gains to shareholders. Michael Jensen points to an SEC estimate that from 1981 to 1985 tender offers accounted for a $40 billion gain for shareholders (Jensen, 426). More specifically, according to Jensen, when Chevron acquired Gulf in 1989 it resulted in a gain of $6 billion for the shareholders of the target company (Jensen, 428). He also found that from 1976 to 1990, tender offers, mergers, divestitures and leveraged buyouts resulted in the creation of $650 billion in value for target shareholders (Jarrell). These large gains resulting from the tender offer, which allows shareholders to sell their shares at a premium over the market price, support the argument that takeovers have a positive effect, especially from the perspective of the shareholders.

A takeover can produce gains for target shareholders even before such an event takes place. The share price can increase significantly even before an official announcement of a takeover bid, and this increase in the run-up to the announcement can even exceed the increase in price after it is officially announced (Martynova, 2153). When such price increases occur with the announcement of a takeover, the shareholders are able to sell their shares at a much higher price than they could if there is no takeover attempt. This results in gains to shareholders even before a tender offer occurs. The increase in price in anticipation of a takeover also suggests that the markets view takeovers to be events which will have a positive effect on shareholders. Takeovers can also produce better information about the target company, which makes the markets more efficient, benefitting shareholders in general (Magnuson, 210).

Since takeovers are argued to offer gains to shareholders, then defenses adopted by the board against takeovers would be seen as being against the interests of the target company's shareholders. Attempts to defeat a takeover cause shareholders to miss out on an opportunity to gain from selling their shares to a bidder who offers them a premium over the current market share price of the target company (Pearce, 15). In contrast to the gains to shareholders resulting from a tender offer, it has been noted that some shareholders have experienced losses following a thwarted takeover (Pearce, 16). One possible explanation for these losses is that if the managers of the target company are able to suppress the threat of being taken over, they have less risk of being dismissed from their managerial positions. With this added job security, they have fewer motives to enhance the profitability of the company or to maximize shareholder value.

Focusing Managers on Shareholders' Interests

Another argument is that having an open market for corporate control means that managers have an increased incentive to maximize gains to shareholders and run the company in the most productive way. Takeovers are viewed as a method of corporate governance that disciplines the managers of a company so that they will focus on maximizing shareholder value, lest they should become a target for a hostile bid and removed from the company by the acquirer (Martynova, 2172-2173).

The benefit of an open market for corporate control is that the threat of a hostile takeover provides incentive for managers of potential target companies to maximize shareholder value (Kesten, 1613). If the company is not run at its full potential, this threat is enough to spur the management of a company to restructure or reorganize the firm to enhance its performance (Jensen, 428). If a company fails to do so, then it will continue on its current path and shareholder value will not be maximized. This will result in an acquirer, believing that it has the ability to operate the company better, making a bid for the target's shares in a takeover attempt. According to Rita Ricardo-Campbell, a former director of Gillette, just the threat of being taken over was enough to prompt the company to make operational changes by restructuring itself and using its resources more efficiently (Ricardo-Campbell, 121). The threat of a takeover from a managerial standpoint is that the acquirer will remove and replace the incumbent managers of the underperforming target company. In order to avoid this fate, managers in an open market for corporate control have an immense incentive to maximize shareholder value by running the company at its fullest potential. An open takeover market creates a large threat of managers being disciplined for poor performance. The high turnover of management following takeovers is evidence that takeovers play a disciplinary role (Pearce, 17). Therefore, it follows that takeover defenses which entrench managers in their current jobs, taking that pressure off of them, would allow the company to continue to underperform under the incumbent managers without the risk of their dismissal, thus diminishing shareholder wealth. This is evidenced in studies by Gompers, Ishii, and Metriak (2003) as well as by Bebchuk, Cohen, and Farrell (2009) that found a relationship between management entrenchment and negative stock returns (Kesten, 1609).

The motives of management can thus come under question when takeover defenses are used. Since takeovers lead to the dismissal of incumbent managers, it may appear that they are attempting to insure their own job security at the expense of shareholders if they try to use defensive provisions in order to prevent a takeover. The use of defensive measures can result from a conflict of interest between the managers, who may be trying to protect their jobs, and the target shareholders who may find a takeover desirable (Magnuson, 210). Target board members may act in conflict with shareholder interests to defend against a takeover which would lead to their being dismissed or losing their rights in the company (Veljković, 87). This can result in a situation where the motives of the incumbent managers are in direct opposition to the interests of the target shareholders, since takeovers have been found to directly benefit the shareholders through stock price gains and shares tendered at a premium. In addition to job security, power and reputation are also factors outside the shareholders' interests which can affect management decisions regarding takeovers (Veljkovic, 88). Since takeovers are argued to focus managers of a company on making gains for shareholders, instead of these self-serving motives, it follows that provisions which make takeovers less likely to occur would increase the ability of managers to forsake maximizing shareholder value without the threat to their job security.

In addition to holding incumbent managers accountable for the interests of the shareholders, it is also argued that the debt that is created in a takeover attempt is also beneficial. Debt that is created in order to fund a takeover by an acquiring firm or a corporate raider creates a threat of bankruptcy once the takeover has been completed (Jensen, 428). The acquired company needs to be productive enough to produce the cash flows required for the acquirer to be able to pay off the debt that was created in order to purchase shares at a premium over their market price. This motivates significant changes in the purchased company's strategy and its structure by the acquirer, including drastic cuts where needed, in order to make the company more productive so as to produce the needed cash flows to cover the debt (Jensen, 428). The end result should be that the company becomes more productive after making the necessary changes, resulting in gains to shareholders. A study by Maksimovic, Phillips and Yang (2010) examined the performance of both public and private firms in terms of gains in productivity, finding that on average, plants that had been acquired improved more than plants that were not (Maksimovic, 24). If the acquisition occurred during a takeover wave, the productivity gains were better than in non-wave years (an overall 1.8% increase in productivity one year after the acquisition with an additional 3.8% increase if it occurred during a takeover wave) (Maksimovic, 24). Since the productivity gains were positive, this provides support for the argument that takeovers result in enhanced profitability for target companies which should increase the shareholders' value.

Detrimental Effects of Defenses

In addition to the missed opportunities for shareholders and the decrease in managerial accountability which takeover defenses allow, the defenses themselves are also argued to adversely affect target shareholders by actually decreasing the stock price of the target company. A number of studies have shown that takeover defenses decrease shareholder value.

There have been many studies done on the effects of the adoption of specific takeover defenses which have found that takeover defenses have negative effects on stock price. A study by Ryngaert and Jarrell (1986) found that the use of poison pill defenses caused the stock price to decrease 1.7% at their announcement (Mallette, 144). Since the stock price decreases when the announcement of a poison pill defense is made, this suggests that the markets anticipate that the poison pill will be detrimental to the shareholders of the company. Jarrell and Paulson (1987) found that fair price amendments, which specify the required offering price and procedures which must occur in order for a takeover to take place, caused negative abnormal returns of 3% (Mallette, 144). A study by Bradley and Wakeman (1983) also found that greenmail, where a target company buys back the shares of a hostile bidder at a premium, caused an initial decrease in the stock price (Pearce, 21). Another defense tactic is the staggered board which forces a hostile bidder to wait at least one year before being able to replace the board of directors of the target company (Bebchuk, 887). In a study by Bebchuk, Coates, and Subramanian (2002), they estimate that from 1996 to 2000, effective staggered boards reduced the returns of target shareholders by 8 to 10%, while increasing the odds that the company remained independent after the hostile bid (Bebchuk, 887). Corporate charter amendments, also known as "shark repellents," have been reported in several studies to have caused a loss of shareholder wealth of 3% on average (Pearce, 19). In the case of a standstill agreement, where an agreement is reached between the target company and a pursuer whereby the pursuer receives a fee from the target in return for agreeing not to acquire any more of the target's stock, a study by Gaughan (1996) found a resulting decline in stock value that negates the increase in price that occurs when a takeover bid is announced (Pearce, 21).

These studies evaluating the effects of specific takeover defenses, showing that they result in negative shareholder returns, have starkly different results compared to the previously mentioned studies showing that takeovers cause increases in shareholder wealth. When viewed in light of each other these studies substantiate the claim that takeovers are a good thing, and that anything that inhibits the market for corporate control comes at the expense of the shareholders. Shareholders gain from an open market for corporate control and the resulting disciplinary threat of takeover which focuses managers on maximizing shareholder value.

Arguments in Favor of Takeover Defenses

On the other side of the debate, there are many who argue that takeover defenses are actually beneficial to shareholders and that takeovers are not necessarily in their best interest. Arguments on this side of the debate include that takeover defenses result in higher premiums for shares as well as increases in stock price. It is also argued that it is the managers of a target company who can best determine whether or not defenses should be used against a hostile bidder. Additionally, it is argued that an open market for corporate control creates a hazardous incentive for managers to focus on short-term gains, while defenses allow the managers to remain focused on the long-term goals of the target company.

Higher Premiums for Shares and Stock Price Increases

One argument for using takeover defenses is that their use cause the premiums offered to shareholders to increase. Under the "bargaining power hypothesis" a company with defenses against a hostile bid will be able to negotiate a higher price than if a company has no such defenses (Subramanian, 85). If the target company's managers are without the ability to defend against a takeover, then shareholders are forced to take the premium offered or else risk having to accept a lower price later. Positive wealth effects for shareholders from takeover defenses have been found to range from 9 to 14% (Pearce, 23).

A number of studies have found that takeover defenses cause increases in premiums offered to shareholders by the bidder. A study by Jackson and Miyajima (2007) found that U.S. companies received larger premiums for mergers and acquisitions than British companies with these premiums being around 6% larger on average (Rosenzweig, 235). This could be partly because U.S. takeover regulation generally allows more freedom for managers to use takeover defenses and this forces negotiation between the bidders and target companies, leading to higher premiums being offered to shareholders (Rosenzweig, 235). Research done by J.P. Morgan found that companies with poison pills received an average 4% over the premium offered for shares for companies without such defense provision (Pearce, 18). According to a study by Jarrell (1985), litigation in response to a hostile bidder causes an initial stock price decrease of 0.45% at its announcement, but on average results in a 17% premium over the original bid (Pearce, 20).

The results of these studies suggest that takeover defenses cause gains to the target company's shareholders by forcing the bidder to increase the premium offered to them. This supports the argument that defenses can be used by managers as a negotiating tool. They can also buy time for a target company, allowing the managers to not only negotiate with the hostile bidder, but also find more favorable alternative buyers for the company (Ricardo-Campbell, 87). Higher premiums resulting from management negotiations mean that shareholders would actually make larger gains on their shares than if the market for corporate control was free of takeover defenses. This provides evidence that takeover defenses are beneficial to both shareholders and incumbent management because they increase shareholder wealth while at the same time they protect the managers of the company from a hostile bidder who plans on replacing them (Pearce, 23). Golden parachutes, agreements that guarantee managers are paid a certain sum of money if they lose their jobs, can also align the interests of managers and shareholders because if managers are paid well in the event they are fired, they will be less likely to resist a hostile takeover which may be in the shareholders' favor (Hanly, 899-900). If this is the case, this would mean that managers, by using defenses, are actually working in accord with the shareholders' interests.

In addition to increasing the premiums paid to shareholders through negotiation, other studies have found that certain takeover defenses cause increases in the target company's stock price. Mikkelson (1991) found that when a hostile attack was fought off by greenmail it resulted in a 7% increase in the stock price (Pearce, 21). Studies by Masulis (1980), Dann (1981), and Vermaelen (1981) found that abnormal stock price increases occur when a share repurchase, where the target company issues debt to buy back shares from its stockholders, is announced (Sinha, 233-234). Also, a study by proxy lawyers from Georgeson & Company found that companies with poison pills outperformed companies without such provisions (Ricardo-Campbell, 87).

One explanation for these increases in stock performance is that there is an expectation that the use of defenses by managers to block a takeover may lead to increases in the premium offered to shareholders resulting from negotiation. In addition, takeover defenses have been argued to create more information in the marketplace about the companies involved as there may have been imperfect information which caused a target company's stock to be undervalued. It is argued that the current stock price of a company may not accurately reflect the true value of the target company because of variances in investor expectations (Ricardo-Campbell, 18). An increase in knowledge about a company would cause an adjustment in stock price toward this "true value." The process of fending off a takeover attempt can have the effect of creating more knowledge about strengths of the target company, which can cause stock price increases (Pearce, 15).

Managerial Decision-Making

Another argument for allowing the managers of a company the discretion to decide whether or not to adopt defenses against takeovers is that they are best qualified to determine what is best for the company. It is argued that the reason that executives become directors is because of their abilities and therefore they can best assess the value of a takeover bid and decide whether to allow it to proceed or to instead deploy a takeover defense (Kamori). Having the sole discretion to make this decision would then benefit the shareholders in the long run. Ralph Saul argues that institutional investors are the major participants in many takeover attempts, and they do not have the company's long-term interests in mind as they are merely looking to enhance the value of their portfolios (Saul, 20). Instead, it is the managers of the company who act in the best interest of the company's long-term strategy rather than focusing on short-term gains.

One issue raised by those who favor the use of takeover defenses over an open market for corporate control is that the fast pace of events surrounding a takeover does not leave much time for participants, including bidders and target shareholders, to make the best decisions that involve a large amount of money (Saul, 22). The use of takeover defenses, such as the staggered board or litigation, can slow down the takeover process, allowing managers and shareholders more time to consider whether the takeover is in their best interest. As previously noted, this can allow time for the target company's managers to seek out other bidders and negotiate a higher price. One of the risks associated with takeovers is that while majority shareholders have an opportunity to sell their shares at a premium to a bidder, minority shareholders may not get this opportunity and instead have their shares bought out at a lower price after the bidder has already acquired majority shares (Magnuson, 211). This can occur in a "squeeze out" or "freeze out," takeovers with a two-tiered tender offer where the acquirer offers a certain price to majority shareholders, then, after the required shares are purchased, buys the rest of the shares from the minority at a lower price (Magnuson, 211). This puts pressure on shareholders to sell their shares even if the price offered is lower than they value them in order to keep from missing out on the opportunity and receiving an even lower price for their shares (Magnuson, 206). Allowing the managers the ability to slow down the takeover through the use of defenses can instead result in the negotiation of a more favorable takeover for shareholders.

Since managers know the most about the company, having takeover defenses which protect their positions in the company may be beneficial as well. If managers have a high threat of being replaced the company may suffer from "demoralization costs" which could reduce efficiency in the company (Kesten, 1624). In addition, takeovers may distract managers, causing them to focus on competing for control of the company instead of running the company (Ricardo-Campbell, 121). Kesten (2010) found that during the years 2007 and 2008, companies with above-average levels of management entrenchment actually outperformed firms with below-average levels of entrenchment, consistent with the theory that the effects of the market for corporate control is subject to variations in the economic climate (Kesten, 1651). This suggests that management entrenchment can actually have positive effects on the performance of companies.

On the other hand, for those who favor the allowance of takeover defenses but view managerial entrenchment as a negative, studies have indicated that the use of certain defensive measures do not actually protect managers from losing their jobs. Bates, Becher, and Lemmon (2008) concluded that management is no more entrenched when staggered boards are used, as they found target companies were acquired at an equivalent rate whether their boards of directors were staggered or not (Bates, 675). Ryngaert (1988) also found regarding the effect of poison pills that his research did not support the "management entrenchment hypothesis" (Ricardo-Campbell, 86). These studies suggest that just because a company uses takeover defenses does not mean managers are immune from the disciplinary effects of takeovers. Managers still have to act in the best interest of the shareholders as the threat of removal resulting from a takeover still exists.

Overall, these arguments support the suggestion that managers should be given the authority to make decisions that have large implications for the company, including whether or not to adopt takeover defenses. If takeover defense provisions do in fact entrench managers, which some evidence has shown not to be the case, then assuming that the managers know what is best for the company, the shareholders will be better off. Giving managers the discretion to decide whether or not a takeover takes place allows them the freedom to focus their attention on pursuing strategies which will benefit the company in the long run.

Short-Term versus Long-Term Interests

Another argument for the use of takeover defenses is that while takeovers may generate short-term gains, they may not be in the best interest of the target company in the long run. Under the theory of market myopia, investors place more value of short-term gains while undervaluing the long-term profitability of a company (Magnuson, 209). This implies that in an open market for corporate control more emphasis is placed on immediate gains for the target's shareholders, than on how well the company is preparing itself for long-term growth.

If a company becomes the target of a takeover bid, the managers may lose their ability to focus on its long-term goals. While takeovers can result in short-term stock price increases, this can come at the cost of the company's long-term growth plans, which can cause a price decline in the long run (Pearce, 15). A study by Ravenscraft and Scherer (1987) found that from 1974 to 1977, takeovers created an average loss to manufacturing output of $3 billion (Ricardo-Campbell, 98). According to Martynova and Renneboog, in the long run, takeovers generally lead to declines in share price, which could reflect the market correcting its overestimated predictions of the efficiency of the capital market, implying that takeovers can actually destroy value (Martynova, 2164). Therefore, while takeovers can initially cause stock price increases, they may not be best for the company, as the focus on short-term gains comes at the expense of long-term plans which can lead to a decline in firm performance in the future.

While thwarting a takeover through defenses may have the negative short-term effect of decreased share price, the long-term effects of being able to defend against a takeover can be desirable. According to Ricardo-Campbell, after fending off a tender offer, Gillette and its shareholders lost millions of dollars in the short run, but afterwards, as the company sold off its unprofitable business lines, it was able to recover with profits rising by $250 million a year after the thwarted tender offer (Ricardo-Campbell, 122). A study by Jiraporn (2005) found that the poison pill reduces the unethical practice of earnings management by a company's managers by an average of 1.9% while staggered boards were shown to reduce earnings management by 1.5% (Jiraporn, 293). According to Jiraporn, this is consistent with the hypothesis that the job security for managers resulting from the company's takeover defenses causes managers to focus more on long-term goals since managers who are entrenched will eventually have to deal with the consequences of manipulating the company's numbers through earnings management (Jiraporn, 301). If takeover defenses cause managers to become more entrenched, as it has been argued, then according to Jiraporn's study, the resulting long run effects would be desirable. The enhanced job security deters managers from engaging in short-sighted and sometimes unethical practices such as earnings management. Instead, managers can expect to stay with the company longer and therefore are likely to focus more on the company's long-term health.

Giving managers the discretion to decide if a takeover defense will be used can have many positive effects. Managers are able to use takeover defenses as an instrument to negotiate higher premiums offered by bidders which results in higher gains to shareholders. If one considers managers to be the most qualified people to make big decisions for the company, then it follows that they should be able to stop a takeover which they believe goes against the best interests of the company and its shareholders. Having the authority to adopt defenses against a takeover can allow managers to make decisions which will benefit the company in the long run.

Policy Implications

Implications of the Arguments in Favor of Takeover Defenses

States play a rather large role in takeover regulation. These regulations seem to favor the incumbent managers by allowing them the authority to decide whether or not a takeover will be fought off through the use of defenses. Given this, it seems likely that those who favor management discretion in the adoption of takeover defenses would be content with the current structure of takeover law, in which states such as Delaware play such a large role.

Nevertheless, there have been calls for policy changes from those who favor management discretion to adopt takeover defenses. These policy changes seek to enhance the ability of a target company to defend itself against takeovers. Ralph Saul, who views the open market for corporate control as creating a “feverish atmosphere,” recommended that the SEC create rules to give corporate boards more time to deliberate and shareholders more time to consider the tender offer (Saul, 22). Rules which give the managers more time could allow them to negotiate a higher premium offered to shareholders or to find an alternative bidder for the company.

Martin Lipton, a corporate lawyer, proposed a legislative ban on two-tiered tender offers by hostile bidders (Saul, 22). As noted previously, two-tiered bids put pressure on shareholders to sell their shares for fear that they may lose out and be forced to accept a lower price for their shares later on. In Britain, the Takeover Code requires that an acquirer offer to buy all of the target shareholders’ stock at the same premium, rather than offering it only to majority shareholders and buying the remaining shares at a lower price once control of the company is established (Rosenzweig, 224). A rule like this would take away the option of the two-tiered offer from the bidder, taking away the pressure on shareholders to sell their shares against their best interest as well as making takeovers more expensive.

The Business Roundtable proposed a rule requiring the board of directors to either approve or disapprove of a tender offer once a bidder acquires a certain number of shares, after which, in the case of disapproval by the board, the shareholders would then get the opportunity to voice their opinion through a proxy vote (Saul, 24). According to Saul, this would create a more orderly takeover process which would ensure a more fair treatment of shareholders as well as focus the target company's managers on the interests of shareholders (Saul, 24). This proposal would also slow down the takeover process, allowing both the managers and the shareholders to carefully consider their options before deciding whether or not to proceed with the takeover.

These proposed regulatory changes serve to increase the positive effects that takeover defenses are argued to have. Slowing down the takeover process through regulation would allow managers the opportunity to negotiate a more favorable takeover for their shareholders. Also, making takeovers more difficult and more expensive by taking away options such as the two-tiered offer would allow managers the opportunity to more carefully consider whether a takeover is in the best interest of the company's long-term strategy.

Implications of the Arguments against Takeover Defenses

On the other hand, there has been a recent trend of decreasing use of common takeover defenses such as the poison pill and staggered board. The percentage of S&P 1500 companies with poison pills fell from 62.5% in 2002 to 44.8% in 2009 while the percentage of those companies with staggered boards fell from 61.6% to 23% (Gallardo). This is the result of pressure put on corporations by activist investors and corporate governance groups (Gallardo). With the success of these groups in forcing companies to drop these defenses, thus encouraging a more open market for corporate control, it seems likely that regulatory changes in regard to the takeover market would have support as the current structure allows incumbent managers to adopt defenses as long as they are not considered “draconian.”

One such change may be to increase the authority of the SEC in order to preempt state regulation of takeovers (Bandow, 49). For those who believe that an open market for corporate control is most beneficial for shareholders, this would be favorable as the original intent of federal regulation of takeovers under the Williams Act was to be neutral between the interests of the hostile bidders and the incumbent managers. Paul Mallette and Robert Spagnola, have gone further in suggesting that corporations be chartered under the federal government instead of by the states (Mallette, 156). Since corporations generally operate outside of state boundaries, they believe that a national charter would be more appropriate (Mallette, 156). Currently, according to Mallette and Spagnola, a corporation can threaten to leave a state if another state better accommodates its preference for takeover defenses (Mallette, 156). This creates a situation where states have an incentive to allow incumbent managers of a corporation the right to use takeover defenses, even if it opposes shareholder interests, in order to keep the company from fleeing. The federal chartering proposal would remove the states from the role of corporate regulation, resulting in one standard that all U.S. companies would have to follow, rather than having differing rules depending on what states the companies are incorporated in.

Another option could be to move to a new regulatory system altogether, one that sets out specific principles for takeover participants to follow rather than precedents set by state courts. This has been recommended by Ben Bernanke, the Chairman of the Federal Reserve

(Rosenzweig, 237). One such regulatory scheme is used in Great Britain, where takeover law is handled by a self-regulatory body. The City Code on Takeovers and Mergers is comprised of ten General Principles and twenty-five rules which are interpreted and enforced by the Takeover Panel, whose members are appointed by members of the financial industry (Rosenzweig, 215). This could serve as a model for a future regulatory structure in the U.S. if there is movement away from allowing states such as Delaware to regulate takeovers and toward giving the SEC the ultimate authority to govern the takeover process through rulemaking.

Michael Jensen argues that the disclosure requirement of ten days for 5% of the company's stock diminishes the gains to the bidder which has the effect of discouraging takeovers (Jensen, 429). He proposes that the disclosure requirements under rule 13(d) either be abolished completely, or the percentage of stock that must be purchased in order to trigger the disclosure requirement be increased (Jensen, 429). Getting rid of the disclosure requirements or increasing the triggering threshold for disclosure would take away the advance notice of a takeover attempt which bidders must give incumbent managers under the rule. This would give the managers less time to prepare for a hostile takeover by adopting quick defenses, thus making a takeover easier to complete. It has also been suggested that relaxing the disclosure requirements would make takeovers less expensive (Bandow, 49).

There are other rules that have been adopted by Great Britain and the European Union which would likely gain favor by proponents of an open market for corporate control. In Great Britain, for example, under the City Code on Takeovers target companies must obtain shareholder approval before adopting defenses against a takeover attempt (Rosenzweig, 223). In the European Union, there are similar provisions in place. Under the European Takeover Directive there is a board neutrality rule which, once a tender offer is made, prevents the board of directors of the target company from adopting a poison pill or other defenses against the bid except for seeking an alternative bidder for the company (Magnuson, 221). If the shareholders vote in approval of the use of defenses, however, the board no longer has to remain neutral and can fend off the bid (Magnuson, 221). Another rule under the Takeover Directive is the breakthrough rule which requires that corporations adhere to a "one share-one vote" policy when a takeover is attempted, making restricting voting rights to any shareholder, including the bidder, unlawful (Magnuson, 221-222). These rules, if adopted by the U.S., would serve to prevent incumbent managers from attempting to fend off a takeover if the target company's shareholders perceive the takeover to be in their best interest. This would effectively eradicate the conflict of interest which is argued to arise when incumbent managers have the sole discretion to adopt defenses against a takeover in order to protect their jobs.

These regulatory changes proposed by those who argue against the use of takeover defenses aim to make takeovers easier to accomplish. Reducing the disclosure requirements for bidders would give incumbent mangers less opportunity to block a hostile tender offer. Allowing the SEC to preempt state regulation or adopting a principles-based regulatory structure would serve to make the rules fairer for hostile bidders and target shareholders than under the current regulatory scheme, where the states have generally given incumbent managers the discretion to decide whether or not to implement takeover defenses. Adopting rules which require that the shareholders approve of a takeover defense measure would serve to prevent incumbent managers from going against the wishes of shareholders and acting in their own self-interest to protect their jobs. The desired result of these proposals is to allow for a more open takeover market so that the managers of underperforming companies are disciplined for failing to maximize shareholder value, while shareholders realize wealth gains from selling their shares at a premium to the bidders.

Conclusion

Generally, there are two opposing sides in the debate over the allowance of corporate takeover defenses. While both sides aim to maximize shareholder value, they disagree significantly on how the shareholders' interests are best served, whether by allowing the managers of a company the discretion to adopt defensive measures against a takeover or by preventing them from taking such action.

Those who are opposed to the use of takeover defenses view them as inhibiting the market for corporate control. They argue that an open takeover market allows bidders to seek underperforming companies and buy the stockholders' shares at a premium through a tender offer in order to gain control of the company and make positive operational changes. Such activity is argued to have a disciplinary effect as incumbent managers, wishing to avoid the fate of dismissal resulting from the company changing hands, would be motivated to improve the company's performance and maximize shareholder wealth. In this view, giving the incumbent managers the discretion to block a takeover would lead to their being entrenched in the company and this added job security would result in a loss of focus on the shareholders' interests. Furthermore, these takeover defenses are argued to have a negative effect on shareholder wealth, in contrast to the gains they would have realized in an open takeover market.

While those who oppose the use of takeover defenses argue that shareholders' interests are best served in an open market for corporate control, those who favor the use of takeover defenses disagree. They argue that having the ability to fend off a takeover attempt gives the managers of the target company the bargaining power to force the bidder to increase the premium offered to the shareholders. The managers are viewed as being most qualified to decide whether or not a takeover is in the company's best interest. It is also argued that without defenses, incumbent managers will shift their focus on short-term activities to avoid becoming a target in a takeover attempt. This may come at the expense of the company's long-term strategy, diminishing its performance in the future.

As these viewpoints have stark contrasts, they result in differing policy implications. Currently, influential states such as Delaware have the authority to regulate takeovers. Through a number of seminal state court cases, they have allowed managers to adopt defenses in response to a takeover threat as long as they are deemed to be reasonable. Those who support the use of takeover defenses likely favor this system and some have even proposed introducing federal legislation to further protect managers' ability to fend off takeover attempts. On the other hand, those who oppose the use of these defenses would prefer to see regulatory change which could come in the form of unifying takeover regulation under the federal government and by instituting new rules limiting the authority of managers by allowing shareholders the ability to decide whether or not a takeover is defended against. Takeover regulation may move in this direction if the recent reduction of defensive provisions is an indication that the side of the debate opposing takeover defenses is gaining influence.

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